Statutory Accounting Principles
SELF-STUDY PROGRAM
This guidance is as adopted by the NAIC as of December 2011, and reflects guidance adopted as of January 1, 2012. Please note that there will be modifications to the accounting guidance included in the Accounting Practices and Procedures Manual from year to year, as such guidance is subject to the maintenance process.
The NAIC is the authoritative source for insurance industry information. Our expert solutions support the efforts of regulators, insurers and researchers by providing detailed and comprehensive insurance information. The NAIC offers a wide range of publications in the following categories:

**Accounting & Reporting**
Accountants, members of the insurance industry and educators will find relevant information about statutory accounting practices and procedures.

**Consumer Information**
Consumers, educators and members of the insurance industry will find important answers to common questions in guides about auto, home, health and life insurance.

**Financial Regulation**
Accountants, financial analysts and lawyers will find handbooks, compliance guides and reports on financial analysis, state audit requirements and receiverships.

**Legal**
State laws, regulations and guidelines apply to members of the legal and insurance industries.

**NAIC Activities**
Insurance industry members will find directories, newsletters and reports affecting NAIC members.

**Special Studies**
Accountants, educators, financial analysts, members of the insurance industry, lawyers and statisticians will find relevant products on a variety of special topics.

**Statistical Reports**
Insurance industry data directed at regulators, educators, financial analysts, insurance industry members, lawyers and statisticians.

**Supplementary Products**
Accountants, educators, financial analysts, insurers, lawyers and statisticians will find guidelines, handbooks, surveys and NAIC positions on a wide variety of issues.

**Securities Valuation Office**
Provides insurers with portfolio values and procedures for complying with NAIC reporting requirements.

**White Papers**
Accountants, members of the insurance industry and educators will find relevant information on a variety of insurance topics.

For more information about NAIC publications, view our online catalog at: [http://store.naic.org](http://store.naic.org)
Companion Products

The following companion products provide additional information on the same or similar subject matter. Many customers who purchase the Statutory Accounting Principles Self-Study Program also purchase one or more of the following products:

**Annual and Quarterly Statement Blanks**
To be used with its companion products, this publication provides the appropriate format for filing quarterly and annual statement data with the states and the NAIC. Proper use allows users to identify system changes that can improve the method in which data is first collected, and allows users to ascertain if their annual statement software vendor has also complied with NAIC requirements. Updated annually.

**Annual and Quarterly Statement Instructions**
Includes a summary of changes to the instructions for the following year. When used with its companion products, it allows for proper preparation of annual and quarterly statements, including all supplemental information that must also be filed to remain in compliance with NAIC mandates. Instructions provide guidance for completing the various pages of the statements when the line descriptions are not self-explanatory. Updated annually.

**Purposes and Procedures Manual of the NAIC Securities Valuation Office**
This publication is the primary source for insurers to comply with regulatory reporting requirements. Contains the NAIC’s credit assessment methodologies and valuation policies, and takes precedence over other SVO publications covering a number of categories. Subscribers receive periodic email alerts relating to regulatory developments concerning securities. These alerts will be sent directly from the NAIC’s Securities Valuation Office. Electronic format only. Updated biannually.

**States’ Prescribed Differences from NAIC Statutory Accounting Principles**
The Accounting Practices and Procedures Manual presents a comprehensive basis of accounting that should be followed if not in conflict with state statutes and/or regulations. Should the domiciliary state set forth accounting guidance that differs from the AP&P Manual, disclosures of such must be made. This publication provides information regarding each state's prescribed differences from NAIC statutory accounting principles, including a citation to the respective state statute and/or regulation. Updated annually.
This self-study training program is designed to help you understand what Statements of Statutory Accounting Principles (SSAPs) are and how they are applied in day-to-day accounting treatment. Specifically, this training program enables you to: (1) become aware of and define statutory accounting guidance as prescribed in the NAIC Accounting Practices and Procedures Manual – As of March 2012 (the Manual); and (2) explain the organization of the SSAPs and related guidance.

The topics covered in this self-study program represent the fundamental concepts of statutory accounting guidance. While the majority of the topics are applicable to all reporting entities (because the accounting guidance represents a common area applicable to all entities), Section 11 is specific to health entities.

**How to Use This Training Program**

Insurance companies are regulated by state insurance department(s) and are required to prepare financial statements that comply with the prescribed or permitted accounting practices of each state in which it writes business. Most of the states use the Manual as the basis for their prescribed accounting practices; therefore, completion of this self-study training program helps you to understand those practices stated within the Manual.

The guidance in this self-study program is based on authoritative accounting literature, as well as the NAIC’s current interpretation of statutory accounting. However, this program is not authoritative guidance as defined in the Statutory Hierarchy contained in the Preamble to the Accounting Practices & Procedures Manual. Additional guidance issued by the NAIC may affect this program’s content. Contact an NAIC staff member to analyze specific issues affected by changes in statutory accounting.

Each section of this training program includes summary information on the related topic. Following the summary information are illustrations and/or exercises, a comprehensive case study and, if you choose to obtain a certificate of completion to submit to the appropriate board for continuing education, an electronic test (additional fee required). It is recommended that you read through the summary information and illustrations and/or exercises, and then work through the comprehensive case study for the applicable section. When you have completed the course, you may pay separately to take the electronic test. Please contact the NAIC Education and Training Department to pay the fee and obtain the information to access the electronic test.

**The Exam**

Notify the Education and Training Department at least one week prior to your anticipated testing date. Once the Education Department has been notified of the testing date and has received payment you will be enrolled to take the exam. You will receive login and password information via email several days in advance. The testing window will be open for one week from the date of the exam. The exam consists of multiple-choice questions and true/false items designed to test recall and application of the material.
PROGRAM OVERVIEW

presented in this text. To pass the exam (and, therefore, successfully complete the course), you must achieve a grade of at least 70%.

Continuing Education (CE) Credit

For those completing the course successfully, you will receive a certificate of completion from the Education and Training Department within two weeks of completing the exam. The number of credits that will be listed for continuing education is 26. Partial credit is not awarded.

For Assistance, Contact:

Related to Purchase of SAP Self-Study Manual:

Publications Help Line
 Email: prodserv@naic.org
 Phone: 816.783.8300

Related to Exam:

Education and Training Help Line
 Email: education@naic.org
 Phone: 816.783.8200

Related to Statutory Content:

Financial Regulatory Services Statutory Accounting Help Line
 Phone: 816.783.8400
The topics covered in this self-study program are as follows:

**Section 1 – Introduction to Insurance**

- Overview of Insurance Industry
- U.S. Formation and Oversight of Insurers
- Insurer Processes

**Section 2 – Using the Accounting Practices & Procedures Manual**

- Purpose and Scope of AP&P Manual
- Key Components of the Preamble
- Audit Opinions
- Relationship to GAAP
- How to use the Manual
- Appendices
- Maintenance of Statutory Accounting
- Anatomy of a SSAP

**Section 3 – Fundamental Statements**

- SSAP No. 4—Assets and Nonadmitted Assets
- SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets
- SSAP No. 3—Accounting Changes and Corrections of Errors
- SSAP No. 1—Disclosure of Accounting Policies, Risks and Uncertainties, and Other Disclosures
- Appendix A-205—Illustrative Disclosure of Differences Between NAIC Statutory Accounting Practices and Procedures and Accounting Practices and Procedures Prescribed or Permitted by the State of Domicile
- SSAP No. 64—Offsetting and Netting of Assets and Liabilities

**Section 4 – SAP, GAAP and IFRS**

- Balance Sheet Comparisons
- IFRS Impact to GAAP and SAP

**Section 5 – Premium and Reserves**

- SSAP No. 50—Classification and Definitions of Insurance or Managed Care Contracts In Force
- SSAP No. 51—Life Contracts
- SSAP No. 52—Deposit-Type Contracts
- SSAP No. 53—Property Casualty Contracts-Premiums
- SSAP No. 54—Individual and Group Accident and Health Contracts
- SSAP No. 65—Property and Casualty Contracts
- SSAP No. 66—Retrospectively Rated Contracts and Contracts Subject to Redetermination
- Case Study
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## Section 6 – Invested Assets: Bonds and Stocks

- SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities
- SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)
- SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)
- INT 06-07—Definition of Phrase “Other-Than-Temporary”
- SSAP No. 100—Fair Value Measurements
- Appendix A-001—Investments of Insurers
- Case Study

## Section 7 – Invested Assets: Mortgage Loans, Real Estate, Leases and Surplus Notes

- SSAP No. 17—Preoperating and Research and Development Costs
- SSAP No. 22—Leases
- SSAP No. 37—Mortgage Loans
- SSAP No. 40—Real Estate Investments
- SSAP No. 41—Surplus Notes
- SSAP No. 76—Reporting on the Costs of Start-Up Activities
- SSAP No. 77—Real Estate Sales – An Amendment to SSAP No. 40, Real Estate Investments
- SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments
- Case Study

## Section 8 – Invested Assets Related Parties, Goodwill and Partnerships

- SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies
- SSAP No. 68—Business Combinations and Goodwill
- SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments

## Section 9 – Premium Receivables and Nonadmitted Assets

- SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers
- SSAP No. 16R—Electronic Data Processing Equipment and Software
- Case Study

## Section 10 – Other Liabilities and Contingencies

- SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8
- SSAP No. 14—Postretirement Benefits Other Than Pensions
- SSAP No. 35R—Guaranty Fund and Other Assessments
- Case Study
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Section 11 – Health Care Delivery Assets, Receivables and Adjustment Expenses ................................................................. 11-1

- SSAP No. 73—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities
- SSAP No. 84—Certain Health Care Receivables and Receivables Under Government Insured Plans

Case Study
At the completion of this section, you will be able to:

1. Explain the significance of the insurance industry within the United States and globally and its impact on the marketplace.

2. Identify key requirements regulating the formation of insurers within the United States and general tools used to provide oversight of insurers.

3. Describe the general operating processes of insurers and how insurer transaction cycles are interrelated.

Overview of Insurance
- Magnitude and impact of insurance industry

Formation and Oversight of Insurers
- Capital Requirements
- State Regulation and Supervision

Insurer Processes (Big Picture)
- Revenue (Premiums)
- Claims/Losses
- Investments
- Reinsurance

A Look At This Section
This section provides statistical information on the insurance industry, provides a high-level overview of insurance regulation and describes the insurer processes for general operations.

A Look Ahead
Section 2 provides an introductory explanation of the use, maintenance and key components within the Accounting Practices and Procedures Manual.
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SECTION PREVIEW

This section is designed to provide an introduction to insurance. It (1) provides information on the insurance industry; (2) discusses preliminary requirements for forming a U.S. insurance company; (3) identifies general regulation and oversight for U.S. insurers; and (4) details the four key processes for insurance operations.

Overview of the Insurance Industry

The function of insurance is one of the most significant industries within the United States and other countries. The financial stability of individuals and businesses are dependent upon the successful operation of the insurance function. Due to the significance and complexity of insurance, strict regulation is necessary to protect the public interest and ensure that insurers maintain solvency to satisfy claim obligations when they arise.

The United States is considered the largest insurance marketplace in the world, and in 2010 had direct written premiums that equaled 26.88% of the total world premiums.

World insurance premiums (life and property/casualty) totaled $4.339 trillion in 2010. The United States accounted for nearly $1.2 trillion of that amount.

The following chart illustrates the top five countries for direct premiums written in 2010.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Total Premiums¹ (in millions and US $)</th>
<th>Percentage of Total World Premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>$1,166,142</td>
<td>26.88%</td>
</tr>
<tr>
<td>Japan</td>
<td>$ 557,439</td>
<td>12.85%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>$ 310,022</td>
<td>7.15%</td>
</tr>
<tr>
<td>France</td>
<td>$ 280,082</td>
<td>6.46%</td>
</tr>
<tr>
<td>Germany</td>
<td>$ 239,817</td>
<td>5.53%</td>
</tr>
</tbody>
</table>

¹ Source: Swiss Re, sigma, No. 2/2010
Quick Check

1. Why would the United States have a greater percentage of direct insurance premiums than other countries?

As a well-developed nation, it is argued that the United States has a greater percentage of direct insurance premiums as a result of economic capability. In 2007, robust sales of savings protection products and annuities due to increased focus on retirement and estate planning caused an increase in market growth in the life sector. However, in 2009, weak new business and soft market conditions in the overall economy caused a slight drop in U.S. premiums in comparison to other nations, whose economic rebound has been greater.

