Statutory Issue Paper No. 25

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

STATUS
Finalized June 23, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 25

Type of Issue:
Common Area

SUMMARY OF ISSUE

Transactions Involving Services

Issue
Paper No. 94—Allocation of Expenses

Disclosure

Purposes and Procedures Manual of the NAIC Securities Valuation Office

DISCUSSION

FASB Statement No. 57 Related Party Disclosures

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APB Opinion No. 16, #39 Transfers and Exchanges Between Companies Under Common Control

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.

Drafting Notes/Comments

Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities

Issue Paper No. 68—Business Combinations and Goodwill

Issue Paper No. 95—Holding Company Obligations

Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance

Issue Paper No. 75—Property and Casualty Reinsurance

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

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.

“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.

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:

1. 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 a r s

5.	Transfer of Loans or Loan Participations		
	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

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

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.

(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.

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.

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

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]

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[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-or-less 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.

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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

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

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