

# **Statutory Issue Paper No. 25**

## **Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties**

### **STATUS**

**Finalized June 23, 1998**

**Original SSAP and Current Authoritative Guidance: SSAP No. 25**

### **Type of Issue:**

**Common Area**

### **SUMMARY OF ISSUE**

1. Transactions with affiliates and other related parties are entered into in the ordinary course of business by reporting entities. Transactions may involve an exchange of assets and liabilities between the related parties or the performance of services. Such transactions may not necessarily be on an arm's length basis. Current statutory literature provides guidance on accounting for certain transactions between affiliates, which is based on whether the transactions are considered economic or non-economic transactions. It also requires reporting entities to disclose transactions with affiliates in the notes to the financial statements.

2. GAAP provides limited guidance on accounting for related party transactions, and there is no discussion regarding accounting for economic versus non-economic transactions with related parties. Rather, existing GAAP guidance focuses on disclosure of related party transactions with specific GAAP literature dealing with related party issues where there is a perceived potential for abusive accounting practices (e.g. sale lease-back transactions, equity accounting, nonmonetary transactions, etc.).

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

### **SUMMARY CONCLUSION**

4. Related parties are defined as entities that have common interests as a result of ownership, control, or affiliation or by contract. Related parties shall include but are not limited to the following:

- a. Affiliates of the reporting entity, as defined in paragraph 5;
- b. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;
- c. The principal owners of the reporting entity;
- d. The management of the reporting entity, its parent or affiliates (including directors);
- e. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;
- f. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other

to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;

- g. A party which can directly or indirectly significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;
- h. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;
- i. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and
- j. A U.S. manager of a U.S. Branch or any affiliate of the U.S. manager of a U.S. Branch.

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and partnerships, joint ventures and limited liability companies. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person or entity, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship, (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in a company and a second member of the group has an 8% interest in the same company the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

8. Related party transactions are subject to abuses because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny.

### **Related Party Loans**

9. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner's independent payment ability. An affiliate's ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e. determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the

balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

10. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm's-length transactions as defined in paragraph 13. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 13 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with Issue Paper No. 5 it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

11. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month's payment shall be nonadmitted assets.

12. Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 9. Indirect loans made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans and advances to related parties as described in paragraphs 10 and 11.

### **Transactions Involving the Exchange of Assets or Liabilities**

13. An arm's length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction shall be defined as an arm's length transaction which results in the transfer of risks and rewards of ownership and represents a consummated act thereof, i.e. "permanence." The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed in the case of the original transaction. Subsequent events are addressed in *Issue Paper No. 9—Subsequent Events*. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance of the transaction and not the form of the transaction.

14. In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

- a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

- b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;
- c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;
- d. Whether limitations or restrictions exist on the buyer's use of the financial interest transferred or on the profits arising from it;
- e. Whether there is retention of effective control of the financial interest by the seller.

15. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at market value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting and therefore the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (market value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

16. A non-economic transaction shall be defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 15, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

17. When accounting for a specific transaction reporting entities shall use the following valuation methods:

- a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 15);
- b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;
- c. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified;
- d. Transactions which are designed to avoid statutory accounting practices shall be included as if the reporting entity continued to own the assets or be obligated for a liability directly instead of through a subsidiary.

Examples of transactions that would be deemed to be non-economic include, security swaps of similar issues between or among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities between or among affiliates.

### Transactions Involving Services

18. Transactions involving services being provided by a related party may not be arm's-length. Amounts charged for services provided may not be at current market rates for such services or may be based on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party's books and expense on the second party's books and therefore do not lend themselves to the mere inflation of surplus. These arrangements may be subject to regulatory approval.

19. Transactions involving services provided between related parties shall be recorded at the amount charged. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, (d) or other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See *Issue Paper No. 94—Allocation of Expenses* for additional discussion regarding the allocation of expenses.

### Disclosure

20. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm's length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

- a. The nature of the relationships involved;
- b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, and any non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:
  1. Date of transaction,
  2. Explanation of transaction,
  3. Name of reporting entity,
  4. Name of affiliate,
  5. Description of assets received by reporting entity,
  6. Statement value of assets received by reporting entity,
  7. Description of assets transferred by reporting entity, and
  8. Statement value of assets transferred by reporting entity.
- c. The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;
- d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;

- e. Any guarantees or undertakings, written or otherwise, for the benefit of an affiliate or related party which result in a material contingent exposure of the reporting entity's or any related party's assets or liabilities;
- f. A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity's financial statements;
- g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises.
- h. The amount deducted from the value of an upstream intermediate company or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated company, in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, "Procedures for Valuing Common Stocks and Stock Warrants."

