

# **Statutory Issue Paper No. 72**

## **Statutory Surplus**

### **STATUS**

**Finalized March 16, 1998**

**Original SSAP and Current Authoritative Guidance: SSAP No. 72**

### **Type of Issue:**

**Common Area**

### **SUMMARY OF ISSUE**

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

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

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

### **SUMMARY CONCLUSION**

4. Statutory surplus of a reporting entity consists of the following:

- a. capital stock;
- b. treasury stock;
- c. gross paid-in and contributed surplus;
- d. surplus notes;
- e. unassigned funds (surplus);
- f. special surplus funds;
- g. other than special surplus funds;

**Capital Stock**

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

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

**Treasury Stock**

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

**Gross Paid-in and Contributed Surplus**

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

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

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

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

**Surplus Notes**

12. Surplus notes are financial instruments that are subject to strict control by the commissioner of the reporting entity’s state of domicile and have been approved by the commissioner as to form and content. These instruments are commonly referred to as surplus notes but are also referred to as surplus debentures or contribution certificates. *Issue Paper No. 41—Surplus Notes* (Issue Paper No. 41) provides

the specific characteristics of surplus notes and provides accounting guidance for surplus notes. Only notes meeting the requirements of Issue Paper No. 41 shall be accounted for as surplus notes.

### **Unassigned Funds (Surplus)**

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

- a. Net Income  
Net income resulting from insurance and other operating activities of the reporting entity since its inception.
- b. Unrealized Capital Gains and Losses on Investments  
The cumulative unrealized capital gain or loss that results from differences between the prescribed statement value of investments carried at market value and the cost of those investments is a component of unassigned funds (surplus). This component changes as periodic unrealized gains and losses are credited or charged directly to unassigned funds (surplus).
- c. Effect of Exchange Rate Fluctuations  
The cumulative gain or loss due to translating foreign operations to U.S. dollars and changes in balance sheet asset and liability values due to foreign currency translation are recorded as unrealized capital gains and losses and therefore are a component of unassigned funds (surplus). This component changes as the exchange rates fluctuate.
- d. Nonadmitted Assets  
The nonadmitted values of assets owned by a reporting entity are a reduction of unassigned funds (surplus). This component of unassigned funds (surplus) changes as nonadmitted asset values change. Changes in nonadmitted asset values are charged or credited directly to unassigned funds (surplus).
- e. Provision for Reinsurance  
A reporting entity must establish a statutory liability, provision for reinsurance, for unsecured reinsurance recoverables from unauthorized reinsurers and certain overdue balances from authorized reinsurers. The liability is charged directly to unassigned funds (surplus). Therefore, at any point in time there is a reduction of unassigned funds (surplus) equal to a reporting entity's liability for unauthorized reinsurance.
- f. Asset Valuation Reserves  
Where an Asset Valuation Reserve is required to be recorded as a statutory liability, there is a reduction of unassigned funds (surplus) in an amount equal to the liability. Changes to the Asset Valuation Reserve are charged or credited directly to unassigned funds (surplus).
- g. Separate Accounts  
A life insurer's balance sheet includes the total assets and liabilities of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Changes in the surplus of the separate accounts business of an insurer are charged or credited directly to unassigned funds (surplus).
- h. Subscribers Savings Accounts  
Subscribers Savings Accounts (SSA) are unique to reciprocals. SSAs represent a portion of a reciprocal insurance company's surplus that has been identified as subscribers (policyholders) accounts. When the source of amounts credited to the subscriber accounts

is from the reciprocal's operations, the amounts are reported as unassigned funds (surplus).