The insurance marketplace within the United States consists of a significant number of insurers. As illustrated in the following chart, in 2009, there were 4,722 insurers filing with the NAIC.

<table>
<thead>
<tr>
<th>Number of Insurers Filing with NAIC²</th>
<th>2009 Direct Written Premium (Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property/Casualty</td>
<td>2,796</td>
</tr>
<tr>
<td></td>
<td>$ 481,400</td>
</tr>
<tr>
<td>Life, Accident&amp; Health</td>
<td>830</td>
</tr>
<tr>
<td></td>
<td>$ 720,200</td>
</tr>
<tr>
<td>Health</td>
<td>856</td>
</tr>
<tr>
<td></td>
<td>$ 387,800</td>
</tr>
<tr>
<td>Fraternal</td>
<td>87</td>
</tr>
<tr>
<td></td>
<td>$ 11,000</td>
</tr>
<tr>
<td>Title</td>
<td>55</td>
</tr>
<tr>
<td></td>
<td>$ 9,400</td>
</tr>
<tr>
<td>Total</td>
<td>4,624</td>
</tr>
<tr>
<td></td>
<td>$1,609,800</td>
</tr>
</tbody>
</table>

By reviewing the above chart, the difference in volume for property/casualty insurers and life, accident & health insurers is identified.

- Property/casualty companies represent 60% of filers, but have only 30% of total premium.
- Life and health companies represent 18% of total filers, but direct written premium reflects 45% of the U.S. market.

² Chart data obtained from the NAIC.
There are a variety of ways to rank and measure insurance companies. Two of the more common measures are direct premium written (volume of direct insurance activity) and revenues.

In addition to providing a sense of financial stability when insured events occur, insurers are also significant players as a means of employment and in financing for the U.S. economy.

- In 2009, U.S. direct insurance carriers provided more than 1.3 million jobs. After considering insurance agents, brokers and other insurance-related activities, it generates a workforce for more than 2.2 million individuals.³

- Life insurers have invested more than $4 trillion in the U.S. economy. Additionally, life insurers are the largest source of bond financing for corporate America, with $2.6 trillion invested in 2009.⁴

- Life insurers provide benefit payments in excess of $500 billion each year.⁵

As the insurance industry is one of the most significant industries globally and, in the United States, strict regulation over the formation of an insurance company, as well as strict oversight, is necessary to ensure that insurers remain solvent to satisfy policyholder claims.

**U.S. Formation and Oversight of Insurers**

**Formation of Insurance Companies**

All of the states have statutes that apply to the operations of insurers. These statutes identify the requirements that must be met to organize an insurance company, as well as license agents and brokers. In addition to financial requirements, the states typically gather and review specific information regarding the individuals that are forming the company. These characteristics include reviewing for competence and experience as an insurance license could be denied if the founders are deemed unworthy of public trust.

NAIC Model #320, *Organization and Ownership of New Insurance Companies*, specifies that minimum paid-in capital of $200,000 and a surplus of $100,000 should be required for the organization of new insurers. However, as each state individually adopts their own regulations, NAIC model laws are often revised with changes deemed appropriate for each individual state. As such, the actual minimum capital and surplus requirements vary from state to state. In establishing the state-specific minimums, the states often set requirements based on the line of business and the type of company (stock or mutual) being formed.

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³ Statistics gathered from the Insurance Information Institute.

⁴ Information taken from the American Council of Life Insurers (ACLI).

⁵ Information taken from the ACLI. Includes Fraternal association data.
SECTION 1 – INTRODUCTION TO INSURANCE

To illustrate, based on the requirements of California, Missouri and New York, it is clear that there is significant variation among the states.

<table>
<thead>
<tr>
<th></th>
<th>Capital6</th>
<th>Surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Life Insurance</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>California – Life</td>
<td>$2,250,000</td>
<td>100% of Capital</td>
</tr>
<tr>
<td>Missouri – Life</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>New York – Life</td>
<td>$2,000,000</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Capital</th>
<th>Surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fire or Property Insurance</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>California – Fire</td>
<td>$350,000</td>
<td>100% of Capital</td>
</tr>
<tr>
<td>Missouri – Property</td>
<td>$800,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>New York – Fire</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Capital</th>
<th>Surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Automobile</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>California – Automobile</td>
<td>$200,000</td>
<td>100% of Capital Plus $200,000</td>
</tr>
<tr>
<td>Missouri – More than One Property/Casualty Line</td>
<td>$1,200,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>New York – Automobile</td>
<td>If licensed to write fire, no additional capital and surplus is required to write motor vehicle.</td>
<td></td>
</tr>
</tbody>
</table>

Quick Check

2. What factors would impact why various states require different start-up capital and surplus amounts?

3. What is your reaction to the fact that a new life insurer would only need capital of $600,000 in Missouri, but would need $2 million in New York?

4. Are you surprised that insurers writing fire insurance need $800,000 in capital for Missouri, but only $350,000 in California??

6 Chart data obtained from the NAIC.
The investment of capital is a key component for insurers, and investment activity is considered a separate cycle within insurance operations. Most state statutes have limitations on the types of investments insurers can participate in, and several statutory accounting principles govern the measurement and reporting of investments. Although initial investments are crucial for the forming of insurers, for this program, we will postpone discussion on statutory accounting investment requirements until consideration is given on the investment of premium received for insurance contracts.

After identifying the capital and surplus requirements, consider how those requirements might relate to other characteristic variations between Missouri, New York and California for life insurance:

<table>
<thead>
<tr>
<th></th>
<th>New York 7</th>
<th>Missouri</th>
<th>California</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Death Benefit Coverage</td>
<td>$2 trillion</td>
<td>$510 billion</td>
<td>$3 trillion</td>
</tr>
<tr>
<td>Current Number of Policies</td>
<td>$8 million</td>
<td>$3 million</td>
<td>$10 million</td>
</tr>
<tr>
<td>Current Average Coverage</td>
<td>$160,000</td>
<td>$92,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Individual Insurance Purchased 2009</td>
<td>$140 billion</td>
<td>$30 billion</td>
<td>$210 billion</td>
</tr>
<tr>
<td>Death Benefits – 2009</td>
<td>$30 billion</td>
<td>$6 billion</td>
<td>$40 billion</td>
</tr>
<tr>
<td>Annuity Benefits – 2009</td>
<td>$6 billion</td>
<td>$1 billion</td>
<td>$8 billion</td>
</tr>
</tbody>
</table>

In addition to the NAIC, there are several great sources of insurance information. The above information was obtained from the American Council of Life Insurers’ (ACLI) website: www.acli.com/Tools/Industry%20Facts/State%20Fact%20Sheets/Pages/Default.aspx.

Oversight of Insurers

The regulation of insurance companies is governed by their domestic state insurance department. Such regulation covers a variety of aspects, including market conduct compliance, rates and regulations, and solvency monitoring. The primary purpose of financial condition examinations and the filing of statutory annual and quarterly financial statements are to enhance the identification of potential insurer insolvencies before they occur.

The requirements and guidelines for financial reporting contained within the Accounting Practice and Procedures Manual and the application of those requirements, impact a multitude of other regulatory tools used to assess insurer financial condition. The following discussion illustrates two tools — Insurance Regulatory Information System (IRIS) ratios and risk-based capital (RBC) ratios — driven from calculations of the completed statutory financial statements, as well as a brief discussion on state insurance department financial condition examinations of insurers.

7 Source: ACLI.
IRIS Ratios

The NAIC IRIS system is considered an early warning system to identify insurers that are showing signs of being financially troubled. IRIS ratios are calculated in accordance with the results from an insurer’s financial filings with the NAIC. IRIS ratios are calculated annually and a confidential “range” of results for each ratio has been established from studies of companies that have become insolvent or have experienced financial difficulties in recent years. Ratio results beyond the established ranges could be caused by a variety of normal actions by an insurer. It is common to have some ratio results that are outside of established ranges. However, as the number of ratios outside of established ranges increases, concern for future solvency also increases.

Common insurer actions that could result with a ratio outside of established ranges:

- Discontinuing or entering a new line of business
- Receiving an influx of capital from a parent/affiliate
- Declining investment results (unrealized losses)
- Changes in accounting principles

There are different IRIS ratios for the different types of insurance companies. Some of the ratios are commonly known and are easily calculated from the financial annual statement.

Example ratios include:

- Investment Yield
- Nonadmitted to Admitted Assets
- Gross Premiums to Policyholder Surplus
- Net Income to Total Income

RBC Ratios

In addition to the IRIS ratios, RBC ratios are another tool used to monitor a company’s financial condition in accordance with the risks taken by an insurer. Similar to the IRIS ratios, the items and amounts reported within the financial annual statement are used to determine the extent of risks that are considered in these calculations.

Risks reflected within the Risk-Based Capital (RBC) calculation:

- Asset Risk – Affiliate: Risk of default of assets for affiliated investments.
- Asset Risk – Other: Risk of default for debt assets and loss in market value for equity assets. (Factors reflect additional risk of high concentrations in single exposures.)
− *Insurance Risk:* Equivalent to underwriting risk. (Risk of pricing and reserving errors.)

− *Interest Rate Risk:* Risk of losses due to changes in interest rate levels. (Factors represent surplus necessary to provide for a lack of synchronization of asset and liability cash flows. Risk increases for products that allow policyholders to respond to changes in interest rates by withdrawing funds.)

A comparison of the company’s Total Adjusted Capital to its Authorized Control Level RBC as computed by the RBC formula determines whether the company will fall into a specified action level. RBC is calculated and reported annually. Insurers that do not fall into one of the four action levels below are considered to be in the “no action” level, with nothing required by regulators.

− **Company Action Level** – Total adjusted capital of 150% to 200% of minimum RBC. Under this level, the insurer must prepare a report to the regulator outlining the corrective actions the company intends to take. The insurer must submit a comprehensive financial plan that identifies the conditions that contribute to the company’s financial condition. The plan must contain proposals to correct the company’s financial problems and provide projections of the company’s financial condition. Failing to file the comprehensive financial plan triggers the next action level.

− **Regulatory Action Level** – Total Adjusted Capital of 100% to 150% of minimum RBC. At this level, the insurance company is required to file an action plan, and the state insurance commissioner is required to perform any examinations or analyses to the insurer’s business and operations that he/she deems necessary. The commissioner can issue appropriate corrective orders to address the company’s financial problems.

− **Authorized Control Level** – Total Adjusted Capital of 70% to 100% of the minimum RBC. The law automatically authorizes the commissioner to take control of the insurer. This authorization is in addition to the remedies available at the higher action levels. This action level occurs at a point where the insurer might still be technically solvent according to technical standards (assets might still be greater than liabilities).

− **Mandatory Control Level** – Total Adjusted Capital of less than 70% of the minimum RBC. This level requires the commissioner to place the insurer under control. This situation can occur when the insurer still has a positive level of capital and surplus, even though a number of the companies that trigger this action level are technically insolvent (liabilities exceed assets).
Financial Condition Examinations

To verify that financial statements are properly completed in accordance with the Accounting Practices and Procedures Manual and insurance operations are in accordance with statutory requirements, every state has established time frames in which to conduct financial condition examinations. All of the states require an examination of their domestic companies at least every three to five years. In accordance with the risk-focused examination approach, the use of tools (such as IRIS ratios and RBC ratios) assists the states in prioritizing exams. Thus, additional exam resources can be focused on those companies with financial concerns with fewer exam resources being utilized on well-capitalized companies.

Although the actual examination procedures performed during a financial condition exam depends on the risk assessment completed by the insurance regulator, it is not unusual for exam procedures to address each of the four key processes of insurance operations: premiums, claims, investments and reinsurance.