## DISCUSSION

21. This issue paper adopts *FASB Statement No. 57, Related Party Disclosures* (FAS 57) with a modification to paragraph 2, to require disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business. It expands the current statutory guidance on accounting and disclosure of transactions with affiliates to include all material related party transactions whereas current statutory guidance requires disclosures for transactions with affiliates, a more narrowly defined group. This modification was made because the nature of dealings with any related party can not be assumed to be at arm's length. The current statutory guidance with respect to accounting for transfers of assets between affiliates that are considered to be non-economic transactions (generally at lower of cost or market) differs from the GAAP guidance for accounting for transfers and exchanges between companies under common control. Current statutory guidance is considered appropriate because of the need to focus on individual reporting entities and the needs of individual states to monitor the obligations of individual reporting entities. GAAP guidance is established in *Accounting Interpretations of APB Opinion No. 16, #39, Transfers and Exchanges Between Companies Under Common Control* (AIN-APB 16, #39), which requires transfers and exchanges to be at historical cost similar to that in pooling of interests accounting. As a result, this issue paper rejects AIN-APB 16, #39. The complete requirements under current statutory guidance and FAS 57 are included in the Relevant Statutory Accounting and GAAP Guidance section below.

22. This issue paper adopts the current statutory guidance with respect to accounting for transfers of assets between affiliates and further expands that guidance to include all transactions (including transactions which relate to the transfer of liabilities) with related parties. It also replaces the 30 day rule by requiring the reversal of any gain or loss recognized on a transaction that subsequently does not meet the appearance of permanence. This issue paper also requires any net increase in the surplus of a parent reporting entity that results from transactions between affiliates where there is no demonstrable and measurable betterment to the parent company reporting entity other than the mere inflation of surplus to be reported as a deferred gain and shall not be recognized by the parent reporting entity until an arms length transaction with a third party gives rise to the recognition.

23. This issue paper adopts current statutory guidance with modification to recognize loans made to a reporting entity's parent or principal owner as an admitted asset if regulatory approval for the transaction has been obtained and the loan appears to be collectible based on the parent's independent ability to pay. Commissioner approval is considered necessary as an additional independent evaluation of such loans or advances due to the highly sensitive nature of such transactions and the significant potential for abuse. This independent evaluation is considered necessary to determine the admissibility of such loans or advances because a reporting entity could be induced by its parent or principal owner to enter into a loan or advance that it would not otherwise consider. Additionally, advances to providers under capitation arrangements that exceed one month's payment shall be nonadmitted. Loans to all other related parties shall be nonadmitted if they do not meet the criteria of an arm's length transaction. Current statutory accounting requires disclosures to include a description of related party transactions as well as other information necessary to obtain an understanding of the transaction. Subparagraph 20 b amends the exclusion to this requirement from non-insurance transactions which involve less than 1/2% of 1% of the total assets of the largest affiliated reporting entity to non-insurance transactions which involve less than 1/2% of 1% of the total admitted assets of the reporting entity.

24. The accounting and disclosure requirements adopted by the conclusion above are consistent with the Statement of Concepts which states:

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

Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity's short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g. notes to financial statements, management's discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.

25. Additionally, such disclosures provide the statutory financial statement user information necessary in evaluating a reporting entity's statutory financial position and results of operations and in assessing the reporting entity's dependence on such relationships to continue operations.

#### **Drafting Notes/Comments**

- Accounting for investments in subsidiaries is addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*.
- Accounting for business combinations is addressed in *Issue Paper No. 68—Business Combinations and Goodwill*.
- Accounting for holding company obligations are addressed in *Issue Paper No. 95—Holding Company Obligations*.
- Accounting and disclosures for related party reinsurance transactions are addressed in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance* and *Issue Paper No. 75—Property and Casualty Reinsurance*.

