Statutory Issue Paper No. 33

Disclosures about Fair Value of Financial Instruments

STATUS
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Original SSAP and Current Authoritative Guidance: SSAP No. 27

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Though disclosures about market values of certain investments are currently made in schedules included in the Annual Statements for Property and Casualty Insurance Companies and for Life and Accident and Health Insurance Companies, the annual statements contain no disclosures of fair values of other financial instruments. Furthermore, there are no specific disclosure requirements in the current statutory guidance requiring fair value disclosures in the financial statements. GAAP has specific disclosure requirements for the fair value of financial instruments. This issue paper establishes statutory accounting principles for disclosures about fair value of financial instruments that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. A financial instrument shall be defined as cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity;

b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

3. Examples of the financial instruments, which encompass both assets and liabilities recognized and not recognized in the statement of financial position, to which this issue paper apply include but are not limited to short-term investments, bonds, common stock, preferred stocks, mortgage loans, derivatives, financial guarantees written, standby letters of credit, notes payable and deposit-type contracts.

4. A reporting entity shall disclose in the notes to the financial statements the fair value of all financial instruments, summarized by type of financial instrument, for which it is practicable to estimate fair value, except for certain financial instruments named in paragraph 8 of *FASB Statement No. 107*, *Disclosure about Fair Value of Financial Instruments* (FAS 107), (which is excerpted in the Relevant GAAP Guidance section in paragraph 14 below). Fair value disclosed in the notes shall be presented together with the related admitted values in a form that makes it clear whether the fair values and admitted values represent assets or liabilities and to which line items in the Statement of Assets, Liabilities, Surplus and Other Funds they relate. Separate disclosure of this information in the notes is required even if such information is presented elsewhere in the financial statements. Unless specified otherwise in another issue paper the disclosures may be made net of encumbrances, if the asset or liability is so reported. A reporting entity shall also disclose the method(s) and significant assumptions used to

estimate the fair value of financial instruments. For example, the notes should specify the reported value of investments using market prices published by the Securities Valuation Office of the NAIC (SVO) investments.

5. For purposes of this issue paper, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Market values published by the SVO, if available, shall always be the fair value amount disclosed. In the absence of SVO published market values or when amortized cost is used by the SVO as market value, quoted market prices by other third party organizations, if available, shall be used as the fair value of financial instruments. If neither SVO published market values nor quoted market prices are available, management's best estimate of fair value shall be based on the quoted market price of a financial instrument with similar characteristics or on industry recognized valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved).

6. If it is not practicable for an entity to estimate the fair value of a financial instrument or a class of financial instruments, the following shall be disclosed:

a. Information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity

b. The reasons why it is not practicable to estimate fair value.

DISCUSSION

7. The conclusion above adopts FAS 107 as amended by *FASB Statement No. 119*, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FAS 119), except that paragraph 15.c. of FAS 119 relating to disclosure of financial instruments held or issued for trading is rejected. This is consistent with the conclusions in *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities* (CMOs), *Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities)*, and *Issue Paper No. 32—Investments in Preferred Stock (including investments in common stock of subsidiary, controlled or affiliated entities)*, in which FASB Statement No. 115, is rejected. This issue paper adopts *FASB Emerging Issues Task Force No. 85-20*, *Recognition of Fees for Guaranteeing a Loan.* Furthermore, this issue paper requires that if the SVO publishes a market value, that amount should be used in the fair value disclosures required by this issue paper.

8. This issue paper rejects *FASB Statement No. 126, Exemptions from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, an amendment of FAS 107*.

9. The Statement of Concepts states that:

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

Disclosures about fair values of financial instruments is consistent with that objective.

10. Current statutory accounting already recognizes the usefulness of fair value disclosures, and requires that disclosure of amounts for certain financial instruments in the Annual Statement schedules. The conclusion above expands this requirement to include disclosure in the notes to the financial statements of all financial instruments.

