

Statutory Issue Paper No. 76

Offsetting and Netting of Assets and Liabilities

STATUS

Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 64

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not provide guidance on the reporting of assets and liabilities when a valid right of setoff exists (offsetting). As a result amounts are not consistently netted for statutory reporting. However, current statutory accounting does require that certain assets and liabilities be shown as a net amount for reporting purposes (netting) regardless of whether a valid right of setoff exists.
2. GAAP guidance on offsetting is provided in paragraph 7 of *Accounting Principles Board Opinion No. 10, Omnibus Opinion - 1966* (APB 10) and *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts* (FIN 39). This guidance allows offsetting only when a valid right of setoff exists and specified conditions are met or where netting is specifically permitted by other GAAP pronouncements. FIN 39 defines the conditions under which a valid right of setoff exists.
3. The purpose of this issue paper is to establish statutory accounting principles on offsetting assets and liabilities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) and to provide a reporting mechanism for the netting of assets and liabilities when required by this codification.

SUMMARY CONCLUSION

4. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 5 and 7. A right of setoff is a reporting entity's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the reporting entity. A valid right of setoff exists only when all the following conditions are met:
 - a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement.
 - b. The reporting party has the right to setoff the amount owed with the amount owed by the other party.
 - c. The reporting party intends to setoff.
 - d. The right of setoff is enforceable by law.
5. Assets and liabilities that meet the criteria for offset shall not be netted when prohibited by specific issue papers. An example of such is in the case of reinsurance recoverables on paid losses and ceded premiums payable as provided for in *Issue Paper No. 75—Property and Casualty Reinsurance* (Issue Paper No. 75).

6. Amounts due to or from affiliates shall be offset and reported net only when the provisions of paragraph 4 above are met.
7. Netting of assets and liabilities for reporting purposes when no valid right of setoff exists shall be allowed only when provided for by specific issue papers. An example of such is in the case of real estate investments required to be shown net of encumbrances as provided for in *Issue Paper No. 40—Real Estate Investments* (Issue Paper No. 40).

DISCUSSION

8. The conclusions above require offsetting when a valid right of setoff exists, unless prohibited in specific issue papers. This issue paper adopts paragraphs 1, 7, and 13 of APB 10 and FIN 39 with a modification to prohibit offsetting as provided in specific issue papers and require netting when provided in specific issue papers. GAAP uses the same criteria to permit offsetting as described in paragraph 4 of this issue paper and also permits netting where existing GAAP literature specifically prescribes it. Because this modification exists, there will be circumstances where items are offset under GAAP but not under statutory accounting principles.

9. Likewise, there are instances as provided for in specific issue papers where balances which do not meet the criteria in paragraph 4 are shown net for statutory reporting purposes where existing GAAP literature would not allow the amounts to be reflected as a single net balance. This difference is reflective of the varying objectives of regulation.

10. *FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (FIN 41) is a further interpretation of paragraph 7 of APB 10 and FIN 39. The guidance adopted in *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (Issue Paper No. 45) is consistent with FIN 41. However, Issue Paper No. 45 did not adopt FIN 41 because offsetting was not addressed in its entirety in the paper. The adoption of paragraph 7 of APB 10 and FIN 39 make it appropriate to adopt FIN 41 in this issue paper. This issue paper also adopts *FASB Emerging Issues Task Force No. 86-25, Offsetting Foreign Currency Swaps*.

11. The statutory principles outlined in the conclusion above are consistent with the consistency concept in the Statement of Concepts. A pertinent excerpt follows:

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.

12. The conclusions reached in this issue paper are consistent with the definition of liabilities in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) which defines a liability as *certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s)* and the definition of assets in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4) which defines an asset as *probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events*. Assets and liabilities exist independent of each other unless the requirements of paragraph 4 of this issue paper are met.

Drafting Notes/Comments

- *Issue Paper No. 2—Definition of Cash* requires netting cash accounts with positive and negative balances.

- *Issue Paper No. 40—Real Estate Investments* requires encumbrances on real estate investments to be netted against the investment.
- *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance* prohibits offsetting of reinsurance recoverables on paid losses with ceded premiums payable and requires due premiums from policyholders to be netted with premiums due the reinsurer.
- *Issue Paper No. 75—Property and Casualty Reinsurance* prohibits offsetting of reinsurance recoverables on paid losses with ceded premiums payable.
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* addresses FIN 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

13. The Property and Casualty Accounting Practices and Procedures Manual (P&C Accounting Practices and Procedures Manual), Chapter 22, Reinsurance, provides the following guidance:

Accounting for Prospective Reinsurance Contracts:

Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding company and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid.

