

Statutory Issue Paper No. 118

Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46

STATUS

Finalized December 9, 2002

Original SSAP and Current Authoritative Guidance: SSAP No. 68 and SSAP No. 97

Type of Issue:

Common Area

1. The purpose of this issue paper is to establish statutory accounting principles for investments in subsidiaries, controlled and affiliated entities (hereinafter referred to as SCA entities) that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. This issue paper replaces the conclusions reached in *SSAP No. 46—Investments in Subsidiary, Controlled and Affiliated Entities* (SSAP No. 46) and nullifies the following interpretations of the Emerging Accounting Issues Working Group:

- a. INT 99-03 – Accounting for Investment in Subsidiary, Controlled or Affiliated Entities with Subsequent Downstream Investment in an Insurance Company
- b. INT 99-28 – Accounting for SCA Mutual Funds, Broker-Dealers and Similar Entities Under SSAP No. 46
- c. INT 00-01 – Investment in a Foreign SCA Entity
- d. INT 01-22 – Use of Interim Financial Statements in Computing Reporting Entity's Investment in Subsidiary Under the GAAP Equity Method (conclusion was incorporated into SSAP)
- e. INT 01-24 – Application of SSAP No. 46 and

5. 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.

6. 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.

7. 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.

8. 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 issue paper.

- iv. If an investment in a SCA results in

- (d) Loans to employees, agents, brokers, representatives of the reporting entity or SCA as described in *SSAP No. 20—Nonadmitted Assets*
- (e) Sale/lease or rental of automobiles, airplanes and other vehicles as described in *SSAP No. 20—Nonadmitted Assets*
- (f) Providing insurance services on behalf of the reporting entity including but not limited to accounting, actuarial, auditing, data processing, underwriting, collection of premiums, payment of claims and benefits, policyowner services
- (g) Acting as an insurance or administrative agent or an agent for a government instrumentality performing an insurance function (e.g. processing of state workers' compensations plans, managing assigned risk plans, Medicaid processing etc).
- (h) Purchase or securitization of acquisition costs

and if 20% or more of the SCA's revenue is generated from the reporting entity and its affiliates, then the underlying equity of the respective entity's audited Generally Accepted Accounting Principles (GAAP) financial statements shall be adjusted to a statutory basis of accounting (refer to paragraph 10). For purposes of this section, revenue means GAAP revenue reported in the audited GAAP financial statements excluding realized and unrealized capital gains/losses. Paragraphs 18-20 provide guidance for investments in holding companies;

- iii. Investments in noninsurance SCA entities that do not qualify under subparagraph 9.b.ii. shall be recorded based on the audited GAAP equity of the investee;
- iv. Investments in foreign insurance SCA entities shall be recorded based on the underlying audited U.S. GAAP equity of the respective entity adjusted to a statutory basis of accounting in accordance with paragraph 10 and adjusted for reserves of the foreign insurance SCA with respect to the business it assumes

- i. *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*
 - ii. *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*
 - iii. *SSAP No. 20—Nonadmitted Assets*
 - iv. *SSAP No. 29—Prepaid Expenses*
 - v. *SSAP No. 16—Electronic Data Processing Equipment and Software*
 - vi. *SSAP No. 79—Depreciation of Nonoperating System Software*
- b. Expense costs that are capitalized in accordance with GAAP but are expensed pursuant to statutory accounting as promulgated by the NAIC in the *Accounting Practices and Procedures Manual* (e.g., deferred policy acquisition costs);
 - c. Adjust depreciation for certain assets in accordance with the following statutory accounting principles:
 - i. *SSAP No. 16—Electronic Data Processing Equipment and Software and SSAP No. 79—Depreciation of Nonoperating System Software*
 - ii. *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*
 - d. Nonadmit the amount of goodwill of the SCA in excess of 10% of the audited GAAP equity of the SCA's last audited financial statements.
 - e. Nonadmit amount of the net deferred tax assets (DTAs) of the SCA in excess of 10% of the audited GAAP equity of the SCA's last audited financial statements.
 - f. Adjust the GAAP annuity account value reserves of a foreign insurance SCA, with respect to the business it wrote directly, using the commissioners' annuity reserve valuation method (CARVM) as defined in paragraphs 12 and 13 of Appendix A-820 (including the reserving provisions in the various Actuarial Guidelines which support CARVM). The valuation interest rate and mortality tables to be used in applying CARVM should be that prescribed by the foreign insurance SCA's country of domicile. If the Foreign SCA's country of domicile does not prescribe the necessary tables and/or rates, no reserve adjustment shall be made.

