

Statutory Issue Paper No. 95

Holding Company Obligations

STATUS

Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 15

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Statutory accounting currently requires disclosure of holding company obligations which are guaranteed. It does not specifically address a reporting entity subsidiaries' accounting treatment of obligations of a holding company parent when the subsidiary does not guarantee the obligation, however, it is accepted statutory practice that these obligations are not recorded or disclosed.

2. The Financial Accounting Standards Board (FASB) has been unable to reach a consensus that any particular method of presentation is preferable related to this issue. The SEC staff believes that when debt is incurred in connection with or otherwise related to the acquisition of a subsidiary in a purchase transaction and a subsidiary subsequently files a registration statement in connection with a public offering of its stock or debt, the parent company's debt, related interest expense, and allocable debt issue costs should be reflected in the subsidiary's financial statements included in the public offering if (1) the subsidiary is to assume the debt of the parent, either presently or in a planned transaction in the future, (2) the proceeds of a debt or equity offering of the subsidiary will be used to retire all or a part of the parent company's debt, or (3) the subsidiary guarantees or pledges its assets as collateral for the parent company's debt.

3. The purpose of this issue paper is to establish statutory accounting principles for recording and disclosure requirements of holding company obligations and any related guarantees in the financial statements of a subsidiary that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. In situations where the reporting entity does not guarantee the obligation of the holding company, there is no legal obligation on the part of the reporting entity. Therefore, the reporting entity shall not record the obligation of its parent holding company unless the obligation relates to services or benefits incurred by a non-insurance parent company or holding company on its behalf. In these situations, the reporting entity shall recognize an expense for its share of the services or benefits incurred on its behalf during the period by the parent company or holding company based on an allocation from the parent or holding company. A liability shall be established for any such amounts due, but not yet paid. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. *Issue Paper No. 8—Accounting for Pensions* (Issue Paper No. 8), *Issue Paper No. 11—Compensated Absences* (Issue Paper No. 11), *Issue Paper No. 13—Employers' Accounting for Postemployment Benefits* (Issue Paper No. 13), and *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions* (Issue Paper No. 14) address specific examples where the obligation relates to benefits provided to the subsidiary by a non-insurance parent company or holding company.

5. If the reporting entity guarantees an obligation of the holding company, the guidance in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) shall be followed for determining the recording and disclosure of the guarantee. Issue Paper Nos. 8, 11, 13 and 14 provide specific accounting and disclosure guidelines for employee benefit plans when the reporting entity is directly liable for obligations under the plan.

DISCUSSION

6. Statutory accounting requires that a reporting entity record only its direct assets and direct obligations and not those of related parties. If the reporting entity has no legal obligation related to the holding company's obligations, the entity shall not record those obligations unless there is a guarantee of such debt that would require recording under the guidance in Issue Paper No. 5 or unless the obligation falls under the requirements discussed in paragraph 4. This is supported by the recognition concept included in the Statement of Concepts.

7. This issue paper rejects the requirements of *SEC Staff Accounting Bulletin No. 73, Push-Down Basis of Accounting Required in Certain Limited Circumstances* (SAB 73). The subsidiary has no direct legal obligation and, therefore, SAB 73 is inconsistent with statutory accounting principles as described in the Statement of Concepts. Other than the instances described in paragraph 4, the only way funding can be provided by the reporting entity to the holding company is through the payment of dividends and these payments are restricted to the amounts approved by the state insurance departments for the purpose of providing protection of surplus. As a result, the holding company can not legally require the reporting entity to fund debt payments in excess of the allowable dividends.

Drafting Notes/Comments

None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. As discussed above, there is no current statutory guidance specifically related to this issue. The following disclosure requirements are outlined in the NAIC Annual Statement Instructions for Property and Casualty Companies - Notes to Financial Statements:

5. Information Concerning Parent, Subsidiaries and Affiliates
 - e. Describe guarantees or undertakings for the benefit of an affiliate which result in a material contingent exposure of the company's or any affiliated insurer's assets to liability, if not disclosed. Report the total amount of guarantees for affiliates.

9. Contingent Liabilities
 - a. Report briefly the nature of any material contingent liabilities including but not limited to: notes receivable discounted, reverse repurchase agreements, accounts and agents' balances assigned, accommodation paper, additional taxes, guarantees of liabilities of other companies (including companies that act as dealers in Over the Counter derivative instruments or as a Futures Commissions Merchant establishing of compensating balances, long-term contracts, loan take-out agreements and indemnification agreements, deferred expense contracts, structured settlements and arrangements between parents, subsidiaries or affiliates. Include in the disclosure: The date incurred or discovered; the nature of the contingent liability, contract, agreement or commitment; the amount or amounts, if known; the status as of the annual statement date; and all other information necessary for a full disclosure. Report the total amount of contingent liabilities.

