

**Statutory Issue Paper No. 48**

**Investments in Joint Ventures, Partnerships and Limited Liability Companies**

**STATUS**

**Finalized March 16, 1998**

7. A limited liability company shall be defined as a form of business organization which is a hybrid of a corporation and partnership whereby the owners have limited liability like a corporation and profits may pass through to the owners for tax purposes like a partnership if certain criteria are met. The owner's personal liability is limited to his own acts and the owners can fully participate in the management of the business with no adverse impact on their limited liability.

8. Investments in the ventures which are defined in paragraphs 5 through 7 meet the definition of assets defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this paper. Investments in joint ventures, partnerships and limited liability companies shall be included in Other Invested Assets in the financial statements.

9. Investments in such ventures, except for limited partnerships with a minor ownership interest, shall be reported using an equity method as defined in paragraphs 7 through 13 of *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities* (Issue Paper No. 46). Limited partnerships in which the entity has a minor ownership interest (i.e., less than 10%) shall be 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 paragraph 7 of *Issue Paper No. 68—Business Combinations and Goodwill*). 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 distributions 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 to unrealized capital gains and losses on investments. 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. Distributions received from an investee shall be recognized in investment income when declared to the extent they are not in excess of the undistributed accumulated earnings attributable to the investee. If distributions declared exceed the investor's share of undistributed accumulated earnings after the date of the investment, this excess portion of the distribution shall be applied to reduce the carrying value of the investment.

### **Impairment**

10. For any decline in the fair value of an investment in a joint venture, partnership or limited liability company which is determined to be 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. This is consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*. 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. Even if the fair value of an investment is below the carrying amount it is not necessarily indicative of a loss in value that is other than temporary. Similarly the existence of investee operating losses may indicate a loss in value; however, it is not necessarily indicative of a loss in value that is other than temporary. All factors shall be considered in determining whether a loss in value is other than temporary.

### **Disclosures**

11. 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. Disclosures as follow shall be made for all investments in joint ventures,

partnerships, or limited liability companies that exceed 10% of the total admitted assets of the reporting entity:

- a. Financial statements of a reporting entity shall disclose (1) the name of each joint venture, partnership or limited liability company and percentage of ownership, (2) the accounting policies of the reporting entity with respect to investments in joint ventures, partnerships and limited liability companies and (3) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., nonadmitted goodwill or other nonadmitted assets) and the accounting treatment of the difference.
  - b. For those joint ventures, partnerships and limited liability companies for which a quoted market price is available, the aggregate value of each joint venture, partnership or limited liability company investment based on the quoted market price shall be disclosed.
  - c. Summarized information as to assets, liabilities, and results of operations shall be presented for joint ventures, partnerships and limited liability companies either individually or in groups.
12. Any commitment or contingent commitment to a joint venture, partnership or limited liability company shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).
13. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write down:
- a. A description of the impaired assets and the facts and circumstances leading to the impairment.
  - b. The amount of the impairment and how fair value was determined.

## DISCUSSION

14. The statutory accounting principles described in paragraphs 8 through 13 above are consistent with current statutory accounting except as follows:
- Current statutory accounting guidance addresses accounting for investments in partnerships and joint ventures but does not address accounting for investments in limited liability companies.
  - Current statutory accounting guidance does not address accounting or disclosures for other than temporary impairments .
  - Current statutory accounting guidance allows the reporting entity's equity in the net earnings of the investee to be recorded, in certain situations, as net investment income.
15. The statutory accounting principle described in paragraph 9 above is inconsistent with the GAAP promulgated in paragraph 17 of APB 18 which specifies "an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. APB 18 is addressed in its entirety and rejected in Issue Paper No. 46. The related interpretation of APB 18, AIN APB 18, is also rejected.
16. The statutory accounting principles referred to in paragraph 9 above with respect to limited partnerships with a minor interest are inconsistent with GAAP guidance described in paragraph 8 of *AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures (SOP 78-9)*,



One investment alternative for insurers is the partnership or joint venture with equity interest in real estate, securities, petroleum and other assets. Real estate partnerships or joint ventures are the most predominant and include investments in apartment complexes, office buildings, shopping centers, mass housing projects, condominiums, and land purchases and sales.

A typical venture will be between partners who offer capital or expertise, or both, to invest in the undertaking. In such a venture, the partners usually are an insurance company (which provides the equity) and a developer (who provides the technical skill and performs the actual work).

The investment made by the insurance company can be the equity investment in the property being developed and/or the permanent financing of the venture (a mortgage loan). The equity investment is returned to the company through its share of cash contributions.

Each venture must maintain its own accounting records that report venture assets, liabilities, partnership equities, and operating income in conformity with generally accepted accounting principles. These are accounting records of the venture and not of the insurance company.

The accounting of a partnership or joint venture is similar to statutory accounting for a subsidiary on the equity method. (See Chapter 6.) Under the equity method of accounting the investment is carried in the balance sheet at the amount invested, plus the investing company's share of undistributed operating results.

There are three types of transactions affecting the insurance company's equity investment in the venture. These are:

1. The actual investment, which is the original contribution to the venture, plus any subsequent contributions;
2. Appreciation or depreciation of the investment, which is the company's share of the GAAP basis net income or loss of the venture;
3. Withdrawals of the company's share of the cash flow that is generated by the operations of the venture.

The partnership agreement designates the percentage of distribution of net income and cash flow between the partners. An insurance company's share of the GAAP net earnings (or losses) of the partnership are reported as investment income in the insurer's statutory financial statements. The second half of the accounting entry involved is to increase (or decrease) the book value of the partnership. Book value also represents the admitted value reported in the statutory financial statement and may be a negative amount. Cash distributions received reduce the company's investment (book value) directly and are not reflected as income except where earnings have not been previously reported.