11. The recorded GAAP equity shall be adjusted for any audit adjustments resulting from either the annual GAAP audit of the respective entity or, if the entity is a member of a consolidated group of insurers, the audit of the consolidated group of companies, as soon as determined. GAAP is defined as those pronouncements included in the United States GAAP Hierarchy as described in *AICPA Statement of Auditing Standards No. 69, The Meaning of "Presents Fairly in Conformity With GAAP."* The statutory equity method as described in paragraph 9.b.i., 9.b.ii. and 9.b.iii. shall be applied by recording an initial and subsequent investment in an investee at cost (excluding any investment in an investee's surplus notes), 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.

12. Once the reporting entity elects to use a valuation approach for a particular subsidiary, the reporting entity may not change the valuation method to another method without the approval of the domiciliary commissioner. For instance, if an entity selects the market valuation method, it may not change to an equity method or vice versa without approval from the domiciliary commissioner. The only exception to this notification requirement is the case in which an investment in a SCA entity that was previously accounted for under one method no longer qualifies under that method 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 a change in facts or circumstances (e.g., paragraphs 9.a.i., 9.a.vii.). Further, in order for an entity to transfer from a paragraph 9.a., 9.b.ii. or 9.b.iii. valuation to a paragraph 9.b.iv. valuation, the SCA shall not exceed the 20% threshold (as defined in paragraphs 9.b.ii. and 9.b.iii.) for three consecutive years. 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.

13. 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 9.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.

14. 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.

15. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 9.b.i. through 9.b.iv.), as applicable, to investments in SCA entities:

- a. A difference between the cost of an investment and the underlying equity in the statutory or GAAP book value, as applicable, 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 6 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 adj

Investments in Holding Companies

18. Valuation of a holding company depends upon the nature of the SCA entities it holds in accordance with paragraph 9 and the guidance contained in the applicable SSAP for non-SCA investments. If an SCA investment of the holding company does not meet the provisions of paragraph 9.a. or if it elects not to use the guidance in paragraph 9.a., and instead uses the guidance in paragraph 9.b., then the holding company would look to its underlying assets and record them as follows:

- a. Investments by a holding company in insurance SCA entities are recorded based upon the guidance in paragraph 9.b.i.;
- b. Investments by a holding company in noninsurance SCA entities that primarily provide services or hold assets that are for the direct or indirect use of the reporting entity or its affiliates are recorded based upon the guidance in paragraph 9.b.ii. or 9.b.iii. as applicable;
- c. Investments by a holding company in noninsurance SCA entities that do not qualify under paragraph 18.b. above shall be recorded based upon the guidance in paragraph 9.b.iii.; and
- d. Investments by a holding company in foreign insurance and noninsurance SCA entities shall be recorded based upon the guidance in paragraphs 9.b.iv. above.

19. In lieu of separate GAAP audits of SCA entities of the holding company, the insurer can choose to have a GAAP audit performed at the holding company level with a consolidating balance sheet showing GAAP equity of all the SCA entities. The consolidating balance sheet shall then be adjusted for GAAP to SAP differences of the insurance entities and paragraph 9.b.ii. 9.b.iii. and 9.b.iv. entities under the holding company. This adjusted amount would then be the reported value of the investment in holding company at the higher level insurance company.

20. A purchased holding company is valued in accordance with the provisions above and the provisions of SSAP No. 68.

Investment in Preferred Stock or Surplus Notes of a Subsidiary, Controlled and Affiliated Entity

21. When the reporting entity also holds an investment in preferred stock or surplus note(s) of an SCA and the carrying amount determined in accordance with paragraphs 9.b. and 10 includes preferred stock or surplus note(s), the investment in the SCA must be separated into its components. The carrying amount of the SCA is reduced by the value of the SCA's preferred stock or surplus note(s).

22. Investments in the preferred stock of an SCA shall be accounted for and reported in accordance with the provisions of *SSAP No. 32—Investments in Preferred Stock* (SSAP No. 32). This statement amends the title of SSAP No. 32 as follows:

SSAP No. 32—Investments in Preferred Stock (~~including~~ ~~excluding~~ investments in preferred stock of subsidiary, controlled, or affiliated entities)

This statement amends paragraphs 2 and 3 of SSAP No. 32 to the following:

2. Investments in preferred stock of subsidiaries, controlled or affiliated entities are included within the scope of this statement.