The Annual Statement Instructions for Life and Accident and Health Companies contain similar requirements.

OTHER SOURCES OF INFORMATION

9. SAB 73 provides the following guidance:

Facts:

Company A (or Company A and related persons) acquired substantially all of the common stock of Company B in one or a series of purchase transactions.

Question 1:

Must Company B's financial statements presented in either its own or Company A's subsequent filings with the Commission reflect the new basis of accounting arising from Company A's acquisition of Company B when Company B's separate corporate entity is retained?

Interpretative Response:

Yes. The staff believes that purchase transactions that result in an entity becoming substantially wholly owned (as defined in Rule 1-02 (z) of Regulation S-X) establish a new basis of accounting for the purchased assets and liabilities.

When the form of ownership is within the control of the parent the basis of accounting for purchased assets and liabilities should be the same regardless of whether the entity continues to exist or is merged into the parent's operations. Therefore, Company A's cost of acquiring Company B should be "pushed down", i.e., used to establish a new accounting basis in Company B's separate financial statements.

Question 2:

What is the staff's position if Company A acquired less than substantially all of the common stock of Company B or Company B had publicly held debt or preferred stock at the time Company B became wholly owned?

Interpretative Response:

The staff recognizes that the existence of outstanding public debt, preferred stock or a significant minority interest in a subsidiary might impact the parent's ability to control the form of ownership. Although encouraging its use, the staff generally does not insist on the application of push down accounting in these circumstances. [Added by SAB No. 54, 11/3/83]

Question 3:

Company A borrows funds to acquire substantially all of the common stock of Company B. Company B subsequently files a registration statement in connection with a public offering of its stock or debt. Should Company B's new basis ("push down") financial statements include Company's A debt related to its purchase of Company B?

Interpretative Response:

The staff believes that Company A's debt, related interest expense and allocable debt issue costs should be reflected in Company B's financial statements included in the public offering (or an initial registration under the Exchange Act) if: (1) Company B is to assume the debt of Company A, either presently or in a planned transaction in the future; (2) the proceeds of a debt or equity offering of Company B will be used to retire all or a part of Company A's debt; or (3) Company B guarantees or pledges its assets as collateral for Company A's debt.

Other relationships may exist between Company A and Company B, such as the pledge of Company B's stock as collateral for Company A's debt. While in this latter situation, it may be clear that Company B's cash flows will service all or part of Company A's debt, the staff does not insist that the debt be reflected in Company B's financial statements providing there is full and prominent disclosure of the relationship between the Companies A and B and the actual or potential cash flow commitment. In this regard, the staff believes that Statements of Financial

Accounting Standards Nos. 5 and 57 requires sufficient disclosure to allow users of Company B's financial statements to fully understand the impact of the relationship on Company B's present and future cash flows. Rule 4-08(e) of Regulation S-X (17 CFR 210.4-08(e)) also requires disclosure of restrictions which limit the payment of dividends. Therefore, the staff believes that the equity section of Company B's balance sheet and any pro forma financial information and capitalization tables should clearly disclose that this arrangement exists.⁽⁴⁾

Regardless of whether the debt is reflected in Company B's financial statements, the notes to Company B's financial statements should generally disclose, at a minimum: (1) the relationship between Company A and Company B; (2) a description of any arrangements that result in Company B's guarantee, pledge of assets or stock, etc. that provides security for Company A's debt; (3) the extent (in the aggregate and for each of the five years subsequent to the date of the latest balance sheet presented) to which Company A is dependent on Company B's cash flows to service its debt and the method by which this will occur; and (4) the impact of such cash flows on Company B's ability to pay dividends or other amounts to holders of its securities.

Additionally, the staff believes Company B's Management's Discussion and Analysis of Financial Condition and Results of Operations should discuss any material impact of the servicing of Company A's debt on its own liquidity pursuant to Item 303(a)(1) of Regulations S-K (17 CFR 229.303(a)(1)). (Added by SAB No. 73, 12/30/87.)

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 8—Accounting for Pensions*
- *Issue Paper No. 11—Compensated Absences*
- *Issue Paper No. 13—Employers' Accounting for Postemployment Benefits*
- *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- SEC Staff Accounting Bulletin No. 73