The most recent financial statements of the partnership should generally be used by an investor to apply the equity method. When a lag in reporting exists, intervening events materially affecting the financial position or results of operations of the partnership should be analyzed to determine whether or not the financial statements of the investment should be adjusted. Reporting should be consistent from period to period. If the method of partnership accounting for tax purposes varies with the accounting for financial reporting purposes, it is necessary that a venture maintain separate accounting records for the areas of difference.

Any contingent commitment to a partnership or joint venture shall be disclosed in the Notes to Financial Statements of the annual statement.

20. The NAIC Annual Statement Instructions provide the following guidance:

**SCHEDULE BA OTHER LONG-TERM INVESTED ASSETS OWNED**

**PARTS 1, 2, AND 3**

Include only those classes of invested assets not clearly or normally includable in any other invested asset schedule. Give a detailed description of each investment and the underlying security. If an asset is to be recorded in Schedule BA, which is normally reported in one of the other invested asset schedules, make full disclosure in Column 1 or a footnote of the reason for

Include: Fixed income instruments that are not corporate or governmental unit obligations (Schedule D) or secured by real property (Schedule B).

Joint Ventures or Partnership Interests for which the primary underlying investments are considered to be:

Fixed Income Instruments

Include: Leveraged Buy-out Fund

## DISCUSSION

5. Investments are sometimes held in stock of companies other than subsidiaries, namely corporate joint ventures and other noncontrolled corporations. These investments are usually accounted for by one of two methods—the cost method or the equity method. While practice varies to some extent, the cost method is generally followed for most investments in noncontrolled corporations, in some corporate joint ventures, and to a lesser extent in unconsolidated subsidiaries, particularly foreign. The equity method is generally followed for investments in unconsolidated domestic subsidiaries, some corporate joint ventures and some noncontrolled corporations. An adaptation of the cost method, the lower of cost or market, has also been followed for investments in certain marketable securities if a decline in market value is evidently not a mere temporary condition.
6. A summary of the two principal methods of accounting for the investments in common stock discussed in this Opinion follows:
- a. The cost method. An investor records an investment in the stock of an investee at cost, and recognizes as income dividends received that are distributed from net accumulated earnings of the investee since the date of acquisition by the investor. The net accumulated earnings of an investee subsequent to the date of investment are recognized by the investor only to the extent distributed by the investee as dividends. Dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are recorded as reductions of cost of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred which is other than temporary and should accordingly be recognized.
  - b. The equity method. An investor initially records an investment in the stock of an investee at cost, and adjusts the carrying amount of the investment to recognize the investor's share of the earnings or losses of the investee after the date of acquisition. The amount of the adjustment is included in the determination of net income by the investor, and such amount reflects adjustments similar to those made in preparing consolidated statements including adjustments to eliminate intercompany gains and losses, and to amortize, if appropriate, any difference between investor cost and underlying equity in net assets of the investee at the date of investment. The investment of an investor is also adjusted to reflect the investor's share of changes in the investee's capital. Dividends received from an investee reduce the carrying amount of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred which is other than temporary and which should be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method.
7. Under the cost method of accounting for investments in common stock, dividends are the
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13. Some hold the view that neither the market value method nor the equity method is appropriate accounting for investments in common stock where the investor holds less than majority ownership of the voting stock. They would account for such investments at cost. Under that view the investor is not entitled to recognize earnings on its investment until a right to claim the earnings arises, and that claim arises only to the extent dividends are declared. The investor is considered to have no earnings on its investment unless it is in a position to control the distribution of earnings. Likewise, an investment or an investor's operations are not affected by losses of an investee unless those losses indicate a loss in value of the investment that should be recognized.

#### OPINION

17. The Board concludes that the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor. The Board recognizes that determining the ability of an investor to exercise such influence is not always clear and applying judgment is necessary to assess the status of each investment. In order to achieve a reasonable degree of uniformity in application, the Board concludes that an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. When the equity method is appropriate, it should be applied in consolidated financial statements and in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity.<sup>7</sup>

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<sup>7</sup> The equity method should not be applied to the investments described in this paragraph insofar as the limitations on the use of the equity method outlined in footnote 4 would be applicable to



minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate. Under the cost method, income recognized by the investor is limited to distributions received, except that distributions that exceed the investor's share of earnings after the date of the investment are applied to reduce the carrying value of the investment. Also, differences between income or losses recognized for financial reporting purposes and the investor's share of taxable income or losses should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

.09 The rights and obligations of the general partners in a limited partnership are different from those of the limited partners. Some believe that general partners should be deemed to have the controlling interest in a limited partnership. However, if limited partners have important rights, such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, the partnership may not be under the control, directly or indirectly, of the general partnership interests. The division believes that the general partners are in control and should account for their investments in accordance with the recommendations in paragraph .07 only if the substance of the partnership or other agreements provides for control by the general partners.

.10 The division believes that if the substance of the partnership arrangement is such that the general partners are not in control of the major operating and financial policies of the partnership, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total partnership interest. A controlling limited partner should be guided in accounting for its investment by the principles for investments in subsidiaries. Noncontrolling limited partners should account for their investments by the equity method and should be guided by the provision of paragraph 19 of APB Opinion 18, as discussed in paragraphs .06 and .07, or by the cost method, as discussed in paragraph .08, as appropriate.

## RELEVANT LITERATURE

### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 6, *Investments in Subsidiary, Controlled or Affiliated Companies*, Chapter 8, *Other Admitted Assets*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 6, *Investments in Subsidiary, Controlled or Affiliated Companies*, Chapter 8, *Other Admitted Assets*
- NAIC Annual Statement Instructions, Schedule BA
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
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