Insurer Processes

Insurance company operations, as complex as they are, can be simplified into four essential transaction cycles. These cycles are considered interrelated to reflect the entire process of insurer operations:

1 – Premium (Revenue) Cycle

The generation of revenue is a fundamental element of all insurers. This cycle generally originates with the insurer obtaining or renewing business, receiving the consideration (cash or receivable) for issuing the insurance policy and recording unearned revenue. Statutory accounting guidance provides various requirements for the recording of premium, as well as how revenue is earned over the insurance contract period. The continued receipt of new or renewed business is a critical element for financial stability. Key financial statement line items impacted by the premiums cycle include:

- Premiums Earned (I/S)
- Unearned Premiums (Liability)
- Advance Premiums (Liability)
- Uncollected Premiums (Asset)
- Deferred Premiums (Asset)
- Cash / Invested Assets (Assets)
2 – Claims, Loss and Loss Adjustment Expenses Cycle

In accordance with the origination of an insurance policy (premium cycle), the insurer accepts an obligation to compensate the beneficiary if and when the insured event occurs. As noted previously, assessing the ability of insurers to pay claims when due is the primary focus of state-based insurance regulation. This cycle encompasses the establishment and evaluation of reserves. Guidance is included within statutory accounting principles for various types of insurance contracts on how and when reserves should be established. Pursuant to the nature of the insurance industry and the conservatism required, several components of reserves may be required, depending on the type of insurance provided: (a) policy reserves; (b) claim reserves; (c) incurred but not reported (IBNR) reserves; (d) contingency reserves; and (e) premium deficiency reserves. Key financial statement line items impacted by the claims/loss cycle include:

- Losses (Liability)
- Loss Adjustment Expenses (Liability)
- Losses Incurred (I/S)
- Loss Expenses Incurred (I/S)

3 – Investment Cycle

The theory of insurance generally encompasses two concepts: (1) law of large numbers; and (2) time value of money. Regarding the law of large numbers, the premium charged to offset the risk of an insured event typically decreases as more individuals become insured. Although an insurer should expect losses, it is assumed that not all insured policyholders would experience the insured event, thus the cost of the actuarial perceived risk, along with a profit margin, is determined as premium and charged to policyholders. The second general concept is the time value of money. As premium is received for insurance contracts, the insurer invests the premium. Investment decisions are driven by the insurer’s process to match risk with investments (maturity dates for investments correlate to actuarially expected losses to prevent liquidity risk) and to generate profit on investments to further reduce the extent of loss from the occurrence of insured events. Guidance is included within the Accounting Practices and Procedures Manual that govern how investments should be valued within the statutory financial statements. NAIC statutory guidance does not place limits on the type of investments that can be utilized, but several of the states have statutes with investment limitations. Key financial statement line items impacted by the investment cycle include:

- Bonds (Asset)
- Stocks (Asset)
- Mortgage Loans on Real Estate (Asset)
- Real Estate (Asset)
- Cash (Asset)
- Other Invested Assets (Asset)
- Interest Income Due and Accrued (Asset)
- Net Investment Income Earned (I/S)
4 – Reinsurance Cycle

As part of the initial assessment of risk from the issuance of an insurance contract, insurers consider the extent to which they will retain the risk or transfer (cede) the risk to others. Reinsurance is the transfer of part, or all, of insurance risk from one insurer to another. However, except in the case of assumption insurance, reinsurance does not result with an absolution of obligation to the policyholder. Under reinsurance arrangements, the direct writer retains the obligation, but receives compensation from the reinsurer.

Generally, business to be written is expected to be profitable; therefore, direct insurance writers will want to retain as much of the risk as possible. However, reinsurance has many beneficial purposes, which include: (a) expand insurer capacity; (b) share large risks with other insurers; (c) spread the risk of potential catastrophes and stabilize underwriting results; (d) finance expanding volume by sharing the financial burden of reserves; (e) withdraw from a line or class of business; and (f) reduce net liability to amounts appropriate for financial resources. Guidelines within the statutory accounting principles detail how the accounting and reporting of reinsurance should occur for life and property/casualty insurance contracts for ceding and assuming reinsurance transactions. Key financial statement line items impacted by the reinsurance cycle include:

- Amounts Recoverable from Reinsurers (Asset)
- Funds Held By or Deposited with Reinsured Companies (Asset)
- Other Amounts Receivable Under Reinsurance Contracts (Asset)
- Reinsurance Payable on Paid Losses and LAE (Liability)
- Ceded Reinsurance Premiums Payable (Liability)
- Funds Held By Company Under Reinsurance Treaties (Liability)
- Provision for Reinsurance (Liability)
Section 1 – Review Questions

Please read Section 1 and answer the following multiple-choice questions. Answers must be entered into the “Test Answer Form” in order to obtain credit. See instructions in the Program Overview for purposes of obtaining credit.

1. Strict regulation of insurance is necessary to ensure that insurers are solvent to satisfy claim obligations when they arise.
   a. True
   b. False

2. In 2010, the amount of worldwide insurance premiums was measured in the:
   a. Thousands
   b. Millions
   c. Billions
   d. Trillions

3. Minimum capital and surplus requirements may vary significantly and are driven by the following factor(s):
   a. Domestic state
   b. Line of business
   c. Type of company
   d. All of the above

4. It is possible for a normal company action to trigger an IRIS ratio that is considered outside of an established range.
   a. True
   b. False

5. The extent of concern for insurer insolvency is greatest under which RBC action level?
   a. Mandatory control level
   b. Regulatory action level
   c. Authorized control level
   d. Company action level
6. Which of the following transaction cycles focuses on an insurer’s ability to pay claims when they arise?
   
a. Premium cycle  
b. Investment cycle  
c. Loss cycle  
d. Reinsurance cycle

7. Reinsurance is a fundamental aspect of insurance as it allows companies to write insurance contracts and cede risk without retaining obligation to the policyholder.
   
a. True  
b. False
At the completion of this section, you will be able to:

1. State the purpose and scope of the Accounting Practices & Procedures Manual

2. Identify the key components of the Preamble

3. Review the issues surrounding the areas of audit opinions and state implementation

4. Explain how to use the various sections of the Accounting Practices & Procedures Manual

5. Describe the maintenance process of statutory accounting principles

Purpose and Scope of AP&P Manual
Key Components of the Preamble
Audit Opinions
Relationship to GAAP
How to use the Accounting Practices & Procedures Manual
Anatomy of a SSAP
Maintenance of Statutory Accounting

A Look Back
Section 1 provided statistical information on the insurance industry, a high-level overview of insurance regulation and the general insurer processes.

A Look At This Section
This section provides an introductory explanation of the use, maintenance and key components within the Accounting Practices & Procedures Manual.

A Look Ahead
Section 3 reviews the four statutory accounting principles known as the “fundamental statements” to all statutory accounting, and other essential statements.
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SECTION PREVIEW

This section is designed to provide an introduction to the Accounting Practices & Procedures Manual. It will: (1) describe the purpose of the AP&P Manual; (2) review key components of the Preamble to statutory accounting principles; (3) review the issues surrounding the areas of audit opinions and state implementation; (4) provide an explanation on how to use the AP&P Manual; and (5) help you understand the maintenance process of statutory accounting principles.

PURPOSE AND SCOPE

The Accounting Practices & Procedures Manual was a result of the NAIC’s codification project. Insurance regulators worked to develop this manual by revisiting principles that had been developed over a long period of time and considering accounting issues not addressed by statutory accounting principles (SAP). In many cases, previously available choices of accounting methods were eliminated. Also considered were the regulatory environment and the tools, such as risk-based capital (RBC).

The purpose of the SAP codification project was to produce a comprehensive guide for use by insurance departments, insurers and auditors. The accounting guidance from that project is contained in the Accounting Practices & Procedures Manual.

The codification project resulted in more complete disclosures and more comparable financial statements, which made the insurance departments’ analysis techniques more meaningful and effective. The Accounting Practices & Procedures Manual provides examiners and analysts with uniform accounting rules against which companies’ financial statements could be evaluated. RBC is reported more consistently with the benefit of codification.

Effective Date

State Implementation
For many states, the Accounting Practices & Procedures Manual was adopted fairly easily. All of the states currently reference the AP&P Manual in their state laws and regulations.
KEY COMPONENTS OF THE PREAMBLE

The Preamble of the *Accounting Practices & Procedures Manual* is a document at the front of the manual that all users of the manual should review. It contains several items that define the statutory accounting framework, including the purpose and history of the codification project; the statement of concepts; the relationship of statutory accounting to generally accepted accounting principles (GAAP); the statutory hierarchy; and discussion about advance notice for permitted practices.

Probably one of the most important functions of the Preamble is the identification of the fundamental concepts of statutory accounting and reporting. Not only are these concepts used within the current SSAPs, but they are also used in the continued development and maintenance of SSAPs. In addition, these concepts and principles constitute an accounting basis for the preparation of statutory financial statements by insurance companies in the absence of state statutes and/or regulations.

Foundation Concepts of SAP

Conservatism

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management’s accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates, as well as when establishing accounting principles for statutory reporting.

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.

Consistency

The regulators’ need for meaningful, comparable financial information to determine an insurer’s financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practices alone should not provide sufficient justification for continuing to follow a particular accounting principle or practice, which might not coincide with the objectives of regulators.
Recognition

The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise’s ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third-party interests, should not be recognized on the balance sheet but, rather, should be charged against surplus when acquired or when availability otherwise becomes questionable.

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities might also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments, which tend to defer expense recognition, do not generally represent acceptable SAP treatment.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus, which are not directly attributable to the earnings process (e.g., changes in nonadmitted assets).

Basis of Accounting

As noted in the Preamble, the statutory reporting guidance as contained in the AP&P Manual is not intended to preempt state legislative and regulatory authority. Therefore, statutory financial statements will continue to be prepared on the basis of accounting practices as prescribed or permitted by the regulatory body (generally, the state of domicile). Additionally, as noted in the Preamble, the American Institute of Certified Public Accountants (AICPA) continues to allow its practitioners to provide audit opinions on the practices prescribed or permitted by the insurance department of the state of domicile.
Audit Opinions
Because the basis of accounting in the annual financial statement and the audited financial statements continues to be those practices prescribed or permitted by the state of domicile, the issues surrounding the audit opinions are listed below. The following topics review the certified public accountants’ (CPAs) standards that pertain to statutory financial statements, as well as the history of the NAIC and AICPA during the project:

✔ Ultimate Position Taken by the AICPA as Noted in the Preamble

Codification is not intended to preempt state legislative and regulatory authority. While codification is expected to be the foundation of a state’s statutory accounting practices, it may be subject to modification by practices prescribed or permitted by a state’s insurance commissioner. Statutory financial statements will continue to be prepared on the basis of accounting practices prescribed or permitted by the states. As a result, in 1998, the AICPA’s Insurance Companies Committee determined that it would not be necessary for the Auditing Standards Board to grant the codification status as an Other Comprehensive Basis of Accounting (OCBOA) since it will not be the sole basis for preparing statutory financial statements. As such, auditors will be permitted to continue to provide audit opinions on practices prescribed or permitted by the insurance department of the state of domicile. AICPA Statement of Position 01-5, Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification (SOP 01-5) requires insurance enterprises to disclose, the date each balance sheet is presented, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices.

(Due to the significance of permitted practices within the statutory financial statements, guidance was added to the Preamble in 2005 that requires the domiciliary state insurance regulator to provide notification to all other states in which the insurer is licensed before approving the permitted practice request.)

✔ Other Effects on Audited Financial Statements as Noted in the Preamble

Annual statutory financial statements that are not accompanied by annual statement exhibits and schedules (e.g., annual audit report) shall include all disclosures required by the SSAPs based on the applicability, materiality and significance of the item to the insurer. Certain disclosures, as noted in individual SSAPs, are required in the annual audited statutory financial statements only.

Relationship to GAAP
As expressed in the Statement of Concepts, SAP utilizes the framework established by GAAP. This training program integrates that framework with objectives exclusive to statutory accounting. The NAIC’s guidance on SAP is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting outlined herein. Those GAAP Pronouncements that are not applicable to insurance companies will
not be adopted by the NAIC. For those principles that do not differ from GAAP, the NAIC may specifically adopt those GAAP Pronouncements to be included in statutory accounting. GAAP Pronouncements do not become part of SAP until and unless adopted by the NAIC. Future GAAP Pronouncements that SAP has not yet addressed shall not be considered as providing authoritative statutory guidance.

Statutory Hierarchy
A model for statutory hierarchy can be found in the Preamble; however, this hierarchy is not intended to preempt state legislative and regulatory authority. Effective September 15, 2009, the Financial Accounting Standards Board (FASB) Codification is the source of authoritative U.S. generally accepted accounting principles. As of that date, the FASB Codification superseded all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the FASB Codification is nonauthoritative. For statutory accounting, GAAP is not authoritative until and unless adopted by the NAIC.

Level 1:
- SSAPs, including GAAP reference material to the extent adopted by the NAIC from the FASB Accounting Standards Codification (FASB Codification or GAAP guidance)\(^1\)\(^2\)

Level 2:
- Consensus positions of the Emerging Accounting Issues (E) Working Group, as adopted by the NAIC

Level 3:
- NAIC Annual Statement Instructions
- *Purpose and Procedures Manual of the NAIC Securities Valuation Office (SVO)*

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\(^1\) FAS 133 Implementation Issues are excluded from the NAIC hierarchy and statutory accounting standard review process unless considered significant and relevant to statutory accounting and specifically requested for review as part of the maintenance process, or in accordance with future projects in which review of a specific FAS 133 Implementation Issue would be considered beneficial. (These items are excluded from the maintenance process as SSAP No. 86 only adopts the framework of the guidance included in FAS 133.)