3. Preferred stock (including investment in affiliates), which may or may not be publicly traded and may include shares against which exchange traded call options are outstanding, shall include:
23. Investments in the surplus notes of an SCA shall be accounted for and reported in accordance with the provisions of *SSAP No. 41—Surplus Notes*.
24. The following example is provided to illustrate the accounting and reporting. The reporting entity holds 100% of the preferred stock. The SCA issued the preferred stock for \$50,000. The investment in the SCA, measured in accordance with this SSAP is \$250,000 including the preferred stock of the SCA. The investment in the SCA is \$200,000 (\$250,000-50,000) and the preferred stock is measured and reported in accordance with SSAP No. 32.

Impairment

25. 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.
26. 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

27. 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

28. 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;
 - 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; and
 - e. For those SCA entities in which the reporting entity elected, or was required to change its

SSAP No. 46 Paragraph	IP 118 No. Paragraph	Description
7 and 13.h	12	Retains guidance from SSAP No. 46 but includes

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

35. See Issue Paper No. 46 for statutory references.

Generally Accepted Accounting Principles

36. See Issue Paper No. 46 for GAAP references.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 46—Investments in Subsidiary, Controlled and Affiliated Entities*

Generally Accepted Accounting Principles

- See Issue Paper No. 46 for GAAP references.

State Regulations

- No additional guidance obtained from state statutes or regulations

EXHIBIT A – ILLUSTRATIVE EXAMPLES FOR PROVISION OF PARAGRAPH 9.b.**Example 1:**

Insurance Company A owns 100% of a third party administrator, TPA1. TPA1 processes claims for noninsurance companies and for Medicare and Medicaid programs. TPA1 is completely independent from Insurance Company A and as such does not receive any management income or lease income from Insurance Company A or its affiliates. TPA1 does not process claims for Insurance Company A.

Equity Method – Insurance Company A would value TPA1 under 9 b. iii. (audited GAAP equity) as TPA1's revenue from Insurance Company A is less than 20%.

Example 2:

Insurance Company A owns 100% of a company that processes insurance claims, TPA2. TPA2 processes claims for Insurance Company A, Insurance Company B, Insurance Company C and Insurance Company D. TPA2 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Companies B, C and D are not affiliates of Insurance Company A. The processing of claims for Insurance Company A constitutes 15% of the revenues of TPA2.

Equity Method – Insurance Company A would value TPA2 under 9 b. iii. (audited GAAP equity) as TPA2's revenue from Insurance Company A is less than 20%.

Example 3:

Insurance Companies A, B, C and D each own 25% of a company, TPA3, that provides administrative services, including all EDP processing, to Insurance Companies A, B, C and D. TPA3 owns the EDP equipment and software and furniture, fixtures and equipment necessary to provide administrative services to its customers. TPA3 does not provide administrative services to any other entities. Insurance Companies A, B, C and D are not part of the same insurance holding company system. The processing that TPA3 does for each of Insurance Companies A, B, C and D constitutes 25% of its business and revenues.

Equity Method – Insurance Company A, B, C and D would value TPA3 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA3's revenue from each Insurance Company A, B, C and D is greater than 20%.

Example 4:

Insurance Company A owns 100% of a company, TPA4, that provides administrative services, including EDP processing, to Insurance Company A, Insurance Company B, Bank C and Manufacturing Company D. TPA4 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Company A, Insurance Company B, Bank C and Manufacturing Company D are not affiliates, i.e. none of the four companies are related to one another. The processing that TPA4 does for Insurance Company A represents 40% of TPA4's business and revenues.

Equity Method – Insurance Company A would value TPA4 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA4's revenue from Insurance Company A is greater than 20%.

Example 5:

Insurance Company A owns 100% of a company, TPA5, that provides claims administration services, including EDP processing, to Insurance Company A, Insurance Company B, numerous self-insured companies and Medicare. TPA5 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Company A, Insurance Company B and the self-insured companies are not affiliates, i.e., they are not related to one another. Insurance Companies A and B may provide stop-loss coverage to some of the self-insured companies for whom TPA5 provides claims

administration services. The processing that TPA5 does for Insurance Company A represents 51% of TPA5's business and revenues.

Equity Method – Insurance Company A would value TPA5 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA4's revenue from Insurance Company A is greater than 20%.

Example 6:

Insurance Company A holds an 18.77% Partnership In