Statutory Issue Paper No. 25

Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

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Type of Issue: Common Area

SUMMARY OF ISSUE

1. Transactions with affiliates and other related parties are entered into in the ordinary course of

to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;

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Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

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balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or

Examples of transactions that would be deemed to be non-economic include, security swaps of similar issues between or among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities between or among affiliates.

Transactions Involving Services

- 18. Transactions involving services being provided by a related party may not be arm's-length. Amounts charged for services provided may not be at current market rates for such services or may be based on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party's books and expense on the second party's books and therefore do not lend themselves to the mere inflation of surplus. These arrangements may be subject to regulatory approval.
- 19. Transactions involving services provided between related parties shall be recorded at the amount charged. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, (d) or other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See *Issue Paper No. 94—Allocation of Expenses* for additional discussion regarding the allocation of expenses.

Disclosure

- 20. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm's length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:
 - a. The nature of the relationships involved;
 - b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, and any non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:
 - 1. Date of transaction,
 - 2. Explanation of transaction,
 - 3. Name of reporting entity,
 - 4. Name of affiliate.
 - 5. Description of assets received by reporting entity,
 - 6. Statement value of assets received by reporting entity.
 - 7. Description of assets transferred by reporting entity, and
 - 8. Statement value of assets transferred by reporting entity.
 - c. The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;
 - d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;

- e. Any guarantees or undertakings, written or otherwise, for the benefit of an affiliate or related party which result in a material contingent exposure of the reporting entity's or any related party's assets or liabilities;
- f. A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity's financial statements;
- g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises.
- h. The amount deducted from the value of an upstream intermediate company or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated company, in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, "Procedures for Valuing Common Stocks and Stock Warrants."

DISCUSSION

- This issue paper adopts FASB Statement No. 57, Related Party Disclosures (FAS 57) with a 21. modification to paragraph 2, to require disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business. It expands the current statutory guidance on accounting and disclosure of transactions with affiliates to include all material related party transactions whereas current statutory guidance requires disclosures for transactions with affiliates, a more narrowly defined group. This modification was made because the nature of dealings with any related party can not be assumed to be at arm's length. The current statutory guidance with respect to accounting for transfers of assets between affiliates that are considered to be non-economic transactions (generally at lower of cost or market) differs from the GAAP guidance for accounting for transfers and exchanges between companies under common control. Current statutory guidance is considered appropriate because of the need to focus on individual reporting entities and the needs of individual states to monitor the obligations of individual reporting entities. GAAP guidance is established in Accounting Interpretations of APB Opinion No. 16, #39, Transfers and Exchanges Between Companies Under Common Control (AIN-APB 16, #39), which requires transfers and exchanges to be at historical cost similar to that in pooling of interests accounting. As a result, this issue paper rejects AIN-APB 16, #39. The complete requirements under current statutory quidance and FAS 57 are included in the Relevant Statutory Accounting and GAAP Guidance section below.
- 22. This issue paper adopts the current statutory guidance with respect to accounting for transfers of assets between affiliates and further expands that guidance to include all transactions (including transactions which relate to the transfer of liabilities) with related parties. It also replaces the 30 day rule by requiring the reversal of any gain or loss recognized on a transaction that subsequently does not meet the appearance of permanence. This issue paper also requires any net increase in the surplus of a parent reporting entity that results from transactions between affiliates where there is no demonstrable and measurable betterment to the parent company reporting entity other than the mere inflation of surplus to be reported as a deferred gain and shall not be recognized by the parent reporting entity until an arms length transaction with a third party gives rise to the recognition.