\(^2\) FASB Staff Positions (FSPs) adopted after May 9, 2008, are reviewed as part of the statutory accounting maintenance review process. FSPs adopted prior to May 9, 2008, were reviewed as part of the maintenance process if considered to be ‘Board-directed’. (Board-directed FSPs were issued to provide narrow and limited revisions to the FASB statements or FASB interpretations formerly provided in FASB Technical Bulletins.) FSPs that were not considered ‘Board-directed’ were considered to provide application guidance similar to that found in FASB Staff Implementation Guides and Staff Announcements and were not reviewed as part of the statutory accounting maintenance review process.
Level 4:
• Statutory Accounting Principles Statement of Concepts

Level 5:
• Sources of nonauthoritative GAAP accounting guidance and literature:
  (a) Practices that are widely recognized and prevalent, either generally or in the industry
  (b) FASB Concept Statements
  (c) AICPA Issue Papers
  (d) International Financial Reporting Standards
  (e) Pronouncements of professional associations or regulatory agencies
  (f) Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids
  (g) Accounting textbooks, handbooks and articles

If the accounting treatment of a transaction or event is not specified by the SSAPs, preparers, regulators and auditors of statutory financial statements should consider whether the accounting treatment is specified by another source of established statutory accounting principles. If an established statutory accounting principle from one or more sources in Level 2 or Level 3 is relevant to the circumstances, the preparer, regulator or auditor should apply such principle. If there is a conflict between statutory accounting principles from one or more sources in Level 2 or Level 3, the preparer, regulator or auditor should follow the treatment specified by the source in the higher level; that is, follow Level 2 treatment over Level 3. Revisions to guidance in accordance with additions or revisions to the NAIC statutory hierarchy should be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

Because of developments — such as new legislation or the evolution of a new type of business transaction — there sometimes are no established statutory accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting a statutory accounting principle that appears appropriate when applied in a manner similar to the application of an established statutory principle to an analogous transaction or event. In the absence of a SSAP or another source of established statutory accounting principles, the preparer, regulator or auditor of statutory financial statements may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes the Statutory Accounting Principles Statement of Concepts and GAAP reference material and accounting literature identified in Level 5.

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3 The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concepts Statements One, Two, Five and Six to the extent they do not conflict with the concepts outlined in the statement. However, for purposes of applying this hierarchy, the FASB Concepts Statements shall be included in Level 5 and only those concepts unique to statutory accounting as stated in the statement are included in Level 4.
The appropriateness of other accounting literature depends on its relevance to the particular circumstances, the specificity of the guidance and the general recognition of the issuer or author as an authority. For example, the Statutory Accounting Principles Statement of Concepts would be more authoritative than any other sources of accounting literature. Similarly, FASB Concept Statements would normally be more influential than other sources of nonauthoritative GAAP pronouncements.

**Financial Statements**

**Annual Financial Statement**
Each state requires all insurance companies doing business in that state to file an annual financial statement. All states use the annual statement blank promulgated by the NAIC, but each state retains the authority to make changes in those statements. Changes made by the states generally require only supplemental information and do not change the basic financial information.

To the extent that disclosures required by a SSAP are made within specific notes, schedules or exhibits to the annual statement, those disclosures are not required to be duplicated in a separate note. Annual statutory financial statements that are not accompanied by annual statement exhibits and schedules (e.g., annual audit report) shall include all disclosures required by the SSAPs based on the applicability, materiality and significance of the item to the insurer. Certain disclosures, as noted in individual SSAPs, are required in the annual audited statutory financial statements only.

**Interim Financial Statements**
Interim financial statements, including quarterly statements, shall follow the form and content of presentation prescribed by the domiciliary state for the quarterly financial statements. The NAIC quarterly statement form has been adopted by each state with minor variations as required by certain states.

The interim financial information shall include disclosures sufficient to make the information presented not misleading. It may be presumed that the users of the interim financial information have read, or have access to, the annual statement for the preceding period and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context.

Accordingly, footnote disclosure which would substantially duplicate a disclosure contained in the most recent annual statement or audited financial statements — such as a statement of significant accounting policies and practices, details of accounts which have not changed significantly in amount or composition since the end of the most recently completed fiscal year — may be omitted. However, disclosure shall be provided when events subsequent to the end of the most recent fiscal year have occurred that have a material impact on the insurer. Disclosures shall encompass, for example, significant changes since the end of the period reported on the last annual statement in such areas as: statutory accounting principles and practices; estimates inherent in the preparation of financial statements; status of long-term contracts; capitalization, including significant
new borrowings or modifications of existing financial arrangements; and the reporting entity resulting from business combinations or dispositions. Notwithstanding the above, where material noninsurance contingencies exist, disclosure of such matters shall be provided even though a significant change since year-end may not have occurred.

Quick Check

I. Why is the Statement of Concepts so critical to the Accounting Practices & Procedures Manual?

The Statement of Concepts summarizes the conceptual framework that the NAIC uses in developing and maintaining statutory accounting principles for insurance companies. These concepts also help ensure that guidance will be provided consistently with the underlying objectives of statutory accounting and aid in the review of emerging accounting issues. The multitude of unique circumstances and individual transactions makes it nearly impossible for any codification of accounting principles to be completely comprehensive. Application of SAP to unique circumstances or individual transactions should be consistent with the concepts of conservatism, consistency and recognition.

HOW TO USE THE AP&P MANUAL

The AP&P Manual contains a number of sections that address specific issues, such as:

How to account for a certain item under NAIC SAP

As the SSAPs represent the highest level of NAIC statutory authority, readers should begin their search there. The Index to SSAPs is a useful tool to identify which SSAP(s) address the issue. Once the pertinent SSAP has been identified, it can be used to locate other documents that may also address the issue. On the SSAP cover page, readers will be referred to other SSAPs (if there have been substantive changes) or to Interpretations (INTs) (refer to the Appendix B discussion later in this section). Within the body of the SSAP, readers may be referred to Appendix A or Appendix C for further guidance. There is a reference located at the end of each SSAP to issue paper(s) used in the development of the SSAP. The “Discussion” section of an issue paper provides documentation supporting the conclusions reached in the SSAP. Readers should only utilize the issue papers as support to the SSAP, because they are NOT authoritative. The Statutory Hierarchy contains a detailed listing of levels of authoritative literature.
How to compare SAP to GAAP for a particular issue
Appendix D is an excellent reference for users who are interested in determining how SAP addresses an issue that has been adopted by GAAP. Appendix D provides a reference to the SSAP and/or INT that addresses a particular GAAP pronouncement. As indicated in the Preamble, users should not utilize GAAP until and unless adopted by the NAIC. Within the body of the applicable SSAP or INT, readers will find documentation as to the reason for adoption, rejection or adoption with modification of a particular GAAP pronouncement.

How to identify the relationship between the AP&P Manual and state law
Once a reader has identified the accounting treatment for a particular transaction or issue within the AP&P Manual, one must consider the effect of state law. That is, the AP&P Manual is not intended to preempt states’ legislative and regulatory authority. It is intended to establish a comprehensive basis of accounting recognized and adhered to if not in conflict with state statutes and/or regulations, or when the state statutes and/or regulations are silent. For instance, if a state prohibits the admission of goodwill, insurers domiciled in that state are required to nonadmit all goodwill instead of following the NAIC guidance contained within SSAP No. 68—Business Combinations and Goodwill. Insurers should refer to their state laws and regulations regarding deviations from the AP&P Manual.

How to obtain updates to the latest published AP&P Manual
The AP&P Manual contains information as of March of the current year. There will be modifications to the accounting pronouncements included in the AP&P Manual from year to year, as such guidance is subject to the maintenance process. To address this, the NAIC has a website dedicated to providing the latest information impacting statutory accounting. Access to the updates posted on the website adopted after March will be included with the pre-purchase of the subsequent year’s manual. Purchasers of the following year’s AP&P Manual may enter a password-protected NAIC website and download updates finalized after the March release of the AP&P Manual. This website also includes the latest minutes of the Statutory Accounting Principles (E) Working Group and the Emerging Accounting Issues (E) Working Group. Further details can be found on the inside front cover of the AP&P Manual.

How changes get made to the AP&P Manual and how to stay abreast of such changes
Appendix F contains several NAIC policy statements that document the process by which the AP&P Manual is modified. It also outlines the process by which the Statutory Accounting Principles (E) Working Group and the Emerging Accounting Issues (E) Working Group will conduct their business. Readers are able to track the development of SAPs by attending the meetings of the working groups or through use of the NAIC website. Further details regarding the working groups can be found at www.naic.org.
Descriptions of Appendices

Appendix A – Excerpts of NAIC Model Laws

The guidance in Appendix A is referred to by specific SSAPs. Some appendices define certain terms. Such definitions are not intended to change the meaning of any terms used elsewhere in the *Accounting Practices & Procedures Manual* and should only be used in the context of the appendix in which it appears and the SSAP that refers to that appendix.

Appendix B – Interpretations of the Emerging Accounting Issues (E) Working Group

The Emerging Accounting Issues (E) Working Group (EAIWG) has been charged with handling questions that arise regarding interpretation of certain SSAPs or certain language within a SSAP. Where only an interpretation is necessary, documentation of the interpretation is issued. If the EAIWG feels that additional work is required, the issue is sent to the Statutory Accounting Principles (E) Working Group for further consideration. Adopted interpretations are included in Appendix B of the *Accounting Practices & Procedures Manual*. Interpretations issued after the annual publication of the AP&P Manual are available for review at www.naic.org.

Appendix C – Actuarial Guidelines

The former Life and Health Actuarial Task Force — now the Life Actuarial (A) Task Force and the Health Actuarial (B) Task Force — has been asked on many occasions to assist a particular state insurance department in interpreting a statute dealing with an actuarial topic relative to an unusual policy form or situation not contemplated at the time of original drafting of a particular statute. The task forces, in developing an interpretation or guideline, must often consider the intent of the statute, the reasons for initially adopting the statute and the current situation. For those situations that are sufficiently common to all states, the task forces might agree that the publishing of an actuarial guideline on a specific topic would be beneficial to the regulatory officials in each state and would promote uniformity in regulation. To this end, the task forces have developed certain actuarial guidelines and will continue to do so as the need arises. The guidelines are not intended to be viewed as statutory revisions, but merely guides to be used in applying a statute to a specific circumstance.

Appendix D – GAAP Cross-Reference to SAP

As expressed in the Statement of Concepts, SAP utilizes the framework established by generally accepted accounting principles (GAAP). Appendix D includes GAAP pronouncements that have been considered in the development of SAP. Appendix D is a valuable and efficient tool for readers who are interested in the status of a particular GAAP pronouncement in the SAP model.

In June 2009, FASB issued *FASB Statement 168, FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (FAS 168).
effective for interim and annual periods ending after September 15, 2009. FAS 168 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of the financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States. As a result of FAS 168, Appendix D was revised to include references to FASB Accounting Standards Updates, as well as include the Accounting Standards Codification Reference (Topic and Subtopic) for pre-codification GAAP guidance. Pre-codification GAAP guidance that has been superseded as a result of exclusion from the GAAP codification has been identified within Appendix D. For additional information, refer to the introduction to Appendix D.

A “pending” comment within the NAIC Status column indicates that the NAIC has not yet completed its deliberation of the GAAP pronouncement.

**NOTE:** The Statutory Accounting Principles (E) Working Group has formed the Accounting Practices & Procedures Manual (E) Subgroup to assess changes necessary to reflect the new GAAP codification within statutory accounting principles. Until this process is complete, or as otherwise noted in specific SSAPs or Interpretations, users of the Accounting Practices & Procedures Manual shall continue to refer to the FASB pre-codification standards, and the applicable references to such standards, to determine the GAAP guidance that has been adopted, adopted with modification or rejected for statutory accounting.

**Appendix E – Issue Papers**

Appendix E includes all of the issue papers adopted in the development of SSAPs. The issue papers are used as the first step in developing new SSAPs and contain a summary conclusion, discussion and relevant literature section. While the issue papers do not constitute an authoritative level of statutory accounting guidance, as defined by the statutory hierarchy, they are an important part of the Accounting Practices & Procedures Manual because they reference the history and discussion of the related SSAP.

