Statutory Issue Paper No. 5

Definition of Liabilities, Loss Contingencies and Impairments of Assets

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Common Area

SUMMARY OF ISSUE

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

SUMMARY CONCLUSION

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

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

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

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

Loss Contingencies or Impairments of Assets

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

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

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

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

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

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

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

b. The amount of loss can be reasonably estimated.

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

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

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

Disclosure

10. If a loss contingency or impairment of an asset is not recorded because only one of the conditions 6 a. or 6 b. is met, or if exposure to a loss exists in excess of the amount accrued pursuant to the provisions described above, disclosure of the loss contingency or impairment of the asset shall be made in the notes to the financial statements when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

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

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

DISCUSSION

13. The Conclusion above adopts certain principles in *FASB Statement No. 5*, *Accounting for Contingencies* (FAS 5), *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan* (FAS 114) – only as it amends in part FAS 5, and paragraphs 35 and 36 of *FASB Statement of Concepts No. 6—Elements of Financial Statements. FASB Interpretation No. 14, Reasonable Estimation of Amounts of a Loss*, *An Interpretation of FASB Statement No.* 5 is adopted with the modification to accrue the loss amount as the midpoint of the range rather than the minimum. This issue paper also adopts *FASB Interpretation No. 34*, *Disclosure of Indirect Guarantees of Indebtedness of Others, An interpretation of FASB Statement No. 5,*and *Accounting Principles Board Opinion No. 12, Omnibus Opinion—1967, paragraphs 2 and 3.*

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

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

16. Paragraph 9 provides guidance on recording an estimate which lies within an estimated range. It is anticipated that using the midpoint in a range will be applicable only in the rare instance where there is a continuous range of possible values, and no amount within that range is any more probable than any other. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine their best estimate of the liability.

17. Disclosure of the nature of accruals made in applying the above statutory accounting principle and in some circumstances the amount accrued may be necessary for the fair presentation of the statutory financial statements.

Drafting Notes/Comments

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

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

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

Generally Accepted Accounting Principles

19. Relevant sections of GAAP literature follow:

FASB Statement of Concepts No. 6, Elements of Financial Statements

35. Liabilities are probable[21] future sacrifices of economic benefits arising from obligations[22] of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

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

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

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

FASB Statement No. 5, Loss Contingencies

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

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

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

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

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

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

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

Accrual of Loss Contingencies

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

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

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

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

   b) The amount of loss can be reasonably estimated.

Disclosure of Loss Contingencies

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

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

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[5] Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57-64 of Accounting Terminology Bulletin No. 1, "Review and Resume").

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

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

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

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[1] Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount.

RELEVANT LITERATURE

Statutory Accounting Practices and Procedures

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

Generally Accepted Accounting Principles

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

State Regulations

- Oregon Insurance Statutes, Title 56, Chapter 733, *Accounting and Investments*

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