### **RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

#### **Statutory Accounting**

26. The NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies (Annual Statement Instructions) provide the following guidance with respect to reporting information on transactions with affiliates in the notes to the financial statements:

5. Information Concerning Parent, Subsidiaries and Affiliates

## Instruction:

- a. If the company is directly or indirectly owned or controlled by any other company, corporation, group of companies, partnership or individual, give full particulars.
  - b. List and describe transactions by the company or any affiliated insurer with any affiliate. Exclude reinsurance transactions, any non-insurance transactions which involve less than  $\frac{1}{2}$  of 1% of the total assets of the largest affiliated insurer, and cost allocation transactions that are based upon generally accepted accounting principles. The following information should be provided:
    1. Date of transaction
    2. Explanation of transaction
    3. Name of insurer
    4. Name of affiliate
    5. Description of assets received by insurer
    6. Statement value of assets received by insurer
    7. Description of assets transferred by insurer
    8. Statement value of assets transferred by insurer
  - c. If the company holds investments in its parent, affiliates, or subsidiaries, disclose the total statement value for each such asset category not included in Schedule D, Summary By Country.
  - d. If the Company owns shares of an upstream intermediate or ultimate parent, either directly or indirectly via a downstream subsidiary, controlled or affiliated company, disclose the amount deducted from the value of such company or companies, in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*.
  - e. Describe any guarantees or undertakings for the benefit of an affiliate which result in a material contingent exposure of the company's or any affiliated insurer's assets to liability, if not disclosed in Note 15. Report the total amount of guarantees for affiliates.
  - f. Describe management or service contracts and all cost-sharing arrangements, other than cost allocation arrangements based upon generally accepted accounting principles, involving the company or any affiliated insurer.
27. The Annual Statement Instructions provide illustrations for the above required disclosures.
28. The Annual Statement Instructions also require the preparation of Schedule Y - Information Concerning Activities of Insurer Members of a Holding Company Group. Part 2 of this schedule—Summary of Insurer's Transactions with Any Affiliates—was designed to provide an overview of transactions among holding company system members. A common schedule is prepared for inclusion in each of the individual annual statements and the consolidated annual statement. The intent of the schedule is to demonstrate the scope and direction of major fund and/or surplus flows throughout the holding company system. The instructions to the schedule provide detailed guidance on a column by column basis. This schedule requires additional disclosures that are not required or are in more detail than the information contained in the notes to the financial statements. The instructions for the schedule include the following guidance:

Include the aggregate transactions, for the reporting period, within each category involving the parent company (companies), all insurance companies in the Holding Company System, and all other companies in the system with which an insurance company member had a transaction. Exclude: transactions of a non-insurer with an insurance company that are of a routine nature (i.e., the purchase of insurance coverage) and cost allocation transactions that are based upon generally accepted principles of accounting.



If the insurer is both a payor and a recipient of amounts in any category, the net of these amounts should be reported on one line. Amounts of transactions that result in an increase in surplus should be shown as positive figures and transactions that result in a decrease in surplus should be reported enclosed in parentheses.

If the nature of the transactions reported in Part 2 require explanation, report such in an explanatory note immediately following Part 2.

29. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies contain guidance substantially consistent with paragraphs 26 to 28 above.

30. The NAIC Annual Statement Instructions for Health Maintenance Organizations contain guidance substantially consistent with paragraphs 26 to 28 above.

31. The Introduction to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies provides the following definition of terms used in connection with transactions with affiliates:

#### “Arm’s-length” Transactions

An “arm’s-length” transaction can be defined as a transaction in which a willing buyer and a willing seller, each being reasonably aware of all relevant facts and neither under compulsion to buy or sell, would be willing to participate.

#### “Affiliate”

An “affiliate” of, or person “affiliated” with a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

#### “Control”

The term “control” (including the terms “controlling by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies, representing 10% or more of the voting securities of any other person.

32. The Introduction to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies provides the following guidance with respect to accounting for assets transferred between affiliates:

#### Accounting for Assets Transferred Between Affiliates

##### Economic vs. Non-economic Gains

An economic transaction is an arm’s-length transaction which results in the transfer of risks and rewards of ownership and represents a consummated act thereof, i.e. “permanence.” Such a transaction must represent a bona fide business purpose demonstrable in measurable terms, such as the creation of a tax benefit, a betterment in cash flow position, etc. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction.