**Appendix F – Policy Statements**

**Maintenance of the Accounting Practices & Procedures Manual**

The AP&P Manual is, like any other accounting guidance, subject to change with new accounting issues, insurance products, etc. Therefore, the NAIC Policy Statement on Maintenance of Statutory Accounting Principles has been included for review. Additionally, the Illustration of Flow of Information for the maintenance process, which includes a flowchart illustrating the process, also has been included.

**NAIC Policy Statement on Maintenance of Statutory Accounting Principles**

Statutory accounting principles provide the basis for insurers to prepare financial statements to be filed with and utilized by state insurance departments for financial regulation purposes. The accuracy and completeness of such filings are critical to
meaningful solvency monitoring. Accordingly, maintenance of SAP guidance for changes in the industry and changes in regulatory concerns is vital to preserving the usefulness of SAP financial statements.

The promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures (E) Task Force. The Task Force employs two working groups with distinctly different functions to carry out the charge of maintaining SAP. The Statutory Accounting Principles (E) Working Group has the exclusive responsibility of developing and proposing new SSAPs. The Emerging Accounting Issues (E) Working Group responds to questions of application, interpretation and clarification that are generally much narrower in scope than development of a new SSAP.

Composition of the Working Groups
The chair of the Task Force shall determine membership on both working groups, subject to approval by the Financial Condition (E) Committee. The groups shall be limited in size to no more than 13 members and include representation from the four zones of the NAIC. Membership shall be vested in the state (until such time as the membership may be changed) but continuity of individuals, to the extent possible, is extremely desirable.

Development of New SSAPs
New SSAPs will be developed from time-to-time that: (1) address issues not covered by existing SAP guidance; (2) amend existing SSAPs; or (3) supersede existing SSAPs. The decision to undertake development of a new SSAP will rest with the SAPWG subject to approval of the task force. The SAPWG will report to the task force on its agenda and progress, if any, at each National Meeting of the NAIC.

Research and drafting on new SSAPs will be performed by the NAIC staff under the direction and supervision of the SAPWG which may enlist the assistance of interested parties with requisite technical expertise as needed or desired. The first step in developing new SSAPs will usually be the drafting of an issue paper (IP), which will contain summary conclusion, discussion and relevant literature sections. Public comment will be solicited on the IPs, and at least one public hearing will be held on an IP before it is converted to a SSAP. Upon approval by the Working Group, all proposed SSAPs will be exposed for public comment for a period commensurate with the length of the draft and the complexities of the issue. Adoption of SSAPs by the Working Group, after hearing and any further amendments, may be by simple majority. All SSAPs must be on the agenda for at least one public hearing before presentation to the Accounting Practices and Procedures Task Force for consideration. Adoption by the Task Force, the Financial Condition (E) Committee and the NAIC membership shall be governed by the NAIC Bylaws.

If accounting guidance, reserving standards, asset valuation standards, or any other standards or rules affecting accounting practices and procedures are developed by other...
NAIC working groups, task forces, subcommittees or committees, such guidance, standards or rules must be reviewed by the Working Group and converted to an SSAP or a revised appendix. In cases where such guidance has already been subjected to substantial due process (e.g., public comment periods or public hearings), the Working Group may recommend to the Task Force that either the IP or SSAP comment periods be shortened or eliminated, or that the hearings be eliminated.

Procedures for Emerging Accounting Issues (E) Working Group

The Emerging Accounting Issues (E) Working Group will be responsible for responding to SAP questions that generally relate to application, interpretation and clarification. In no event shall a consensus opinion of the Working Group amend, supersede or otherwise conflict with existing, effective SSAPs. In no event will a consensus be less than six out of a quorum of nine members of the Working Group; a consensus also will be determined by a vote of seven of 10 members, eight of 11 or 12 members, and nine of 13 members. In the rare event that an opinion of the Working Group would create SAP not addressed by SSAPs, concurrence of the Statutory Accounting Principles (E) Working Group (as determined by a majority vote) will be necessary before the guidance becomes effective.

The Emerging Accounting Issues (E) Working Group agenda will be established at the discretion of the chair, subject to approval of the Accounting Practices and Procedures (E) Task Force. Every issue taken up by the Working Group must be discussed at no less than two open meetings with opportunity for interested parties to present comments. The guidance contained in the consensus opinions of the Working Group will become effective upon publication, unless otherwise stated in the opinion. Consensus opinions can be overturned, amended or deferred only by a two-thirds majority of the Task Force.

As new issues are considered, papers will be available for review at www.naic.org.
Statutory Accounting Principles Maintenance Agenda Process

Illustration of Flow of Information

**Level 1**
Information and issues can come to the Statutory Accounting Principles (E) Working Group in a variety of ways. It can come from other NAIC working groups or task forces, interested parties or the GAAP Hierarchy (see Section IV of the Preamble). A **GAAP Status Report** will be maintained by NAIC staff to identify the material the Working Group should address through maintenance (as required by the Preamble). All of these items will be placed on a **Pending List** for consideration by the Working Group to place on the agenda. If the Working Group does not wish to address the issue (e.g., the issue is deemed not applicable to statutory accounting) or rejects the position presented, then the item is moved to the **Rejected Report.** Should the Working Group choose to address an issue, it is moved to either the **Substantive Listing** or **Nonsubstantive Listing.**

**Level 2**
This level consists of two different listings. The **Substantive Listing** contains items that require a new SSAP to address the issue. Once items are placed on this listing, the formal maintenance policy is followed. The **Nonsubstantive Listing** contains items that are considered editorial or technical in nature. A revision to a SSAP for these items will not be deemed to modify its conclusion or original intent.

**Level 3**
This level consists of status reports. The **Active Report** identifies items that are in the process of completion. The Active Report is prioritized and shows the status of issue papers and SSAPs. The **Disposition Report** captures the conclusions of the Working Group. The **Rejected Report** identifies all of the items that were proposed to the Working Group and rejected or deemed not applicable.
NOTE: This flowchart depicts the flow of information, and not the timing of such. For instance, an item can move from the pending list to the substantive disposition report in one, two or three meetings. The timing is left to the discretion of the Working Group.


This section includes the NAIC Implementation Guide for the Annual Financial Reporting Model Regulation (#205), which is commonly referred to as the Model Audit Rule. This section is for informational purposes. The Implementation Guide should not be viewed as a requirement of complying with the Accounting Practices & Procedures Manual.

The responsibility of developing and maintaining the Implementation Guide resides with the NAIC/AICPA (E) Working Group, with changes to the Implementation Guide following the NAIC regulatory due process. The Implementation Guide resides as an informational appendix to the Accounting Practices & Procedures Manual. The AP&P Manual was selected as the logical repository, because the Implementation Guide provides instruction about compliance with Model #205, which directly relates to financial reporting and statutory accounting.

Appendix H – Superseded SSAPs and INTs (NEW as of the 2011 AP&P Manual)

To clarify what is authoritative guidance, and thereby enhancing the search features of the AP&P Manual on CD-ROM, 100% superseded SSAPs and INTs will be removed from Volume I of the AP&P Manual and included within this appendix. This will maintain the historical references, while clarifying the authoritative guidance currently in effect.
Anatomy of a SSAP

To help understand the structure of a SSAP, the following diagram describes the anatomy of SSAP No. 1.

NOTE: Some SSAPs have an additional line in the Status for INTs that have been nullified by the SSAP.

---

**Statue of Statutory Accounting Principle No. 1**

**Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures**

**Status**

<table>
<thead>
<tr>
<th>Type of Issue:</th>
<th>Common Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issued:</td>
<td>Initial Draft</td>
</tr>
<tr>
<td>Effective Date:</td>
<td>January 1, 2001</td>
</tr>
<tr>
<td>Affects:</td>
<td>No other pronouncements</td>
</tr>
<tr>
<td>Affected by:</td>
<td>No other pronouncements</td>
</tr>
</tbody>
</table>

**Type of Issue:** Describes what type of reporting entity the statement applies to. Most issues are common to all entities, while some are specific to life, accident and health, property and casualty and health entities.

**Issued:** This is the date the SSAP was issued. All SSAPs adopted by the NAIC in 1998 will be considered “initial draft.”

**Affects and Affected by:** The purpose of these sections is to cross-reference the SSAPs that amend or supersede other SSAPs. This will provide for the historical reference necessary to track the effective dates of statutory guidance.

**Scope of Statement:** This section describes the issue that the statement pertains to.

**Summary Conclusion:** This section outlines the primary accounting guidance adopted by the Statutory Accounting Principles Working Group.

**Relevant Literature:** This section summarizes the relevant GAAP and SAP literature and is useful for comparisons to GAAP guidance.

**Effective Date and Transition:** This section summarizes the transition period, if any, allowed by the statement.

**Authoritative Literature:** This section summarizes all literature that falls within the statutory hierarchy as described in the Preamble.

**Relevant Issue Papers:** This section summarizes the issue papers addressed by the SSAP. More than one issue paper may be listed in cases where two or more issue papers were combined into one SSAP.
At the completion of this section, you will be able to:

1. Identify admitted and nonadmitted assets and their specific differences

2. Explain specific liabilities, contingencies and impairments of assets

3. State the accounting for corrections of errors and accounting changes from one reporting period to another

4. Identify disclosures of accounting policies, risks and uncertainties

5. Describe the offsetting and netting of assets and liabilities

SSAP No. 4—Assets and Nonadmitted Assets

SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets

SSAP No. 3—Accounting Changes and Corrections of Errors

SSAP No. 1—Disclosure of Accounting Policies, Risks and Uncertainties, and Other Disclosures

Appendix A-205—Illustrative Disclosure of Differences Between NAIC Statutory Accounting Practices and Procedures and Accounting Practices Prescribed or Permitted by the State of Domicile

SSAP No. 64—Offsetting and Netting of Assets and Liabilities

A Look Back

Section 2 provided an introductory explanation of the use, maintenance and key components within the Accounting Practices & Procedures Manual.

A Look At This Section

This section delves into the four prominent statutory principles, whose philosophies preface each of the remaining statutory principles within the AP&P Manual. Four key principles serve as the foundation for statutory accounting: SSAP No. 4, SSAP No. 5R, SSAP No. 3 and SSAP No. 1.

A Look Ahead

Section 4 provides an explanation of generally accepted accounting principles and statutory accounting principles, as well as illustrates the differences between a GAAP and SAP balance sheet.
SECTION 3 – FUNDAMENTAL STATEMENTS

SECTION PREVIEW

This section covers the fundamental statements of statutory accounting principles. These statements are presented in detail to form a foundation for all following SSAPs contained in this program. SSAP No. 4—Assets and Nonadmitted Assets; SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets; SSAP No. 3—Accounting Changes and Corrections of Errors; and SSAP No. 1—Disclosure of Accounting Policies, Risks and Uncertainties, and Other Disclosures are cited as being the fundamental SAP statements of statutory accounting. Various disclosures are referred to throughout the specific SSAPs within the AP&P Manual. Appendix A-205—Illustrative Disclosure of Differences Between NAIC Statutory Accounting Practices and Procedures and Accounting Practices Prescribed or Permitted by the State of Domicile provides an illustration of the disclosures required by SSAP No. 1. SSAP No. 64—Offsetting and Netting of Assets and Liabilities also is included to further augment these fundamental statements and their discussion.

There are a few statutory principles that are considered fundamental to the overall understanding of statutory accounting. In this section, we will look at the following statements: No. 4—Assets and Nonadmitted Assets (SSAP No. 4); SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R); SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3); and SSAP No. 1—Disclosure of Accounting Policies, Risks and Uncertainties, and Other Disclosures (SSAP No. 1).

In addition to these fundamental SSAPs, Appendix A-205—Illustrative Disclosure of Differences Between NAIC Statutory Accounting Practices and Procedures and Accounting Practices Prescribed or Permitted by the State of Domicile (Appendix A-205) is reviewed in this section, as it illustrates the disclosures in SSAP No. 1. SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64) is included to further augment these fundamental statements and their discussion.
Quick Check

(Answers are at the end of this section.)

What publication is the comprehensive guide to statutory accounting principles?
_________________ ___________________ & ___________________ ___________________

SAP is accounting __________________ or __________________ prescribed or
_________________ by an insurer’s domiciliary state.

Does the NAIC Accounting Practices & Procedures Manual accept all GAAP guidance?
Yes or No

Why or why not?
________________________________________________________________
________________________________________________________________

What are some of the attributes of Generally Accepted Accounting Principles?