- This issue paper adopts current statutory guidance with modification to recognize loans made to a 23. reporting entity's parent or principal owner as an admitted asset if regulatory approval for the transaction has been obtained and the loan appears to be collectible based on the parent's independent ability to pay. Commissioner approval is considered necessary as an additional independent evaluation of such loans or advances due to the highly sensitive nature of such transactions and the significant potential for abuse. This independent evaluation is considered necessary to determine the admissibility of such loans or advances because a reporting entity could be induced by its parent or principal owner to enter into a loan or advance that it would not otherwise consider. Additionally, advances to providers under capitation arrangements that exceed one month's payment shall be nonadmitted. Loans to all other related parties shall be nonadmitted if they do not meet the criteria of an arm's length transaction. Current statutory accounting requires disclosures to include a description of related party transactions as well as other information necessary to obtain an understanding of the transaction. Subparagraph 20 b amends the exclusion to this requirement from non-insurance transactions which involve less than 1/2% of 1% of the total assets of the largest affiliated reporting entity to non-insurance transactions which involve less than 1/2% of 1% of the total admitted assets of the reporting entity.
- 24. The accounting and disclosure requirements adopted by the conclusion above are consistent with the Statement of Concepts which states:

Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

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

25. Additionally, such disclosures provide the statutory financial statement user information necessary in evaluating a reporting entity's statutory financial position and results of operations and in assessing the reporting entity's dependence on such relationships to continue operations.

Drafting Notes/Comments

- Accounting for investments in subsidiaries is addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.*
- Accounting for business combinations is addressed in *Issue Paper No. 68—Business Combinations and Goodwill*.
- Accounting for holding company obligations are addressed in *Issue Paper No. 95—Holding Company Obligations*.
- Accounting and disclosures for related party reinsurance transactions are addressed in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance* and *Issue Paper No. 75—Property and Casualty Reinsurance*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

26. The NATC Annual Statement Instructions for Life and Accident and Health Insurance Companies (Annual Statement Instructions) provide the following guidance with respect to reporting information on transactions with affiliates in the notes to the financial statements:

Instruction:

a. If the company is directly or indirectly owned or controlled by any other company, corporation, group of companies, partnership or individual, give full particulars.

b. List and describe transactions by the company or any affiliated insurer with any affiliate. Exclude reinsurance transactions, any non-in

If the insurer is both a payor and a recipient of amounts in any category, the net of these amounts should be reported on one line. Amounts of transactions that result in an increase in surplus should be shown as positive figures and transactions that result in a decrease in surplus should be reported enclosed in parentheses.

If the nature of the transactions reported in Part 2 require explanation, report such in an explanatory note immediately following Part 2.

- 29. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies contain guidance substantially consistent with paragraphs 26 to 28 above.
- 30. The NAIC Annual Statement Instructions for Health Maintenance Organizations contain guidance substantially consistent with paragraphs 26 to 28 above.
- 31. The Introduction to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies provides the following definition of terms used in connection with transactions with affiliates:

"Arm's-length" Transactions

An "arm's-length" transaction can be defined as a transaction in which a willing buyer and a willing seller, each being reasonably aware of all relevant facts and neither under compulsion to buy or sell, would be willing to participate.

"Affiliate"

An "affiliate" of, or person "affiliated" with a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

"Control"

The term "control" (including the terms "controlling by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies, representing 10% or more of the voting securities of any other person.

32. The Introduction to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies provides the following guidance with respect to accounting for assets transferred between affiliates:

Accounting for Assets Transferred Between Affiliates

Economic vs. Non-economic Gains

An economic transaction is an arm's-length transaction which results in the transfer of risks and rewards of ownership and represents a consumma

for the purpose of the inflation (deflation) of a particular company's financial statements including effects on the balance sheet or income statement.

Transfer of risks and rewards of ownership - "determining that the risks and other incidents of ownership have been transferred to the buyer requires an examination of the underlying facts and circumstances. The following circumstances may raise the question about the transfer of risks:

- 1. A continuing involvement by the seller in the transaction or in the assets transferred, such as through the exercise of managerial authority to a degree usually associated with ownership, perhaps in the form of a remarketing agreement or a commitment to operate the property.
- 2. Absence of significant financial investment by the buyer in the asset transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer.
- 3. Repayment of debt that constitutes the principal consideration in the transaction dependent on the generation of sufficient funds from the asset transferred.
- 4. Limitations or restrictions on the purchaser's use of the asset transferred or on the profits from it.
- 5. Retention of effective control of the asset by the seller.