A bona fide business purpose would exist, for example, if an asset was transferred in order to create a specific advantage/benefit. The advantage/benefit must inure to the benefit of the insurance company. A bona fide business purpose would not exist if the transaction was initiated

for the purpose of the inflation (deflation) of a particular company's financial statements including effects on the balance sheet or income statement.

Transfer of risks and rewards of ownership - "determining that the risks and other incidents of ownership have been transferred to the buyer requires an examination of the underlying facts and circumstances. The following circumstances may raise the question about the transfer of risks:

1. A continuing involvement by the seller in the transaction or in the assets transferred, such as through the exercise of managerial authority to a degree usually associated with ownership, perhaps in the form of a remarketing agreement or a commitment to operate the property.
2. Absence of significant financial investment by the buyer in the asset transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer.
3. Repayment of debt that constitutes the principal consideration in the transaction dependent on the generation of sufficient funds from the asset transferred.
4. Limitations or restrictions on the purchaser's use of the asset transferred or on the profits from it.
5. Retention of effective control of the asset by the seller.

The first three items on the list are suggested by the Securities Exchange Commission Staff Accounting Bulletin 30; the last two are found in SEC Accounting Series Release No. 95, "Accounting for Real Estate Transactions where circumstances indicate that profits were not earned at the time the transactions were recorded" .\*

\*(Note: From the Accountants' Handbook, 6th edition, Vol. 1, edited by Lee J. Seidler and D. R. Carmichael)

Security swaps of similar issues between or amongst affiliated companies would be considered as a non-economic transaction. Swaps of dissimilar issues accompanied by exchanges of liabilities between or amongst affiliates are considered non-economic transactions.

The appearance of permanence is also an important criterion in establishing the economic substance of a transaction. If subsequent events or transactions reverse the effect of an earlier transaction, the question is raised as to whether economic substance existed in the case of the original transaction. Basically, in order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed.

It is important to note that in today's environment, where many of the transactions are complex and involve great uncertainty, it will be necessary to exercise professional judgment in the evaluation of whether economic substance exists as it is not possible to establish detailed guidelines sufficient to cover the realm of all possible transactions.

In the case of any gain from transfer of securities or other assets to an affiliate where it appears that, within a period beginning 30 days before the date of such transfer and ending 30 days after such date, the company has acquired by transfer from an affiliate, or has entered into a contract or option to acquire, substantially identical securities or assets, then no gain on the transfer to the affiliate shall be recognized in the Annual Statement.

The following is the exception to the 30-day rule:

1. Swaps of repurchased securities. The agreements must be formalized in writing and provide adequate collateral as defined by either statute or security valuation manual.
2. Gains on transfers which involve real estate will not be recognized if transferred back or repurchased within an 18-month period.

### General Accounting Guidelines

When accounting for a specific transaction, the following valuation methods should be used. If the transaction involves the transfer of assets not covered by the attached [table] then the following general guidelines should be used:

- Economic based transfers between affiliates should be recorded at prevailing fair market values at the date of the transfer.
- Non-economic based transfers between affiliated insurers should be recorded at the lower of existing book values or prevailing fair market values at the date of transfer.
- Non-economic based transfers between an insurer and a non-insurance affiliate should be recorded at the prevailing fair market value at the date of transfer; however, to the extent that the transfer results in a gain, that gain should be deferred until such time as permanence can be verified.
- Transactions which are designed to avoid statutory accounting practices shall be included as if the insurer continued to own the assets directly instead of through a subsidiary. Therefore, the assets of a subsidiary will be valued as they would constitute lawful investments for the insurer if acquired or held by the insurer. (e.g., transaction dealing with agents' balances, furniture and equipment.)
- Assets may be valued on a different basis if held by a life insurer versus a property and casualty insurer; therefore, a regulator must take this into consideration when using the general guidelines.
- In the absence of specific guidelines or where doubt exists as to the propriety of a special accounting method the Insurance Department of the state of domicile should be consulted.