- Designed to meet the varying needs of different users of financial statements or
general-purpose use.

- Stresses the measurement of ____________ by matching of revenue to expense.

- What section of the financial statements is emphasized? __________  _______

- Assumes the “__________  __________ concept.”

What are some of the attributes of Statutory Accounting Principles?

- Designed to address the concerns of ________________.

- Stresses the measurement of ability to satisfy ____________  ________________.

- Takes a __________  _______ emphasis, stressing liquidity.

- Conservative approach for calculating surplus.

- Practical approach: Can the insurer pay its ________________?
SSAP No. 4—Assets and Nonadmitted Assets

What is an Asset?
An asset is defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics:

1. it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows;
2. a particular entity can obtain the benefit and control others’ access to it; and
3. the transaction or other event, giving rise to the entity’s right to or control of the benefit has already occurred.

Transactions that do not give rise to assets shall be charged to operations in the period the transactions occur. Transactions that may meet the definition of assets, but are specifically identified within the Accounting Practices & Procedures Manual as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.

Is it an Admitted Asset?
As stated in the Statement of Concepts, assets that cannot be used to pay policyholder claims shall be considered nonadmitted.

The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

Once an asset has been determined, it shall then be evaluated to determine whether it is admissible in the statutory statements. A nonadmitted asset is defined as one that is accorded limited or no value in statutory reporting and is one that is:

(a) Specifically identified within the AP&P Manual as a nonadmitted asset; or
(b) not specifically identified as an admitted asset within the AP&P Manual.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus, unless otherwise specifically addressed within the Accounting Practices & Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity’s written capitalization policy, amounts less than a predefined threshold for furniture, fixtures, equipment, supplies and health care delivery assets shall be expensed when purchased.


SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets

What is a Liability?
A liability has the following three essential characteristics and shall be recorded on a reporting entity’s financial statements when incurred.

1. It embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand,
2. the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and
3. the transaction or other event obligating the entity has already happened.

Estimates (e.g., loss reserves) are required in financial statements for many ongoing and recurring activities of a reporting entity. The mere fact that an estimate is involved does not constitute a loss contingency. For example, estimates of losses utilizing appropriate actuarial methodologies meet the definition of liabilities as outlined above and are not loss contingencies.

Loss Contingencies or Impairments of Assets
A loss contingency or impairment of an asset is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future event(s) occur or fail to occur (e.g., collection of receivables).

For purposes of implementing the statutory accounting principles for loss contingencies or the impairment of assets, the following additional definitions shall apply:

(a) Probable: The future event or events are likely to occur.
(b) Reasonably Possible: The chance of the future event or events occurring is more than remote, but less than probable.
(c) Remote: The chance of the future event or events occurring is slight.

When to Record a Loss Contingency
An estimated loss from a loss contingency or the impairment of an asset shall be recorded by a charge to operations if both of the following conditions are met:

(a) Information available prior to issuance of the statutory financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability; and
(b) the amount of loss can be reasonably estimated.

This accounting shall be followed, even though the application of other prescribed statutory accounting principles or valuation criteria may not require, or does not address,
the recording of a particular liability or impairment of an asset (e.g., a known impairment of a bond, even though the NAIC Securities Valuation Office has not recognized the impairment).

**What if the Estimate is a Range?**

When an amount within management’s estimate of the range of a loss appears to be a better estimate than any other amount within the range, then that amount shall be accrued. When, in management’s opinion, no amount within management’s estimate of the range is a better estimate than any other amount, the midpoint (mean) of management’s estimate in the range shall be accrued. It is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management’s best estimate shall be used.

The use of the midpoint in a range will be applicable only in the rare instance where there is a continuous range of possible values, and no amount within that range is more probable. This guidance is not applicable when there are several point estimates that have been determined as equally possible values, as point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine their best estimate of the liability. The following illustration provides an example of this concept:

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**Illustration #3-1**

DEF Insurance Company has been named as the defendant in a class action lawsuit. At December 31, 20X1, DEF has estimated a range of possible losses under the lawsuit, with the lowest point being $1,000,000 and the highest point being $10,000,000 and that the range of possible losses is equally distributed between the low and high points. No point within this range of reasonably possible estimates is determined to be better than any other point. What should DEF accrue as a contingent liability at December 31, 20X1?

**Solution #3-1**

When no point within management’s range of reasonably possible estimates is determined to be a better estimate than any other point, SSAP No. 5R requires the accrual of the midpoint of the range of estimated losses. Therefore, DEF would accrue $5,500,000 at December 31, 20X1. However, this represents the rare circumstance when every point within a range is considered to be equally probable.
Gain Contingencies
A gain is defined as an increase to surplus that results from peripheral or incidental transactions of a reporting entity and from all other transactions and other events and circumstances affecting the reporting entity, except those that result from revenues or investments by owners. Gains are recognized in the financial statements if the transaction has been fully completed and the amount of the gain is determinable. (Investment activities resulting in increases to surplus are excluded from the definition of gains.)

A gain contingency is an existing condition, situation or set of circumstances involving uncertainty as to possible gain, that will ultimately be resolved when one or more future events occur or fail to occur. Gain contingencies shall not be recognized in the financial statements. If subsequent to the balance sheet date, but prior to the issuance of the financial statements, the gain contingency is realized, the gain shall be disclosed in the notes to the financial statements. (The unissued financial statements shall not be adjusted to record the gain.) A gain is generally considered realizable when noncash resources or rights are readily convertible to known amounts of cash or claims to cash.

Guarantees
Guidance was added to SSAP No. 5R for guarantees and is effective for all guarantees issued or outstanding as of December 31, 2011. The guarantor shall recognize a liability in its statement of financial position at the inception of a guarantee. The initial measurement of the liability is the fair value of the guarantee at its inception. Expanded disclosures for guarantees have also been incorporated into the standard.

Tax Contingencies
Effective January 1, 2012, are revisions to SSAP No. 5R related to tax contingencies. The insurer is directed to SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10 for detailed guidance. SSAP No. 101 is covered in an advanced class.

SSAP No. 3—Accounting Changes and Corrections of Errors
SSAP No. 3 dictates how changes in accounting principles, changes in accounting estimates, corrections of an error, historical schedules and mergers should be accounted for and the related disclosure requirements.

With the exception of mergers, prior year numbers in the current year statement shall not be changed. Amounts reported for assets, liabilities, surplus, revenues, and expenses for prior years in the current year’s annual statement should be identical to the amounts previously reported in the annual statement. That does not mean the financial statements are not to be corrected. Corrections are needed to bring a reporting company’s surplus to the correct amount. In almost all cases, corrections will be made directly to surplus as an adjustment.
Change in Accounting Principle

The cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods.

The cumulative effect of a change in accounting principles or practices, or a change in the method of applying accounting principles or practices shall be reported, as a change in the capital and surplus of the company. This cumulative effect is detailed on a specific line titled, “Cumulative effect of changes in accounting principles” within the reconciliation of the Capital and Surplus Account.

### Quick Check

2. **How are statutory accounting changes reflected in the annual statement?**

As stated in the Effective Date and Transition section of most SSAPs, a change resulting from the adoption of a SSAP shall be accounted for as a change in accounting principle in accordance with SSAP No. 3.
SECTION 3 – FUNDAMENTAL STATEMENTS

Change in Accounting Estimate
A change in accounting estimate shall be included in the statement of income in the period when the change becomes known.

If the effect of a change in accounting principle is inseparable from the effect of a change in accounting estimate, then the change shall be considered as a change in accounting estimate for purposes of applying the accounting principles set forth in SSAP No. 3.

The effect of changes in accounting estimates to current year income and expenses shall be included within the appropriate lines in the Statement of Revenue and Expenses. This is the one exception to the rule of recording all corrections/adjustments through the surplus account. Examples of this treatment include a change in the service lives of depreciable assets and changes in loss reserves estimates.

<table>
<thead>
<tr>
<th>Hospital and Medical:</th>
</tr>
</thead>
<tbody>
<tr>
<td>9. Hospital/medical benefits .................................................................</td>
</tr>
<tr>
<td>10. Other professional services ..............................................................</td>
</tr>
<tr>
<td>11. Outside referrals ..................................................................................</td>
</tr>
<tr>
<td>12. Emergency room and out-of-area ...........................................................</td>
</tr>
<tr>
<td>13. Prescription drugs................................................................................</td>
</tr>
<tr>
<td>14. Aggregate write-ins for other hospital and medical ...............................</td>
</tr>
<tr>
<td>15. Incentive pool, withhold adjustments, and bonus amounts....................</td>
</tr>
<tr>
<td>subtotal (Lines 9 to 15) ..............................................................................</td>
</tr>
</tbody>
</table>

Prior year corrections for reserve estimates are run through the income statement.

NOTE: Line numbers vary between statement types; however, the concepts are the same.

Correction of an Error
Corrections of errors in previously issued financial statements shall be reported as adjustments to unassigned funds (surplus) in the period an error is detected. Changes resulting from corrections of errors in previously filed information shall be reported as an adjustment to capital and surplus in the current year. These amounts are reported as a write-in adjustment to the capital and surplus reconciliation.

If a reporting entity becomes aware of a material error in a previously filed financial statement after it has been submitted to the appropriate regulatory agency, the entity shall file or be directed to file an amended financial statement if approved by its domiciliary regulator.
STATEMENT OF REVENUE AND EXPENSES (Continued)

<table>
<thead>
<tr>
<th>CAPITAL &amp; SURPLUS ACCOUNT</th>
<th>1</th>
<th>2</th>
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<tbody>
<tr>
<td>33. Capital and surplus prior reporting year</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GAINS AND LOSSES TO CAPITAL &amp; SURPLUS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>34. Net income or (loss) from Line 32</td>
<td></td>
<td></td>
</tr>
<tr>
<td>46. Dividends to stockholders</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>47. Aggregate write-ins for gains or (losses) in surplus</td>
<td></td>
<td></td>
</tr>
<tr>
<td>48. Net change in capital and surplus (Lines 34 to 47)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>49. Capital and surplus end of reporting year (Line 33 plus 48)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>DETAILS OF WRITE-INS</th>
<th>1</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>4701. 2001 Correction of errors</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>4702.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4703.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4798. Summary of remaining write-ins for Line 47 from overflow page</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4799. Totals (Lines 4701 through 4703 plus 4798)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

NOTE: Line numbers vary between statement types; however, the concepts are the same.

Impact on Historical Schedules
Changes that do not affect assets, liabilities, revenues, expenses or surplus, but that materially affect historical information in the financial statement supplemental schedules (e.g., Schedule P for property/casualty insurers or Schedule O for life and accident and health insurers), shall be reflected in the current year’s schedules with appropriate notations made directly to the affected schedules and in the notes to the financial statements.

Mergers
For mergers, prior years’ amounts in the annual statement shall be restated as if the merger had occurred as of January 1 of the prior year. Additionally, restatement shall be required for the two most recent years included in the Five-Year Historical Summary. The Five-Year Historical Summary shall include a footnote indicating that the other three years have not been restated. A reporting entity that merges with an entity that effectively is a shell company shall be exempt from the above requirements.

In addition, merged companies are asked to file a merger form with the NAIC. This form provides merged information on certain annual statement elements needed to run Insurance Regulatory Information System (IRIS) ratios. The merged information keeps the IRIS ratio results from being skewed as a result of the merger.
Many of the schedules within the annual statement provide reconciliation, or verification, between prior-year numbers and the current-year numbers. The desired result is the current-year ending balance. On these pages and schedules, the beginning prior-year numbers would need to be changed to allow the reconciliation to work.

In some instances, changing the beginning numbers on the reconciliation will cause crosscheck errors to occur. This is to be expected. A listing of these crosscheck errors with an explanation of why the errors are occurring should be provided with the annual statement filing.

**Revised Annual Statements**

There are times where the filing of an amended or revised annual statement may be necessary. When such cases occur, all related filings, including the electronic filing, should be resubmitted.

Revisions for statements are accepted and loaded to the NAIC database for one full year after the initial year-end; for example, revisions and amendments for year-end December 31, 20X2, will be processed through December 31, 20X3. The new information then becomes the “official” filed amounts for that company. Any revisions or amendments filed with the state of domicile must also be filed with the NAIC.

**SSAP No. 1—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures**

SSAP No. 1 establishes statutory accounting principles for the disclosure of accounting policies, risks and uncertainties, the use of accounting practices that depart from NAIC statutory accounting practices, and other disclosures.