- i. Dividends to Stockholders  
Dividends declared are charged directly to unassigned funds (surplus) on the declaration date and are carried as a liability until paid. The amount of the dividend is the cash paid if it is a cash dividend, the fair market value of the assets distributed if it is property dividend, or the par value of the company's stock if it is a stock dividend. A stock dividend is recorded as a transfer from unassigned funds (surplus) to capital stock. Stock dividends have no effect on total capital and surplus while other forms of dividends reduce surplus. Forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholders shall be accounted for as a dividend. Dividends paid to related parties are subject to the requirements of *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.
- j. Change in Accounting Principles  
The effects of a change in accounting principle or the application of an accounting principle, such as a change in reserve account because of a change in valuation basis, are reported as a charge or credit to unassigned funds (surplus). The effect of these changes shall not be included in the determination of net income or loss.
- k. Correction of an Error  
Corrections of errors in previously reported financial statements are charged or credited directly to unassigned funds (surplus). The effect of corrections of errors shall not be included in the determination of net income or loss.
- l. Stock Issuance Expenses  
Expenses relating to the issuance of capital stock, for example underwriting commissions and filing fees are charged to unassigned funds (surplus).
- m. Change in Surplus as a Result of Reinsurance  
Life and accident and health insurers report increases in surplus that result from certain types of reinsurance transactions on a net of tax basis. As profits emerge from the ceded business the increase in surplus is amortized to income as described in paragraph 39.
- n. Changes in Deferred Tax Assets and Deferred Tax Liabilities  
Consistent with the conclusions reached in *Issue Paper No. 83—Accounting for Income Taxes*, changes in deferred tax assets and deferred tax liabilities, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of unassigned funds (surplus).
- o. Other  
This category includes other gains and losses in surplus not specifically identified elsewhere in this issue paper including but not limited to; net proceeds from life insurance on employees and unearned compensation relating to stock issuances made under compensatory Employee Stock Ownership Plans, Stock Option Plans and Stock Purchase Plans.

### Special Surplus Funds

14. A reporting entity may establish a segregated surplus account to provide for contingencies. Surplus thus appropriated is called appropriated surplus or special surplus funds. Surplus resulting from any retroactive reinsurance transaction entered by a property and casualty insurer must be recorded as an appropriation of surplus by the ceding company (special surplus from retroactive reinsurance account).

Voluntary and general contingency reserves which are not actual liabilities of the reporting entity are shown as appropriated surplus or special surplus funds.

### **Other Than Special Surplus Funds**

15. Amounts provided to reporting entities, other than stock companies, in the organization stage to defray the expenses and meet initial minimum surplus requirements required to obtain a license to do the business of insurance shall be reported as a separate component of surplus called Other than Special Surplus Funds. Examples of these types of deposits include but are not limited to: guaranty fund notes, contribution certificates, and subscriber accounts that represent individual subscriber contributions.

### **Changes in Statutory Surplus**

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

### **Disclosure**

17. The financial statements shall disclose the following items:

- a. the number of shares of each class of capital stock authorized, issued and outstanding as of the balance sheet date and the par value or stated value of each class;
- b. the dividend rate, liquidation value and redemption schedule (including prices and dates) of any preferred stock issues;
- c. dividend restrictions, if any, and an indication if the dividends are cumulative;
- d. the portion of the profits that may be paid as ordinary dividends to stockholders;
- e. a description of any restrictions placed on the unassigned funds (surplus) funds including for whom the surplus is being held;
- f. for mutual reciprocals and similarly organized entities, the total amount of advances to surplus not repaid, if any;
- g. the total amount of stock held by the reporting entity, including stock of affiliated entities, for special purposes such as conversion of preferred stock, employee stock options and stock purchase warrants;
- h. a description of the reasons for changes in the balances of any special surplus funds from the prior period;
- i. the cumulative portion of unassigned funds (surplus) represented or reduced by each of the following items:
  - i. unrealized gains and losses;
  - ii. nonadmitted asset values;
  - iii. separate account business;
  - iv. asset valuation reserves;
  - v. provision for reinsurance;
- j. For reciprocal insurance companies only:
  - i. the amount of surplus identified as subscriber savings accounts;
  - ii. the source of the funds (either from the reciprocal's operations or contributed by the individual subscriber) and, the reporting location in surplus;

- iii. the conditions upon which the balances are paid to the subscribers;
- k. Disclosures required by *Issue Paper No. 41—Surplus Notes*;
- l. Disclosures required by *Issue Paper No. 9—Subsequent Events*.

## DISCUSSION

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

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

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

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

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

23. Current statutory accounting does not address stock purchase warrants. The conclusions reached in this issue paper are consistent with *APB Opinion No. 14, Accounting for Convertible Debt and Debt and Debt Issued with Stock Purchase Warrants* (APB 14) which was adopted in *Issue Paper No. 80—Disclosures* regarding stock purchase warrants required by this issue paper are an expansion of current statutory guidance.