	<u>TRANSACTION</u>	<u>VALUATION METHOD AFFILIATE</u>	
		<u>NON-ECONOMIC TRANSACTION</u>	<u>ECONOMIC TRANSACTION</u>
1.	<u>Transfer of Bonds</u>		
	a. Appreciated	Cost (1)/Amortized	Market
	b. Depreciated	LCM (1)	Market
2.	<u>Transfer of Preferred Stock</u>		
	a. Sinking Fund	Cost (1)	Market
	b. Perpetual Preferred Held by Life Co.	Cost (1)	Market
	c. All others	Market	Market
3.	<u>Transfer of Common Stock</u>	Market	Market
4.	<u>Transfer of Real Estate</u>	Cost	Market

5.	<u>Transfer of Loans or Loan Participations</u>		
	a. Appreciated	Cost	Market
	b. Depreciated	LCM	Market
6.	<u>Intercompany Loans</u>	LCM (2)	Market (2)
7.	<u>Sale/Leaseback</u>	Cost/LCM (3)	Market
8.	<u>Reverse Repurchase Agreements</u>	LCM (2)	Market (2)
9.	<u>Transfer of nonadmitted assets from an insurer to a non-insurer subsidiary</u>	The value of the subsidiary must be adjusted and revalued as if the insurer held the assets.	Market (2)
10.	<u>Transfer of Schedule BA asset</u>	LCM	Market

NOTE: Cost = Book Value

- (1) Assumes securities are in good standing or eligible for amortization, otherwise at market.
- (2) Based on current market interest rates.
- (3) LCM (Lower of Cost or Market) would apply under scenario involving depreciated assets.

33. The Insurance Holding Company System Model Laws, Regulations and Guidelines, which has been adopted by various states, specifies that certain disclosures be made in Form B of an insurer's registration statement (insurers required to file registration statements with the NAIC do so on the format prescribed by the NAIC). Form B instructions are as follows:

#### ITEM 5. TRANSACTIONS AND AGREEMENTS

Briefly describe the following agreements in force, and transactions currently outstanding or which have occurred during the last calendar year between the registrant and its affiliates:

- a. Loans, other investments, or purchases, sales or exchanges of securities of the affiliates by the Registrant or of the Registrant by its affiliates;
- b. Purchases, sales or exchanges of assets;
- c. Transactions not in the ordinary course of business;
- d. Guarantees or undertakings for the benefit of an affiliate which result in an actual contingent exposure of the Registrant's assets to liability, other than insurance contracts entered into in the ordinary course of the registrant's business;
- e. All management agreements, service contracts and all cost-sharing arrangements;
- f. Reinsurance agreements;
- g. Dividends and other distributions to shareholders;
- h. Consolidated tax allocation agreements; and
- i. Any pledge of the registrant's stock and/or of the stock of any subsidiary or controlling affiliate, for a loan made to any member of the insurance holding company system.

No information need be disclosed if such information is not material for purposes of Section 4 of the Act.

Sales, purchases, exchanges, loans or extensions of credit, investments or guarantees involving one-half of 1% or less of the registrant's admitted assets as of the 31st day of December next preceding shall not be deemed material.

Note: Commissioner may by rule, regulation or order provide otherwise.

The description shall be in a manner as to permit the proper evaluation thereof by the Commissioner, and shall include at least the following: the nature and purpose of the transaction, the nature and amounts of any payments or transfers of assets between the parties, the identity of all parties to the transaction, and relationship of the affiliated parties to the registrant.

34. Section 5 of the Insurance Holding Company System Regulatory Act also contains the following guidance:

- (2) The following transactions involving a domestic insurer and any person in its holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into the transaction at least thirty (30) days prior thereto, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period.
  - (a) Sales, purchases, exchanges, loans, extensions of credit, or investments, provided the transactions are equal to or exceed:
    - (i) With respect to nonlife insurers, the lesser of three percent (3%) of the insurer's admitted assets or twenty-five percent (25%) of surplus as regards policyholders as of the 31st day of December next preceding;
    - (ii) With respect to life insurers, three percent (3%) of the insurer's admitted assets as of the 31st day of December next preceding;
  - (b) Loans or extensions of credit to any person who is not an affiliate, where the insurer makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the insurer making the loans or extensions of credit.

35. The NAIC Model Law for HMO Investment Guidelines, contains the following:

Section 3. Excessive Commissions Prohibited—Interest of Officers and Directors.

