

## Statement of Statutory Accounting Principles No. 46

### Investments in Subsidiary, Controlled, and Affiliated Entities

#### STATUS

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## Investments in Subsidiary, Controlled, and Affiliated Entities

### SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in subsidiaries, controlled, and affiliated entities (hereafter referred to as SCA entities).

### SUMMARY CONCLUSION

#### Definitions

2. Parent and subsidiary are defined as follows:

- a. Parent—An entity that directly or indirectly owns and controls the reporting entity;
- b. Subsidiary—An entity that is, directly or indirectly, owned and controlled by the reporting entity.

3. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48). Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments.

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

5. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*, provides guidance on determining when such evidence exists. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

6. Investments in SCA entities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

### Applying the Market Valuation, Statutory Equity and GAAP Equity Methods

7. The admitted investments in SCA entities shall be recorded using a market valuation approach (as described in paragraph 7.a.), or equity methods (as described in paragraph 7.b.). Once the reporting entity elects to use a valuation approach for a particular subsidiary, the reporting entity cannot change the valuation method to another method without the approval of the domiciliary commissioner.

- a. In order to use the market valuation approach for SCA entities, the following requirements apply:
  - i. The subsidiary must be traded on one of the following three major exchanges: (1) the New York Stock Exchange, (2) the American Stock Exchange, or (3) the NASDAQ National exchange;
  - ii. The reporting entity must submit subsidiary information to the Securities Valuation Office (SVO) for their calculation of the subsidiary's market value. Such calculation could result in further discounts in market value above the established base discounts based on ownership percentages detailed below;
  - iii. Ownership percentages for determining the discount rate shall be measured at the holding company level;
  - iv. If an investment in a SCA results in an ownership percentage between 10% and 50%, a base discount percentage between 0% and 20% on a sliding scale basis is required;
  - v. If an investment in a SCA results in an ownership percentage greater than 50% up to and including 80%, a base discount percentage between 20% and 30% on a sliding scale basis is required;
  - vi. If an investment in a SCA results in an ownership percentage greater than 80% up to and including 85%, a minimum base discount percentage of 30% is required. Further, the SCA must have at least two million shares outstanding, with a total market value of at least \$50 million in the public's control; and
  - vii. Any ownership percentages exceeding 85% will result in the SCA being recorded on an equity method.
- b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 7.a. or, if the requirements are met, but a reporting entity elects not to use that approach, investments in SCAs shall be recorded as follows:
  - i. Investments in insurance SCA entities shall be recorded based on the underlying statutory equity of the respective entity's financial statements, adjusted for unamortized goodwill as provided for in *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68).
  - ii. Investments in noninsurance SCA entities that have no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded based on the underlying equity of the respective entity's financial statements adjusted to a statutory basis of accounting and the resultant proportionate share of the subsidiary's adjusted surplus, adjusted for unamortized goodwill as provided for in SSAP No. 68. Examples include but are not limited to: (i) an insurer and a SCA entity that leases autos, furniture, office equipment, or computer equipment to the insurer; (ii) an insurer and a SCA entity that owns real estate property that is leased to the insurer for office space; and (iii) an insurer and an SCA entity that holds investments that an insurer could acquire directly (i.e., "look through" investment subsidiary);

- iii. Investments in noninsurance SCA entities that have significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates shall be recorded based on the audited GAAP equity of the investee. Examples include but are not limited to: (i) a property-casualty or life insurer and a SCA entity that is an oil and gas venture; and (ii) a property-casualty insurer or life insurer and a SCA manufacturer.

8. This statement requires that investments for noninsurance SCA entities that have no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, and that do not qualify for the market valuation approach outlined in paragraph 7.a. or for which the reporting entity does not elect that approach, shall be recorded based on their underlying equity adjusted to a statutory basis of accounting. In applying the provisions of this statement to noninsurance SCA entities, the focus is on the primary operations of the SCA for purposes of determining if it is required to be accounted for under subparagraph 7.b.ii. Entities whose primary operations do not provide services to the insurance industry fall under provisions of subparagraph 7.b.iii. It is not the intent of subparagraph 7.b.ii. to apply to an affiliate which has insignificant transactions within the insurance industry. This rule requires judgment by the reporting entity in making the determination and provides flexibility to the regulator in analyzing the determination.

9. For investments in entities recorded based on the underlying audited GAAP equity of the investee, the amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in SSAP No. 68). The carrying amount of the investment shall be adjusted to recognize the reporting entity's share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. A reporting entity's share of adjustments that are recorded directly to the investee's stockholder's equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded directly to unrealized capital gains and losses on investments.

10. The statutory equity method as described in subparagraph 7.b.i. shall be applied by recording an initial and subsequent investment in an investee at cost, which is defined in SSAP No. 68 as the sum of (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. After the date of acquisition, the investment amount shall be adjusted for the amortization of goodwill and the reporting entity's share of the change in special surplus funds, other than special surplus funds and unassigned funds (surplus), as defined in *SSAP No. 72—Surplus and Quasi-Reorganizations*. This represents the carrying amount of the investment.

11. To apply the equity method of accounting to investees as described in subparagraph 7.b.ii., certain adjustments shall be made to GAAP (or other basis) income to determine the reporting entity's share of the investee's statutory earnings and losses and other changes in surplus. Further guidance on recording the initial investment (including goodwill and negative goodwill) and other aspects of applying the equity method are discussed in paragraph 13.