Changes in amounts of estimated recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current period's statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, "reinsurance recoverables on loss and loss adjustment expense payments", in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

Accounting for Retroactive Reinsurance Contracts:

Certain reinsurance contracts which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the contract. Due to potential abuses involving the creation of surplus to policyholders, and the distortion of underwriting results, a special accounting treatment for such agreements is warranted.

Effective for accounting periods commencing on or after January 1, 1995, all retroactive reinsurance contracts entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) must be fully disclosed in the NAIC annual and interim financial statements required to be filed and shall be accounted for in the following manner:

1. The ceding company must record, without recognition of the retroactive reinsurance, its loss and loss expense reserves on a gross basis on its balance sheet and in all schedules and exhibits.
2. The assuming company must exclude the retroactive reinsurance from its loss and loss expense reserves and from its schedules and exhibits.
3. The ceding company and the assuming company must report by write-in item on Page 3, the total amount of all retroactive reinsurance, identified as "retroactive reserve ceded or assumed" recorded as a contra-liability by the ceding company and as a liability by the assuming company.

14. The P&C Accounting Practices and Procedures Manual, Chapter 4, Real Estate, provides the following guidance:

Book Value

In general, book value refers to amounts at which individual items are stated in books of account or in financial statements. For real estate that is occupied by the company, and for investment in real estate, this would be cost or other basic value, stated net of any encumbrances, plus additions and increases by adjustments, less retirements and decreases by adjustments, including depreciation. Encumbrances include mortgages and other related debt, and may also include accrued costs of acquisition or construction.

Statement Value

Real estate shall be shown net of any encumbrance. The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual costs, plus capitalized improvement, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company.

Similar guidance is provided in The Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4, Real Estate.

Generally Accepted Accounting Principles

15. Paragraph 7 of APB 10 provides the following guidance:

1. It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists. Accordingly, the offset of cash or other assets against the tax liability or other amounts owing to governmental bodies is not acceptable except in the circumstances described in paragraph 3 below.
2. Most securities now issued by governments are not by their terms designed specifically for the payment of taxes and, accordingly, should not be deducted from taxes payable on the balance sheet.
3. The only exception to this general principle occurs when it is clear that a purchase of securities (acceptable for the payment of taxes) is in substance an advance payment of taxes that will be payable in the relatively near future, so that in the special circumstances the purchase is tantamount to the prepayment of taxes. This occurs at times, for example, as an accommodation to a local government and in some instances when governments issue securities that are specifically designated as being acceptable for the payment of taxes of those governments.

16. FIN 39 provides the following guidance:

INTERPRETATION

General Principle

5. Opinion 10, paragraph 7, states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met:

- a. Each of two parties owes the other determinable amounts.
- b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
- c. The reporting party intends to set off.

- d. The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.

6. Generally, debts may be set off if they exist between mutual debtors each acting in its capacity as both debtor and creditor. In particular cases, however, state laws about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the U.S. Bankruptcy Code imposes restrictions on or prohibitions against the right of setoff in bankruptcy under certain circumstances. Legal constraints should be considered to determine whether the right of setoff is enforceable.

Special Applications

7. Various accounting pronouncements specify accounting treatments in circumstances that result in offsetting or in a presentation in a statement of financial position that is similar to the effect of offsetting. This Interpretation does not modify the accounting treatment in the particular circumstances prescribed by any of the following pronouncements:

FASB Statements and Interpretations
 APB Opinions
 Accounting Research Bulletins
 FASB Technical Bulletins
 AICPA Accounting Interpretations
 AICPA Audit and Accounting Guides
 AICPA Industry Audit Guides
 AICPA Statements of Position

Examples of those pronouncements are:

FASB Statement No. 13, Accounting for Leases (leveraged leases, paragraphs 42-47)

FASB Statement No. 87, Employers' Accounting for Pensions (accounting for pension plan assets and liabilities)

FASB Statement No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions (accounting for plan assets and liabilities)

FASB Statement No. 109, Accounting for Income Taxes (net tax asset or liability amounts reported)

APB Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions (reporting of discontinued operations)

AICPA Audit and Accounting Guides, Audits of Brokers and Dealers in Securities (trade date accounting for trading portfolio positions), *and Construction Contractors and Audits of Federal Government Contractors* (advances received on construction contracts)

AICPA Industry Audit Guide, Audits of Banks (reciprocal balances with other banks)

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 4 and 22
- Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4
- *Issue Paper No. 2—Definition of Cash*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 40—Real Estate Investments*

- *Issue Paper No. 75—Property and Casualty Reinsurance*
- *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements.*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 10, Omnibus Opinion - 1966*
- *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts*
- *FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*
- *FASB Emerging Issues Task Force No. 86-25, Offsetting Foreign Currency Swaps*

State Regulations

No additional guidance obtained from state statutes or regulations.