- (2) No such HMO shall knowingly invest in or loan upon any property, directly or indirectly, whether real or personal, in which any officer or director of such HMO has a financial interest, nor shall any such HMO make a loan of any kind to any officer or director of such HMO, except that this Section shall not apply in circumstances where the financial interest of such officer or director is only nominal, trifling or so remote as not to give rise to a conflict of interest. In any case, the Director may approve a transaction between an HMO and its officers or directors under this Section if he is satisfied that (a) the transaction is entered into in good faith for the advantage and benefit of the company, and (b) the amount of the proposed investment or loan does not violate any other provision of this Article nor exceed the reasonable, normal value of the property or the interest which the HMO proposed to acquire, and that the transaction is otherwise fair and reasonable, and (c) the transaction will not adversely affect, to any substantial degree, the liquidity of the company's investments or its ability thereafter to comply with requirements of this Article or the payment of its claims and obligations.

36. The NAIC *Financial Condition Examiners Handbook*, Section I, Part IV, Conducting Examinations, contains the following guidance:

a. Affiliates Defined

Affiliates exist when there is a relationship that offers the potential for self-dealing, transactions at less than arm's length, favorable treatment, or the ability to direct the outcome of events differently from what might result in the absence of that relationship.

Some examples of affiliates are:

- A company's affiliates
- Principal owners
- Management (including directors)
- Entities for which investments are accounted for by the equity method
- Pension and profit-sharing trusts managed by or under the trusteeship of management

An affiliate also includes any other person with which the reporting entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. A third person also is affiliated if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

b. **Affiliated Transactions Defined**

An affiliated transaction is any direct or indirect transaction between the reporting entity and an affiliate. Affiliated Transactions include transactions between:

- A parent company and its subsidiaries
- Subsidiaries of a common parent
- The reporting entity and:
  - (1) Other affiliated businesses
  - (2) Management (including directors)
  - (3) Principal owners
  - (4) Pension and profit-sharing trusts managed by or under the trusteeship of management
  - (5) Other parties having the ability to exert significant influence

**Generally Accepted Accounting Principles**

37. FAS 57 provides the following guidance:

**INTRODUCTION**

1. The FASB has been asked to provide guidance on disclosures of transactions between related parties.<sup>1</sup> Examples of related party transactions include transactions between (a) a parent company and its subsidiaries; (b) subsidiaries of a common parent; (c) an enterprise and trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of the enterprise's management; (d) an enterprise and its principal owners, management, or members of their immediate families; and (e) affiliates. Transactions between related parties commonly occur in the normal course of business. Some examples of common types of transactions with related parties are: sales, purchases, and transfers of realty and personal property; services received or furnished, for example, accounting, management, engineering, and legal services; use of property and equipment by lease or otherwise; borrowings and lendings; guarantees; maintenance of bank balances as compensating balances for the benefit of another; intercompany billings based on allocations of common costs; and filings of consolidated tax returns. Transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an enterprise may receive services from a related party without charge and not record receipt of the services.

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<sup>1</sup> Terms defined in the glossary (Appendix B) are in boldface type the first time they appear in this Statement.

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## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

## Disclosures

2. Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements.<sup>2</sup> The disclosures shall include:<sup>3</sup>

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<sup>2</sup> The requirements of this Statement are applicable to separate financial statements of each or combined groups of each of the following: a parent company, a subsidiary, a corporate joint venture, or a 50-percent-or-less owned investee. However, it is not necessary to duplicate disclosures in a set of separate financial statements that is presented in the financial report of another enterprise (the primary reporting enterprise) if those separate financial statements also are consolidated or combined in a complete set of financial statements and both sets of financial statements are presented in the same financial report.

<sup>3</sup> In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed.

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- a. The nature of the relationship(s) involved
  - b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
  - c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
  - d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement

3. Transactions involving related parties cannot be presumed to be carried out on an arm's length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions unless such representations can be substantiated.

4. If the reporting enterprise and one or more other enterprises are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting enterprise significantly different from those that would have been obtained if the enterprises were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the enterprises.

38. For purposes of FAS 57, certain terms are defined as follows:

- a. **Affiliate.** A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise.
- b. **Control.** The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.