The first three items on the list are suggested by the Securities Exchange Commission Staff Accounting Bulletin 30; the last two are found in SEC Accounting Series Release No. 95, "Accounting for Real Estate Transactions where circumstances indicate that profits were not earned at the time the transactions were recorded".*

*(Note: From the Accountants' Handbook, 6th edition, Vol. 1, edited by Lee J. Seidler and D. R. Carmichael)

Security swaps of similar issues between or amongst affiliated companies would be considered as a non-economic transaction. Swaps of dissimilar issues accompanied by exchanges of liabilities between or amongst affiliates are considered non-economic transactions.

The appearance of permanence is also an important criterion in establishing the economic substance of a transaction. If subsequent events or transactions reverse the effect of an earlier transaction, the question is raised as to whether economic substance existed in the case of the original transaction. Basically, in order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed.

It is important to note that in today's environment, where many of the transactions are complex and involve great uncertainty, it will be necessary to exercise professional judgment in the evaluation of whether economic substance exists as it is not possible to establish detailed guidelines sufficient to cover the realm of all possible transactions.

In the case of any gain from transfer of securities or other assets to an affiliate where it appears that, within a period beginning 30 days before the date of such transfer and ending 30 days after such date, the company has acquired by transfer from an affiliate, or has entered into a contract or option to acquire, substantially identical securities or assets, then no gain on the transfer to the affiliate shall be recognized in the Annual Statement.

The following is the exception to the 30-day rule:

- Swaps of repurchased securities. The agreements must be formalized in writing and provide adequate collateral as defined by either statute or security valuation manual.
- 2. Gains on transfers which involve real estate will not be recognized if transferred back or repurchased within an 18-month period.

General Accounting Guidelines

When accounting for a specific transaction, the following valuation methods should be used. If the transaction involves the transfer of assets not covered by the attached [table] then the following general guidelines should be used:

- Economic based transfers between affiliates should be recorded at prevailing fair market values at the date of the transfer.
- Non-economic based transfers between affiliated insurers should be recorded at the lower of existing book values or prevailing fair market values at the date of transfer.
- Non-economic based transfers between an insurer and a non-insurance affiliate should be recorded at the prevailing fair market value at the date of transfer; however, to the extent that the transfer results in a gain, that gain should be deferred until such time as permanence can be verified.
- Transactions which are designed to avoid statutory accounting practices shall be
 included as if the insurer continued to own the assets directly instead of through
 a subsidiary. Therefore, the assets of a subsidiary will be valued as they would
 constitute lawful investments for the insurer if acquired or held by the insurer.
 (e.g., transaction dealing with agents' balances, furniture and equipment.)
- Assets may be valued on a different basis if held by a life insurer versus a property and casualty insurer; therefore, a regulator must take this into

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| 5. | <u>Transfer of Loans or Loan Participations</u> | | | | | |
|-----|--|--|------------|--|--|--|
| | a. Appreciated | Cost | Market | | | |
| | b. Depreciated | LCM | Market | | | |
| 6. | Intercompany Loans | LCM (2) | Market (2) | | | |
| 7. | Sale/Leaseback | Cost/LCM (3) | Market | | | |
| 8. | Reverse Repurchase Agreements | LCM (2) | Market (2) | | | |
| 9. | Transfer of nonadmitted assets from an insurer to a non-insurer subsidiary | The value of the subsidiary must be adjusted and revalued as if the insurer held the assets. | Market (2) | | | |
| 10. | Transfer of Schedule BA asset | LCM | Market | | | |

NOTE: Cost = Book Value

- Assumes securities are in good standing or eligible for amortization, otherwise at market. Based on current market interest rates.
- (1) (2)

The description shall be in a manner as to permit the proper evaluation thereof by the Commissioner, and shall include at least the following: the nature and purpose of the transaction, the nature and amounts of any payments or transfers of assets between the parties, the identity of all parties to the transaction, and relationship of the affiliated parties to the registrant.