24. This issue paper rejects *Accounting Research Bulletin No. 43*, Chapter 1, *Prior Opinions* (ARB 43). The underlying concepts addressed by ARB 43, Chapter 1, are addressed within other relevant GAAP literature to the extent they are applicable.

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

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

Consistency

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

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

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

- a. Capital stock and treasury stock are treated consistently between statutory surplus and stockholders' equity;
- b. Gross paid-in and contributed surplus for statutory reporting purposes is consistent with the accounting treatment afforded to additional paid in capital in a reporting entity's stockholders' equity under GAAP reporting.

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

30. Statutory accounting utilizes unassigned funds (surplus) to account for several additional components of policyholder surplus. These items include net income, unrealized gains and losses on investments and unrealized gains and losses resulting from exchange rate fluctuations, nonadmitted asset values, certain statutory liabilities such as the asset valuation reserve and the provision for reinsurance, the effects of changes in accounting principles and corrections of errors, appropriations of surplus, separate accounts, subscriber savings accounts, stock issuance expenses and dividends to stockholders.

31. GAAP requires some of the items in unassigned funds (surplus) to be reflected in retained earnings while others are reported as a separate and distinct component of stockholders' equity. Those items that are accounted for as part of retained earnings include:

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

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

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

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

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

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

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

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

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

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

#### **Statutory Accounting**

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

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



### Minimum Capital

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

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

### Par Value Requirements

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

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

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

### Original Stock Sale

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

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

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

### Subsequent Stock Issues

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

### Treasury Stock

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

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

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

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

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

Chapter 26, Capital Stock, of the Life/A&H Accounting Practices and Procedures Manual contains similar guidance.

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

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

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

Initial contributed or organizational surplus is obtained to provide both protection to the policyholders and the necessary working capital with which a company can pay the expense of commencing business. The minimum surplus a company must have and at all times maintain is customarily somewhat less than the initial amount required to obtain a certificate of authority.

While paid-in or organizational surplus will not be decreased (except upon a return of original investment), unassigned surplus deficits are subtracted from the amount of original surplus to determine if a company has fallen below the required minimum surplus.

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

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

#### Minimum Surplus Requirements - Stock Companies

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

#### Minimum Surplus Requirements - Mutual Companies

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

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

#### Minimum Surplus Requirements - Reciprocals

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

#### Capital or Surplus Impairment

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

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

37. Chapter 25, Unassigned Funds (Surplus), of the P&C Accounting Practices and Procedures Manual provides the following guidance:

Unassigned funds (surplus) is the undistributed and unappropriated amount of surplus and includes net income as well as the following items.

#### Unrealized Capital Gains and Losses on Investments

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

#### Change in Nonadmitted Assets

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

#### Change in Liability for Unauthorized Reinsurance

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

#### Change in Foreign Exchange Adjustment

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

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

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

#### Dividends to Stockholders

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

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

#### Stock Issuance Expenses

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

#### Appropriations of Surplus

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

### Subscribers Savings Accounts

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

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

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

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

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

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

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

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

#### Instruction:

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

- d. Indicate the total amount of stock held by the company, including stock of affiliated companies, for special purposes such as conversion of preferred stock and employee stock options.

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

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

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

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

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

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

Instruction:

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

Illustration:

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

Line 23C). The subscriber savings account balances are paid to the subscribers upon the termination from the Company.

### Generally Accepted Accounting Principles

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

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.
2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made there against. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.
3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.
4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.
5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable.
6. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

#### Section B -- Opinion Issued by Predecessor Committee

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

“Profits or Losses on Treasury Stock”

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

To the Executive Committee,  
American Institute of Accountants:

3. "This committee has had under consideration the question regarding treatment of purchase and sale by a corporation of its own stock, which was raised during 1937 by the New York Stock Exchange with the Institute's special committee on cooperation with stock exchanges.
  4. "As a result of discussions which then took place, the special committee on cooperation with stock exchanges made a report which was approved by the committee on accounting procedure and the executive committee, and a copy of which was furnished to the committee on stock list of the New York Stock Exchange. The question raised was stated in the following form:
  5. "Should the difference between the purchase and resale prices of a corporation's own common stock be reflected in earned surplus (either directly or through inclusion in the income account) or should such difference be reflected in capital surplus?"
  6. "The opinion of the special committee on cooperation with stock exchanges reads in part as follows:
  7. "Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock."
  8. "This committee is in agreement with the views thus expressed; it is aware that such transactions have been held to give rise to taxable income, but it does not feel that such decisions constitute any bar to the application of correct accounting procedure as above outlined.
  9. "The special committee on cooperation with stock exchanges continued and concluded its report with the following statement:
  10. "Accordingly, although your committee recognizes that there may be cases where the transactions involved are so inconsequential as to be immaterial, it does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account)."
  11. "This committee agrees with the special committee on cooperation with stock exchanges, but thinks it desirable to point out that the qualification should not be applied to any transaction which, although in itself inconsiderable in amount, is a part of a series of transactions which in the aggregate are of substantial importance.
  12. "This committee recommends that the views expressed be circulated for the information of members of the Institute."
42. APB 12, *Omnibus Opinion 1967*, provides the following guidance:
9. Paragraph 7 of *APB Opinion No. 9, Reporting the Results of Operations*, states that "The statement of income and the statement of retained earnings (separately or combined) are designed to reflect, in a broad sense, the 'results of operations'." Paragraph 28 of *APB Opinion No. 9* states that certain capital transactions ". . . should be excluded from the determination of net income or the results of operations under all circumstances." Companies generally have reported the current year's changes in stockholders' equity accounts other than retained earnings in separate statements or notes to the financial statements when presenting both financial position and results of operations for one or more years. A question has arisen as to whether,



because of the language of APB Opinion No. 9, changes in stockholders' equity accounts other than retained earnings are required to be reported.

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

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

#### Capital Transactions

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

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

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

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

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

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

#### Appropriation of Retained Earnings

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

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

12. The Board considers that the following accounting practices, in addition to the accounting practices indicated in Chapter 1B, are acceptable, and that they appear to be more in accord with current developments in practice:

- a. When a corporation's stock is retired, or purchased for constructive retirement (with or without an intention to retire the stock formally in accordance with applicable laws):
  - i. an excess of purchase price over par or stated value may be allocated between capital surplus and retained earnings. The portion of the excess allocated to capital surplus should be limited to the sum of (a) all capital surplus arising from previous retirements and net "gains" on sales of treasury stock of the same issue and (b) the prorata portion of capital surplus paid in, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue. For this purpose, any remaining capital surplus applicable to issues fully retired (formal or constructive) is deemed to be applicable prorata to shares of common stock. Alternatively, the excess may be charged entirely to retained earnings in recognition of the fact that a corporation can always capitalize or allocate retained earnings for such purposes.
  - ii. an excess of par or stated value over purchase price should be credited to capital surplus.
- b. When a corporation's stock is acquired for purposes other than retirement (formal or constructive), or when ultimate disposition has not yet been decided, the cost of acquired stock may be shown separately as a deduction from the total of capital stock, capital surplus, and retained earnings, or may be accorded the accounting treatment appropriate for retired stock, or in some circumstances may be shown as an asset in accordance with paragraph 4 of Chapter 1A of ARB 43. "Gains" on sales of treasury stock not previously accounted for as constructively retired should be credited to capital surplus; "losses" may be changed to capital surplus to the extent that previous net "gains" from sales or retirements of the same class of stock are included therein, otherwise to retained earnings.
- c. Treasury stock delivered to effect a "pooling of interests" should be accounted for as though it were newly issued, and the cost thereof should receive the accounting treatment appropriate for retired stock.

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

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

**Issue**

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

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

**EITF Discussion**

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

The SEC requires that public companies report notes received in payment for the enterprise's stock as a deduction from shareholders' equity. Task Force members confirmed that the

predominant practice is to offset the notes and stock in the equity section. However, such notes may be recorded as an asset if collected in cash prior to issuance of the financial statements.

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

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

#### Status

No further EITF discussion is planned.

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

#### Section B -- Stock Dividends and Stock Split-ups

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

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

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

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

#### As to the Issuer

##### Stock dividends

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

otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

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

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

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

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

#### Stock Split-ups

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

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

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

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

**Generally Accepted Accounting Principles**

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

**State Regulations**

- No additional guidance obtained from state statutes or regulations.

**This page intentionally left blank.**