11. Paragraph 4 above requires the disclosure of the fair value of all financial instruments if it is practicable to estimate those values. In the context of this issue paper, practicable means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another. For example, it might not be practicable for an entity to estimate the fair value of a class of financial instruments for which a quoted market price is not available because it has not yet obtained or developed the valuation model necessary to make the estimate, and the cost of obtaining an independent valuation appears excessive considering the materiality of the instruments to the entity. Practicability, that is, cost considerations, also may affect the required precision of the estimate; for example, while in many cases it might seem impracticable to estimate fair value on an individual instrument basis, it may be practicable for a class of financial instruments in a portfolio or on a portfolio basis. In those cases, the fair value of that class or of the portfolio should be disclosed. Finally, it might be practicable for an entity to estimate the fair value only of a subset of a class of financial instruments; the fair value of that subset should be disclosed.

12. Paragraph 8 of FAS 107, which is included in the Relevant GAAP Guidance section, discusses financial instruments which are exempt from fair value disclosure. Included as exempt instruments are insurance contracts, except for financial guaranty and investment contracts. Accordingly, the fair value disclosures should be made for guaranteed interest contracts (GICs), and liabilities associated with certain annuities and deposit accounts.

Drafting Notes/Comments

- Disclosure of concentration of credit risk is addressed in *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentration of Credit Risk.*

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

13. The NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies require market values to be included in several invested asset schedules (e.g. Schedule A on real estate, Schedule BA on other long term assets, Schedule C on collateral loans, Schedule D on bonds, Schedule DB on options, caps and floors and Schedule DC on futures options). The schedules and the notes to the financial statement, however, do not contain market values for all investments or other financial instruments that are required by this issue paper.

Generally Accepted Accounting Principles

14. FAS 107 discusses fair value disclosures as follows:

> 3. A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that both:
>
> a. Imposes on one entity a contractual obligation[1] (1) to deliver cash or another financial instrument[2] to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity

[1] Contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability set forth in *FASB Concepts Statement No. 6, Elements of Financial Statements*, although some may not be recognized as liabilities in financial statements—may be "off-balance-sheet" —because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

[2] The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual

obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

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b. Conveys to that second entity a contractual right[3] (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

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[3] Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements—may be "off-balance-sheet" —because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

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4. The definition in paragraph 3 is essentially the same as that in paragraph 6 of Statement 105, which is hereby amended to conform to this Statement. Appendix A of Statement 105 provides examples of instruments that are included in and excluded from the definition of a financial instrument.

5. For purposes of this Statement, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be disclosed for that instrument is the product of the number of trading units of the instrument times that market price.

6. Under the definition of fair value in paragraph 5, the quoted price for a single trading unit in the most active market is the basis for determining market price and reporting fair value. This is the case even if placing orders to sell all of an entity's holdings of an asset or to buy back all of a liability might affect the price, or if a market's normal volume for one day might not be sufficient to absorb the quantity held or owed by an entity.

7. This Statement requires disclosures about fair value for all financial instruments, whether recognized or not recognized in the statement of financial position, except for those specifically listed in paragraph 8. It applies to all entities. It does not change any requirements for recognition, measurement, or classification of financial instruments in financial statements.

8. The disclosures about fair value prescribed in paragraphs 10-14 are not required for the following:

a. Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in *FASB Statements No. 35, Accounting and Reporting by Defined Benefit Pension Plans, No. 87, Employers' Accounting for Pensions, No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions*, and *No. 43, Accounting for Compensated Absences*, and *APB Opinions No. 25, Accounting for Stock Issued to Employees*, and *No. 12, Omnibus Opinion -- 1967*

b. Substantively extinguished debt subject to the disclosure requirements of *FASB Statement No. 76, Extinguishment of Debt*, and assets held in trust in connection with an in-substance defeasance of that debt.

c. Insurance contracts, other than financial guarantees and investment contracts, as discussed in *FASB Statements No. 60, Accounting and Reporting by*

Insurance Enterprises, and *No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

d. Lease contracts as defined in *FASB Statement No. 13, Accounting for Leases* (a contingent obligation arising out of a canceled lease and a guarantee of a third-party lease obligation are not lease contracts and are included in the scope of this Statement)

e. Warranty obligations and rights

f. Unconditional purchase obligations as defined in paragraph 6 of *FASB Statement No. 47, Disclosure of Long-Term Obligations*

g. Investments accounted for under the equity method in accordance with the requirements of *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock*

h. Minority interests in consolidated subsidiaries

i. Equity investments in consolidated subsidiaries

j. Equity instruments issued by the entity and classified in stockholders' equity in the statement of financial position.