**Accounting Policies and Practices (Audit Report and Annual Statement)**

Disclosure shall be made of all accounting policies that affect the assets, liabilities, capital and surplus, or results of operations of the reporting entity.

NAIC statutory accounting practices and procedures are those that are set forth in the AP&P Manual. If a reporting entity employs accounting practices that depart from NAIC accounting practices and procedures, disclosure of the following information about those accounting practices that affect statutory surplus or risk-based capital shall be made.

- A description of the accounting practice;
- A statement that the accounting practice differs from NAIC statutory accounting practices and procedures; and
- The monetary effect on net income and statutory surplus of using an accounting practice that differs from NAIC statutory accounting practices and procedures.
NOTE: Appendix A-205 provides an illustration of the disclosure requirements and is discussed below.

Disclosure of the following information shall be made about accounting practices when NAIC statutory accounting practices and procedures do not address the accounting for the transaction.

- A description of the transaction and of the accounting practice used; and
- A statement that NAIC statutory accounting practices and procedures do not address the accounting for the transaction.

**Risks and Uncertainties**

Companies shall make disclosures in their financial statements about risks and uncertainties existing as of the statement date in the following areas.

- **Nature of Operations**: Financial statements shall include a summary of the ownership and relationships of the reporting entity and all affiliated companies, along with a description of the major products or services the reporting entity sells or provides and its principal markets, including the locations of those markets. This disclosure is required in the annual audited statutory financial reports only.

- **Use of Estimates in the Preparation of Financial Statements**: Financial statements shall include an explanation that the preparation of financial statements in conformity with the *Annual Statement Instructions* and *Accounting Practices & Procedures Manual* requires the use of management’s estimates. This disclosure is required in both the annual statement and the annual audited statutory financial report.

- **Certain Significant Estimates**: Disclosures regarding an estimate shall be made based on certain criteria outlined within SSAP No. 1. These disclosures are required in the annual audited statutory financial reports only.

- **Current Vulnerability Due to Certain Concentrations**: Financial statements shall disclose certain concentrations as described in SSAP No. 1 if, based on information known to management prior to issuance of the financial statements, specific criteria are met. This disclosure is required in the annual audited statutory financial reports only.

**Supplemental Investment Disclosure**

Reporting entities shall disclose the information required by Appendix A-001—*Investments of Insurers* (Appendix A-001). A Summary Investment Schedule shall be filed with the annual statement and Investment Risk Interrogatories shall be filed as a supplement to the annual statement by April 1 for the applicable reporting period. Appendix A-001 is discussed in detail as part of the invested assets section of this workbook.
Subprime Mortgage-Related Risk Exposure
Reporting entities shall disclose subprime mortgage-related risk exposure and related risk-management practices, regardless of materiality. These disclosures are required in the statutory financial statements, but are not required in the annual audited financial statements.

Guidance is included within SSAP No. 1 to assist reporting entities in identifying characteristics of subprime mortgage loans, as well as how exposure to subprime mortgage-related risk should be considered through other sources, to assist reporting entities in accurately (and fully) completing the required disclosures.

- Narrative description of the manner in which the reporting entity specifically defines its exposure to subprime mortgage-related risk in practice.
- Direct exposure through investments in subprime mortgage loans.
- Direct exposure through other investments.
- Underwriting exposure to subprime mortgage risk through mortgage guaranty or financial guaranty insurance coverage.

Characteristics of Subprime Mortgage Loans

- Interest rate above prime to borrowers who do not qualify for prime rate loans;
- Borrowers with low credit ratings;
- Interest-only or negative amortizing loans;
- Unconventionally high initial loan-to-value ratios;
- Low initial payments based on a fixed introductory rate that expires after a short initial period, then adjusts to a variable index rate plus a margin for the remaining term of the loan;
- Borrowers with less than conventional documentation of their income and/or net assets;
- Very high or no limits on how much the payment amount or the interest rate may increase at reset periods, potentially causing a substantial increase in the monthly payment amount, and/or;
- Include substantial prepayment penalties and/or prepayment penalties that extend beyond the initial interest rate adjustment period.

Sources of Subprime Mortgage Related Risk

- Direct investments in subprime mortgage loans;
- Direct investments in securities with underlying subprime exposure;
- Equity instruments in subsidiary, controlled or affiliated entities with significant subprime related risk exposure;
- Underwriting risk on policies issued on mortgage guaranty or financial guaranty insurance coverage.
Appendix A-205—Illustrative Disclosure of Differences Between NAIC Statutory Accounting Practices and Procedures and Accounting Practices Prescribed or Permitted by the State of Domicile

The Preamble states that comparability is one of the desired results of statutory accounting principles. Each state knows its domestic industry better than any other state and, therefore, has the authority to determine what accounting and reporting requirements best fit their industry. However, it is important that the states be able to compare financial statements prepared on their prescribed or permitted basis of accounting to a foreign company’s financial statements prepared on a different state’s prescribed or permitted basis. Such comparability will result in better analysis techniques by state insurance departments and increased consumer protection. This comparability is achieved through the illustrative disclosure of Appendix A-205.

SSAP No. 1 summarizes the disclosures that are required when the accounting practices employed by a reporting entity depart from the NAIC statutory accounting practices and procedures set forth in the AP&P Manual. The statement also refers to the illustrative disclosure provided in Appendix A-205.

Advance Notification Requirement
As discussed previously, the Preamble requires regulators to provide fellow state regulators advance notification prior to granting a permitted practice. This notification requirement requires that the regulator also disclose the financial statement impact of this and other permitted practices.

An illustrative disclosure for permitted accounting practices is shown on the following two pages.
Illustrative Disclosure

XYZ Insurance Company
Footnotes to Financial Statements
December 31, 20X2 and 20X1

Note 1–Organization

The XYZ Company is a mutual life insurance company domiciled in the state of ABC and licensed to do business in all 50 states. The company markets traditional whole life, term and disability income insurance policies to individuals through its career agency force.

Note 2–Basis of Presentation

The financial statements of XYZ Company are presented on the basis of accounting practices prescribed or permitted by the ABC Insurance Department.

The ABC Insurance Department recognizes only statutory accounting practices prescribed or permitted by the state of ABC for determining and reporting the financial condition and results of operations of an insurance company, for determining its solvency under the ABC Insurance Law. The National Association of Insurance Commissioners’ (the “NAIC”) Accounting Practices & Procedures Manual version effective January 1, 2001 (“NAIC SAP”) has been adopted as a component of prescribed or permitted practices by the state of ABC. The state has adopted certain prescribed accounting practices, which differ from those found in NAIC SAP. Specifically, 1) goodwill arising from the purchase of a subsidiary, controlled or affiliated entity is written off directly to surplus in the year it originates by ABC domiciled companies; in NAIC SAP, goodwill in amounts not to exceed 10% of an insurer’s capital and surplus may be capitalized and all amounts of goodwill are amortized to unrealized gains and losses on investments over periods not to exceed 10 years, and 2) 100% of all fixed assets may be admitted by ABC domiciled companies; in NAIC SAP, fixed assets are not admitted. The Commissioner of Insurance has the right to permit other specific practices, which deviate from prescribed practices.

The Company, with the explicit permission of the Commissioner of Insurance of the state of ABC, records the value of its home office building at fair market value instead of at the depreciated cost method required by NAIC SAP. If the home office building were carried at depreciated cost, home office property and statutory surplus would be decreased by $2,500,000 and $2,300,000 as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased by $120,000 and $103,000, respectively, for the years then ended.
A reconciliation of the Company’s net income and capital and surplus between NAIC SAP and practices prescribed and permitted by the state of ABC is shown below.

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income, ABC state basis</td>
<td>$3,200,000</td>
<td>$2,900,000</td>
</tr>
<tr>
<td><strong>State Prescribed Practices:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation of fixed assets</td>
<td>100,000</td>
<td>110,000</td>
</tr>
<tr>
<td><strong>State Permitted Practices:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation, home office property</td>
<td>120,000</td>
<td>103,000</td>
</tr>
<tr>
<td>Net Income, NAIC SAP</td>
<td>$3,420,000</td>
<td>$3,113,000</td>
</tr>
<tr>
<td>Statutory Surplus, ABC state basis</td>
<td>$30,000,000</td>
<td>$27,900,000</td>
</tr>
<tr>
<td><strong>State Prescribed Practices:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill, net</td>
<td>3,000,000</td>
<td>2,700,000</td>
</tr>
<tr>
<td>Fixed Assets, net</td>
<td>( 850,000)</td>
<td>( 950,000)</td>
</tr>
<tr>
<td><strong>State Permitted Practices:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home Office Property</td>
<td>( 2,500,000)</td>
<td>( 2,300,000)</td>
</tr>
<tr>
<td>Statutory Surplus, NAIC SAP</td>
<td>$29,650,000</td>
<td>$27,350,000</td>
</tr>
</tbody>
</table>

### Quick Check

1. *Why is the disclosure illustrated in Appendix A-205 such a powerful regulatory tool?*

The disclosure illustrated in Appendix A-205 makes financial statements for insurers domiciled in different states to be comparable. Also, recall from the Preamble that increased comparability of financial statements was expected to result in better analysis work by state insurance departments and increased consumer protection.
SSAP No. 64—Offsetting and Netting of Assets and Liabilities

SSAP No. 64 establishes statutory accounting principles for offsetting and netting of assets and liabilities.

What is the Right of Offset?

SSAP No. 64 states that, in general, assets and liabilities shall be offset and reported net only when a valid right of setoff exists. However, there are exceptions to this rule. A right of setoff is a reporting entity’s legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying an amount that the other party owes to the reporting entity against the debt. **A valid right of offset exists only when all the following conditions are met.**

(a) Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement;

(b) The reporting party has the right to setoff the amount owed with the amount owed by the other party;

(c) The reporting party intends to offset; and

(d) The right of setoff is enforceable at law.

Exceptions to the General Guideline

- **Sometimes netting is required, even if there is not a right of offset.** Statutory accounting requires that certain assets and liabilities be shown as a net amount for reporting purposes, regardless of whether a valid right of setoff exists. Occasionally, a SSAP provides for netting of assets and liabilities that would not normally qualify for offset treatment. SSAP No. 40—Real Estate Investments exemplifies this treatment when dealing with certain real estate transactions.

- **Sometimes netting is prohibited, even with a valid right of offset.** Assets and liabilities meeting the SSAP No. 64 requirements cannot be netted if prohibited by specific SSAPs. SSAP No. 62R—Property and Casualty Reinsurance, for example, specifically prohibits netting of reinsurance recoverables on paid losses and ceded premiums payable.

It is not appropriate to offset amounts due to or from affiliates unless all the outlined qualifications have been met.
Quick Check

Answers

What publication is the comprehensive guide to statutory accounting principles?

The NAIC **Accounting Practices & Procedures Manual** is the comprehensive guide of statutory accounting principles.

SAP is accounting **practices** or **procedures** prescribed or **permitted** by an insurer's domiciliary state.

Does the NAIC *Accounting Practices & Procedures Manual* accept all GAAP guidance?

Yes or **No**

Why not?

*It first becomes part of the Statutory Accounting Principles (E) Working Group’s agenda process to be reviewed. Once the GAAP guidance is reviewed by the Working Group, it is either rejected outright, adopted with modification, or adopted outright by the Working Group.*

What are some of the attributes of Generally Accepted Accounting Principles?

– Designed to meet the varying needs of different users of financial statements or general-purpose use.
– Stresses the measurement of **income** by matching of revenue to expense
– What section of the financial statements is emphasized? **Income statement**
– Assumes the “**going concern**” concept.”

What are some of the attributes of Statutory Accounting Principles?

– Designed to address the concerns of **regulators**.
– Stresses the measurement of ability to satisfy **policyholder obligations**.
– Takes a **balance sheet** emphasis, stressing liquidity
– Conservative approach for calculating surplus.
– Practical approach: Can the insurer pay its **claims**?
Section 3 – Review Questions

Please read Section 3 and answer the following multiple-choice questions. Answers must be entered into the “Test Answer Form” in order to obtain credit. See instructions in the Program Overview for purposes of obtaining credit.

HINT: There might be review questions from previous sections.