- 34. Section 5 of the Insurance Holding Company System Regulatory Act also contains the following quidance:
 - (2) The following transactions involving a domestic insurer and any person in its holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into the transaction at least thirty (30) days prior thereto, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period.
 - (a) Sales, purchases, exchanges, loans, extensions of credit, or investments, provided the transactions are equal to or exceed:
 - (i) With respect to nonlife insurers, the lesser of three percent (3%) of the insurer's admitted assets or twenty-five percent (25%) of surplus as regards policyholders as of the 31st day of December next preceding;
 - (ii) With respect to life insurers, three percent (3%) of the insurer's admitted assets as of the 31st day of December next preceding;
 - (b) Loans or extensions of credit to any person who is not an affiliate, where the insurer makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the insurer making the loans or extensions of credit.
- 35. The NAIC Model Law for HMO Investment Guidelines, contains the following:

Section 3. Excessive Commissions Prohibited—Interest of Officers and Directors.

- (2) No such HMO shall knowingly invest in or loan upon any property, directly or indirectly, whether real or personal, in which any officer or director of such HMO has a financial interest, nor shall any such HMO make a loan of any kind to any officer or director of such HMO, except that this Section shall not apply in circumstances where the financial interest of such officer or director is only nominal, trifling or so remote as not to give rise to a conflict of interest. In any case, the Director may approve a transaction between an HMO and its officers or directors under this Section if he is satisfied that (a) the transaction is entered into in good faith for the advantage and benefit of the company, and (b) the amount of the proposed investment or loan does not violate any other provision of this Article nor exceed the reasonable, normal value of the property or the interest which the HMO proposed to acquire, and that the transaction is otherwise fair and reasonable, and (c) the transaction will not adversely affect, to any substantial degree, the liquidity of the company's investments or its ability thereafter to comply with requirements of this Article or the payment of its claims and obligations.
- 36. The NAIC Financial Condition Examiners Handbook

Some examples of affiliates are:

- A company's affiliates
- Principal owners
- Management (including directors)
- Entities for which investments are accounted for by the equity method
- Pension and profit-sharing trusts managed by or under the trusteeship of management

An affiliate also includes any other person with which the reporting entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. A third person also is affiliated if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

b. Affiliated Transactions Defined

An affiliated transaction is any direct or indirect transaction between the reporting entity and an affiliate. Affiliated Transactions include transactions between:

- A parent company and its subsidiaries
- Subsidiaries of a common parent
- The reporting entity and:
 - (1) Other affiliated businesses
 - (2) Management (including directors)
 - (3) Principal owners
 - (4) Pension and profit-sharing trusts managed by or under the trusteeship of management
 - (5) Other parties having the ability to exert significant influence

Generally Accepted Accounting Principles

37. FAS 57 provides the fo7r32856(The reporting enti22/ profit-sharing trusts) an / 0 0 10.9

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STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Disclosures

2. Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements.² The disclosures shall include:³

a. The nature of the relationship(s) involved

- b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
- c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
- d. Amounts due from or to related parties

² The requirements of this Statement are applicable to separate financial statements of each or combined groups of each of the following: a parent company, a subsidiary, a corporate joint venture, or a 50-percent-orless owned investee. However, it is not necessary to duplicate disclosures in a set of separate financial statements that is presented in the financial report of another enterprise (the primary reporting enterprise) if those separate financial statements also are consolidated or combined in a complete set of financial statements and both sets of financial statements are presented in the same financial report.

³ In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed.

- Insurance Holding Company System Regulatory Act
- Model Law for HMO Investment Guidelines
- NAIC Financial Condition Examiners Handbook, Section I, Part IV, Conducting Examinations

Generally Accepted Accounting Principles

- FASB Statement No. 57, Related Party Disclosures
- EITF 84-39, Transfers of Monetary and Nonmonetary Assets among Individuals and Entities under Common Control (Not a consensus opinion)
- EITF 85-21, Changes of Ownership Resulting in a New Basis of Accounting (Not a consensus opinion)
- Accounting Interpretations of APB Opinion No. 16, #39, Transfers and Exchanges Between Companies Under Common Control

State Regulations

- Wisconsin Administrative Code Ins. 3.50