12. If the reporting entity is using an equity method, the reporting entity's share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity's share of other changes in the investee's surplus (e.g., the change in the investee's nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. If the reporting entity uses the market valuation approach outlined in paragraph 7.a., changes in that valuation shall be included in unrealized gains and losses. Dividends or distributions received from an investee shall be recognized in investment income when declared to the extent that they are not in excess of the undistributed accumulated earnings attributable to the investee. Dividends or distributions declared in excess of the undistributed accumulated earnings attributable to the investee shall reduce the carrying amount of the investment.

13. The procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 7.b.i. through 7.b.iii.), as applicable, to investments in SCA entities:

- a. A difference between the cost of an investment and the underlying equity in the statutory book value (GAAP book value if a noninsurance SCA entity that has significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates) of the acquired company at the date of acquisition shall be accounted for in accordance with SSAP No. 68;
- b. A transaction of an investee of a capital nature that affects the reporting entity's share of stockholders' equity of the investee shall be reflected as an unrealized gain or loss (e.g., where the investee issues additional stock or a new class of stock that impacts the reporting entity's equity ownership in the investee, the reporting entity's recorded investment shall be adjusted to reflect the transaction);
- c. Realized gains or losses on the sale of an investment in a SCA entity shall be recorded in an amount equal to the difference at the time of sale between the selling price and carrying amount of the investment plus any previously recorded unrealized gain or loss;
- d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period;
- e. A reporting entity's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;
- f. When an investee has outstanding cumulative preferred stock, the reporting entity shall compute its share of earnings (losses) after deducting the investee's preferred dividends, whether or not such dividends are declared;
- g. An investment in a SCA entity may fall below the level of ownership described in paragraph 4 from the sale of a portion of an investment by the reporting entity, the sale of additional interests by an investee, or other transactions. The reporting entity shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for an equity method. The earnings or losses that relate to the investment interests retained by the reporting entity and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this subparagraph. However, dividends received by the investor in subsequent periods which exceed the reporting entity's share of earnings for such periods shall be applied as a reduction of the carrying amount of the investment;

- h. An investment in a SCA entity that was previously accounted for under one method may become qualified for use of another method (as prescribed in paragraph 7) because of a change in the level of ownership (i.e., acquisition of additional interests by the reporting entity, acquisition or retirement of interests by the investee, or other transactions, or a change in facts or circumstances (e.g., paragraphs 7.a.i., 7.a.viii.)). When an investment qualifies for use of another method of accounting, the reporting entity shall adopt the new method of accounting and the investment shall be adjusted to reflect the reporting entity's equity interest in the SCA entity under the new method. A corresponding amount shall be recorded as an unrealized gain or loss.
14. A reporting entity that owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent shall reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by a reporting entity, via a downstream SCA entity, the directly held entity, which owns the parent's shares, shall have its value reduced for the reciprocal ownership.
15. Any parent reporting entity that owns an interest in itself via either direct or indirect ownership of a down-stream affiliate, which in turn owns shares of the parent reporting entity, shall eliminate its proportionate interest in these shares from the valuation of such affiliate.

### **Impairment**

16. When there is a decline in the fair value of an asset owned by a SCA entity that is other than temporary, the SCA entity shall write the asset down to fair value.
17. For any decline in the fair value of an investment in a SCA entity that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

### **Consolidation**

18. Majority-owned subsidiaries shall not be consolidated for individual entity statutory reporting. This does not exempt certain reporting entities that are members of an affiliated group from the requirement to issue consolidated or combined annual statements as supplemental information in accordance with NAIC guidelines.

### **Disclosures**

19. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. The following disclosures shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:
- a. Financial statements of a reporting entity shall disclose (i) the name of each SCA entity and percentage of ownership of common stock, (ii) the accounting policies of the reporting entity with respect to investments in SCA entities, and (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying

equity in net assets (i.e., goodwill, other nonadmitted assets, market value or discounted market value adjustments) and the accounting treatment of the difference;

- b. For those SCA entities for which a quoted market price is available, the aggregate value of each SCA investment based on the quoted market price and the difference, if any, between the amount at which the investment is carried and the quoted market price shall be disclosed;
- c. Summarized information as to assets, liabilities, and results of operations shall be presented for SCA entities, either individually or in groups; and
- d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances shall be disclosed in notes to the financial statements of the reporting entity.

20. Any commitment or contingent commitment to a SCA entity shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

21. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment writedown:

- a. A description of the impaired assets and the facts and circumstances leading to the impairment; and
- b. The amount of the impairment and how fair value was determined.

22. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 19.d. above shall be included in the annual audited statutory financial reports only.

### Relevant Literature

23. This statement adopts the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*.

24. This statement adopts *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18* as guidance to be considered in determining the existence of control.

25. This statement rejects *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, AICPA Accounting Interpretations, The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretations of APB Opinion No. 18, FASB Technical Bulletin No. 79-19, Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee, FASB Emerging Issues Task Force No. 87-21, Change of Accounting Basis in Master Limited Partnership Transactions, and FASB Emerging Issues Task Force No. 96-16, Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*.

### Effective Date and Transition

26. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Correction of Errors*.

**AUTHORITATIVE LITERATURE****Statutory Accounting**

- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*

**Generally Accepted Accounting Principles**

- *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*

**RELEVANT ISSUE PAPERS**

- *Issue Paper No. 1—Consolidation of Majority-owned Subsidiaries*
- *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*