9. Generally accepted accounting principles already require disclosure of or subsequent measurement at fair value for many classes of financial instruments. Although the definitions or the methods of estimation of fair value vary to some extent, and various terms such as market value, current value, or mark-to-market are used, the amounts computed under those requirements satisfy the requirements of this Statement and those requirements are not superseded or modified by this Statement.

Disclosures about Fair Value of Financial Instruments

10. An entity shall disclose, either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. An entity also shall disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

11. Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models).

12. In estimating the fair value of deposit liabilities, a financial entity shall not take into account the value of its long-term relationships with depositors, commonly known as core deposit intangibles, which are separate intangible assets, not financial instruments. For deposit liabilities with no defined maturities, the fair value to be disclosed under this Statement is the amount payable on demand at the reporting date. This Statement does not prohibit an entity from disclosing separately the estimated fair value of any of its nonfinancial intangible and tangible assets and nonfinancial liabilities.

13. For trade receivables and payables, no disclosure is required under this Statement when the carrying amount approximates fair value.

14. If it is not practicable for an entity to estimate the fair value of a financial instrument or a class of financial instruments, the following shall be disclosed:

a. Information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity

b. The reasons why it is not practicable to estimate fair value.

15. In the context of this Statement, practicable means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another. For example, it might not be practicable for an entity to estimate the fair value of a class of financial instruments for which a quoted market price is not available because it has not yet obtained or developed the valuation model necessary to make the estimate, and the cost of obtaining an independent valuation appears excessive considering the materiality of the instruments to the entity. Practicability, that is, cost considerations, also may affect the required precision of the estimate; for example, while in many cases it might seem impracticable to estimate fair value on an individual instrument basis, it may be practicable for a class of financial instruments in a portfolio or on a portfolio basis. In those cases, the fair value of that class or of the portfolio should be disclosed. Finally, it might be practicable for an entity to estimate the fair value only of a subset of a class of financial instruments; the fair value of that subset should be disclosed.

15. During 1994, the FASB issued FAS 119 which amended FAS 107 as follows:

15. Statement 107 is amended as follows:

a. In paragraph 10, the following footnote is added after either in the body of the financial statements or in the accompanying notes:

* If disclosed in more than a single note, one of the notes shall include a summary table. The summary table shall contain the fair value and related carrying amounts and cross-references to the location(s) of the remaining disclosures required by this Statement, as amended.

b. In paragraph 10, the following is added after the first sentence:

Fair value disclosed in the notes shall be presented together with the related carrying amount in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities and how the carrying amounts relate to what is reported in the statement of financial position.

c. The following is added to the end of paragraph 10:

The disclosures shall distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading.

d. The following paragraph and footnote are added after paragraph 13:

In disclosing the fair value of a derivative financial instrument,** an entity shall not (a) combine, aggregate, or net that fair value with the fair value of nonderivative financial instruments or (b) net that fair value with the fair value of other derivative financial instruments -- even if those nonderivative or derivative financial instruments are considered to be related, for example, by a risk management strategy -- except to the extent that the offsetting of carrying amounts in the statement of financial position is permitted under the general principle in paragraphs 5 and 6 of FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts, or the exception for master netting arrangements in paragraph 10 of Interpretation 39.

** For purposes of this Statement, derivative financial instrument is used in the same sense as in paragraph 5 of *FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.*

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies

Generally Accepted Accounting Principles

- *FASB Statement No. 107, Disclosure about Fair Value of Financial Instruments*
- *FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*
- *FASB Statement No. 126, Exemptions from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, an amendment of FAS 107*
- *FASB Emerging Issues Task Force No. 85-20, Recognition of Fees for Guaranteeing a Loan*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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