- c. Immediate family. Family members whom a principal owner or a member of management might control or influence or by whom they might be controlled or influenced because of the family relationship.
- d. Management. Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy making functions. Persons without formal titles also may be members of management.
- e. Principal owners. Owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise.
- f. Related parties. Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

39. GAAP literature acknowledges the basic problem of when to use predecessor basis vs. fair value or exchange price in accounting for transfers of noncash assets between related parties. Guidance on accounting for transfers of assets between affiliated companies includes the discussion section of EITF 85-21. This indicates that the SEC staff require transfers of assets between companies under common control or between a parent and its subsidiary be valued at their historical cost in the separate statements of each entity that is a party to the transaction. These views relate primarily to transfers of net assets (as in a business combination) or long-lived assets. The form of consideration, whether cash or other, does not change the method of accounting. Any excess paid over the historical cost is treated as a reduction of equity. Certain excerpts follows:

The SEC Observer stated that the SEC staff's views on carrying over historical cost to record, in the separate financial statements of each entity, transfers between companies under common control or between a parent and its subsidiary run primarily to transfers of net assets (as in business combination ) or long-lived assets. Those views would not normally apply to recurring transactions for which valuation is not in question (such as routine transfers of inventory) in the separate financial statements of each entity that is a party to the transaction.

The Task Force members were not in agreement as to whether new basis accounting is acceptable for privately held companies. One Task Force member indicated that the authoritative literature could be read to support the practice. One Task Force member indicated that a concept of the reporting entity would be helpful. Some Task Force members indicated a need for FASB guidance.

40. EITF 84-39 discusses the transfer of monetary and nonmonetary assets among individuals and entities under common control. Certain excerpts follow:



**ISSUE**

When an asset (for example, real estate) is transferred from an individual to a corporation controlled by that individual in exchange for cash or stock, should the corporation record the transferred property at its fair value at the date of transfer or at its cost to the individual.

**EITF DISCUSSION**

The Task Force did not reach a consensus on this issue.

Task Force members noted that diversity in practice in certain specific types of transactions, with some members starting from a presumption that carrying amounts should be adjusted to fair value at the date of transfer, while others preferred no change in carrying amount until an asset leaves the controlled group.

41. Accounting Interpretations of APB Opinion No. 16 (AIN-APB 16, #39) discusses transfers and exchanges between companies under common control:

Question - Paragraph 5 of APB Opinion No. 16 states the Opinion does not apply to a transfer of net assets or to an exchange of shares between companies under common control. What are some examples of the types of transactions excluded from the Opinion by this provision and what accounting should be applied?

Interpretation - In general, paragraph 5 excludes transfers and exchanges that do not involve outsiders. For example, a parent company may transfer the net assets of a wholly owned subsidiary into the parent company and liquidate the subsidiary, which is a change in legal organization but not a change in the entity. Likewise, a parent may transfer its interest in several partially owned subsidiaries to a new wholly owned subsidiary, which is again a change in legal organization but not in the entity. Also, a parent may exchange its ownership or the net assets of a wholly owned subsidiary for additional shares issued by the parent's partially owned subsidiary, thereby increasing the parent's percentage of ownership in the partially owned subsidiary but leaving all of the existing minority interest outstanding.

None of the above transfers or exchanges is covered by APB Opinion No. 16. The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting.

It should be noted, however, that purchase accounting applies when the effect of a transfer or exchange is to acquire all or part of the outstanding shares held by the minority interest of a subsidiary (see paragraph 43). The acquisition of all or part of a minority interest, however acquired, is never considered a transfer or exchange by companies under common control. (See Interpretation No. 26 of APB No. 16, "Acquisition of Minority Interest.")

**RELEVANT LITERATURE****Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Introduction, Accounting for Assets Transferred Between Affiliates
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Introduction, Accounting for Assets Transferred Between Affiliates
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies, Notes to Financial Statements and Schedule Y
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes to Financial Statements and Schedule Y
- NAIC Annual Statement Instructions for Health Maintenance Organizations, Notes to Financial Statements and Schedule Y
- Insurance Holding Company System Model Regulation with Reporting Forms and Instructions, Form B

- Insurance Holding Company System Regulatory Act
- Model Law for HMO Investment Guidelines
- NAIC Financial Condition Examiners Handbook, Section I, Part IV, Conducting Examinations

**Generally Accepted Accounting Principles**

- *FASB Statement No. 57, Related Party Disclosures*
- *EITF 84-39, Transfers of Monetary and Nonmonetary Assets among Individuals and Entities under Common Control (Not a consensus opinion)*
- *EITF 85-21, Changes of Ownership Resulting in a New Basis of Accounting (Not a consensus opinion)*
- *Accounting Interpretations of APB Opinion No. 16, #39, Transfers and Exchanges Between Companies Under Common Control*

**State Regulations**

- Wisconsin Administrative Code Ins. 3.50