8. The foundation concepts are found in SSAP No 1.
   a. True
   b. False

9. The SSAPs are the highest level of authoritative literature in the statutory hierarchy.
   a. True
   b. False

10. A nonadmitted asset is one that is:
    a. Specifically identified within statutory accounting principles as a nonadmitted asset
    b. Required to be charged to operations in the period the asset is purchased
    c. Not specifically identified as an admitted asset within statutory accounting principles
    d. Both a and c

11. An asset is defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
    a. True
    b. False

12. Statutory accounting principles require entities to disclose their capitalization policy threshold for their assets. The assets affected include, but are not limited to:
    a. Furniture, fixtures and equipment or supplies
    b. Leasehold improvements paid by the reporting entity as lessee
    c. Health care delivery assets
    d. All of the above
13. The Investment Risk Interrogatories are required to be included within:
   a. The annual statement
   b. The supplement to the annual statement filed by April 1
   c. The audited statutory financial statements
   d. Both b and c

14. The Summary Investment Schedule is required to be included within:
   a. The annual statement
   b. The supplement to the annual statement filed by April 1
   c. The audited statutory financial statements
   d. Both a and c
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At the completion of this section, you will be able to:

1. Identify specific items of difference between a GAAP and SAP balance sheet

2. Distinguish between how GAAP and SAP handle specific accounting elements on the balance sheet

3. Recognize admitted and nonadmitted assets

4. Recognize liabilities

5. Describe IFRS and how it may impact the future of GAAP and statutory accounting

A Look Back

Section 3 focused on the four prominent statutory principles that serve as a foundation for statutory accounting.

A Look At This Section

After an explanation of generally accepted accounting principles and statutory accounting principles, this section illustrates the differences between a GAAP and SAP balance sheet.

A Look Ahead

Section 5 addresses statements specific to premium and details the standards specific to different classifications of insurance, managed care contracts, and retrospectively rated contracts. Some reserving is also addressed.
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This section illustrates how the variations between SAP and GAAP would be identifiable through comparison of the balance sheets for individual line items. It also discusses the development of International Financial Reporting Standards (IFRS) and how the potential convergence of IFRS and U.S. GAAP might impact statutory accounting principles.

**GAAP AND SAP BALANCE SHEET COMPARISON**

SAP utilizes the framework established by GAAP as a basis for statutory financial accounting and reporting, thus including the foundational GAAP concepts of relevance, reliability, neutrality comparability and materiality. SAP places additional emphasis on the concepts of conservatism, consistency and recognition due to differences in reporting objectives.

The objectives of GAAP reporting differ from the objectives of SAP reporting for various reasons. Primarily, GAAP reporting is designed to meet the varying needs of the different users of financial statements, whereas SAP reporting is designed to address the concerns of regulators, the primary users of statutory financial statements. As a result, GAAP stresses measurement of earnings of a business from period to period (i.e., matching revenue to expense), while SAP stresses measurement of ability to pay claims in the future.

GAAP has recognized certain assets that, for statutory purposes, have been either nonadmitted or immediately expensed. For example, policy acquisition costs are expensed as incurred under SAP because the funds are not available to pay future claim liabilities. Insurance company financial statements prepared in accordance with GAAP defer specific acquisition costs incurred in the acquisition of new business and amortize them over the premium recognition period.

In 2009, the Financial Accounting Standards Board (FASB) issued *FASB Statement 168, FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (FAS 168), effective for interim and annual periods ending after September 15, 2009. FAS 168 (Topic 105 of the FASB Codification) identified the sources of accounting principles and the framework for selecting the principles used in the preparation of the financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States. Pursuant to this standard:

- FASB Accounting Standards Codification was established as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities.
- Accounting Standards Updates issued after the effective date of FAS 168 are not considered authoritative in their own right, and only provide background information.
On the effective date (September 15, 2009), all non-SEC accounting and reporting standards were superseded. Additionally, all non-grandfathered, non-SEC accounting literature not included in the FASB Codification was deemed non-authoritative.

The Statutory Accounting Principles (E) Working Group has formed the Accounting Practices & Procedures Manual (E) Subgroup to assess changes necessary to reflect the GAAP codification within statutory accounting principles. Until this process is complete, or as otherwise noted in specific SSAPs or Interpretations, users of the NAIC Accounting Practices & Procedures Manual shall continue to refer to the FASB pre-codification standards, and the applicable references to such standards, to determine the GAAP guidance that has been adopted, adopted with modification, or rejected for statutory accounting. Hence, this course also reference pre-codification standards. Appendix D of the AP&P Manual offers a cross-reference tool to assist with location of specific guidance.

To better understand specific differences between GAAP and SAP, a complete balance sheet for Burning Down the House Insurance Company is included in this self-study. The differences that exist between the GAAP and SAP balance sheet for Burning Down the House Insurance Company are summarized throughout this section.

NOTE: For illustrative purposes, differences from health, life, accident/health and property/casualty insurance companies are included in this presentation.
### Assets

**NONADMITTED ASSETS**

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>3,111,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,794,000</td>
<td>254,000</td>
</tr>
</tbody>
</table>

In summary, GAAP financial statements do not include “nonadmitted assets,” while SAP financial statements require certain assets to be nonadmitted.

### ASSETS AND NONADMITTED ASSETS (SSAP No. 4 and SSAP No. 20)

A primary difference between GAAP and SAP accounting is the concept of a nonadmitted asset. This concept is not present in GAAP accounting. GAAP, for the most part, keeps these items in the balance sheet, but requires that they meet tests of recoverability or realization. In some cases, allowances or other reductions in value are established.

SAP addresses the concept of nonadmitted assets throughout the SSAPs and specifically in *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) and *SSAP No. 20—Nonadmitted Assets* (SSAP No. 20). SSAP No. 4 provides a definition of what constitutes an asset; therefore, once an asset has been determined, it shall then be evaluated to determine if it is admitted.
Statutory accounting defines a nonadmitted asset as one that is accorded limited or no value in statutory reporting and is one that is:

(a) specifically identified within the *Accounting Practices & Procedures Manual* as a nonadmitted asset; or
(b) not specifically identified as an admitted asset within the *Accounting Practices & Procedures Manual*.

SSAP No. 20 provides a list of nonadmitted assets. This list is not intended to be all-inclusive and includes:

a. Deposits in Suspended Depositories
b. Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments
c. Loans on Personal Security, Cash Advances to, or in the Hands of, Officers or Agents and Travel Advances
   Some of these items may also be considered prepaid expenses that, per *SSAP No. 29—Prepaid Expenses*, are nonadmitted.
d. All “Non-Bankable” Checks
   Examples of non-bankable checks are non-sufficient funds (NSF) checks, post-dated checks or checks for which payment has been stopped.
e. Trade Names and Other Intangible Assets
f. Automobiles, Airplanes and Other Vehicles
   Automobiles, airplanes and other vehicles meet the definition of assets established in SSAP No. 4. However, they are not readily available to satisfy policyholder obligations and as a result the undepreciated portion shall be nonadmitted.
g. Company’s Stock as Collateral for Loan
   When a reporting entity lends money and accepts its own stock as collateral for the loan, it shall report the amount of the loan receivable and any related accrued interest on the loan as a nonadmitted asset.

The reason that many assets are nonadmitted is due to concern as to their collectibility or because there is an insufficient basis for determining their value. The general guideline is if it is not available to meet policyholder obligations, the asset is nonadmitted or expensed as incurred.

**Other Examples of Nonadmitted Assets:**
- Agents’ balances over 90 days due
- Equipment, furniture and supplies
- Amounts recoverable from insolvent reinsurers or on deposit with insolvent reinsurers
- Loans with inadequate collateral
- Mortgage loans in excess of statutory requirements

GAAP keeps these items on the balance sheet, but requires that they meet tests of recoverability or realization. In some cases, allowances or other reductions in value are established.
INVESTMENTS

With the investments above, the statutory total of $17,000 in nonadmitted asset represents investments that exceed the statutory investment limitations imposed by the state of domicile. Most of the states impose such limitations.

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investments:</strong></td>
<td><strong>Investments:</strong></td>
</tr>
<tr>
<td>Trading securities</td>
<td>Bonds</td>
</tr>
<tr>
<td>$56,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Securities available for sale</td>
<td>Common stocks</td>
</tr>
<tr>
<td>$1,200,000</td>
<td>$1,119,000</td>
</tr>
<tr>
<td>Securities held to maturity</td>
<td>$598,000</td>
</tr>
<tr>
<td>$600,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

In summary, GAAP and SAP reporting classifications and valuation requirements are quite different. In an appreciating market, one may expect to see a larger investment balance for GAAP than SAP for these investments (as fair values begin to exceed amortized cost measurements). In a depreciating market, one may expect the opposite effect. Additionally, almost every state imposes investment limitations for statutory reporting, when no such limitations exist in GAAP.

- GAAP does not recognize the concept of “nonadmitted assets,” nor does it impose investment limitations.
- GAAP (FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities) requires investments in debt and equity securities to be classified into three separate categories.
  - Securities held to maturity – Reported at amortized cost;
  - Securities available for sale – Reported at fair value (with unrealized gains and losses reported as a separate component of equity); and
  - Trading securities – Reported at fair value (with unrealized gains and losses reported in earnings).

- Under SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities, bonds are generally reported at amortized cost, except for those considered to be low-quality, which are reported at the lower of amortized cost or fair value.
- Under SSAP No. 30—Investments in Common Stocks (excluding investments in common stock of subsidiary, controlled or affiliated entities), common stocks are generally reported at fair value.
- The states often have quantitative and qualitative investment limitations.
GOODWILL

To calculate goodwill, we must be aware that Burning Down the House’s adjusted capital and surplus is $170,000. This allows $17,000 of goodwill to be recorded as an admitted asset ($170,000 * 10% = $17,000).

NOTE: The difference between the $50,000 under SAP (before nonadmitting assets) and the $20,000 under GAAP is the difference in calculating goodwill based on the book value or the market value of the investment. Because GAAP takes the purchase price against market value, SAP generally has a larger initial value of goodwill.

<table>
<thead>
<tr>
<th>GOODWILL</th>
<th>GAAP</th>
<th>SAP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>For investments in subsidiaries, GAAP requires investments in the common stock of subsidiaries to be reported as a line item on the balance sheet, separate from the entity’s other common stock investments.</strong></td>
<td></td>
<td><strong>SAP requires investments in the common stock of subsidiaries to be reported within the applicable investment category on the face of the balance sheet, rather than as a separate investment. The amount included in the common stock line of the balance sheet for investments in subsidiaries also includes any goodwill on the investment.</strong></td>
</tr>
<tr>
<td><strong>GAAP requires goodwill on investments to be calculated as the purchase price less the market value of the investment. Additionally, GAAP does not limit the amount of goodwill that can be recorded in the financial statements.</strong></td>
<td></td>
<td><strong>SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities amends SSAP No. 68—Business Combinations and Goodwill and calculates goodwill as the purchase price less the book value of the investment.</strong></td>
</tr>
<tr>
<td><strong>SSAP No. 68 requires goodwill that exceeds 10% of adjusted capital and surplus to be nonadmitted. The capital and surplus limit is calculated as 10% of the previous quarter’s capital and surplus after first deducting:</strong></td>
<td></td>
<td><strong>SSAP No. 68 requires goodwill that exceeds 10% of adjusted capital and surplus to be nonadmitted. The capital and surplus limit is calculated as 10% of the previous quarter’s capital and surplus after first deducting:</strong></td>
</tr>
<tr>
<td>(1) Electronic data processing (EDP) equipment;</td>
<td></td>
<td>(1) Electronic data processing (EDP) equipment;</td>
</tr>
<tr>
<td>(2) Operating system software;</td>
<td></td>
<td>(2) Operating system software;</td>
</tr>
<tr>
<td>(3) Goodwill; and</td>
<td></td>
<td>(3) Goodwill; and</td>
</tr>
<tr>
<td>(4) Net deferred tax assets.</td>
<td></td>
<td>(4) Net deferred tax assets.</td>
</tr>
</tbody>
</table>
In summary, SAP financial statements are more conservative than GAAP, in that SAP financial statements will generally include a smaller balance for investments in subsidiaries than GAAP financial statements. This is primarily because of the limitations that SAP places on the amount of admissible goodwill. While the initial goodwill calculated for SAP purposes will exceed initial goodwill calculated for GAAP purposes, SAP limits the amount of goodwill recorded in the financial statements to 10% of adjusted capital and surplus. Finally, the presentation of the investment in a subsidiary is different under GAAP and SAP.
MORTGAGE LOANS

Mortgage loans are valued at the unpaid principal amount and impairment of the asset can be measured using varying methods.

Mortgage loans are valued at the unpaid principal amount for SAP purposes, pursuant to SSAP No. 37—Mortgage Loans. Impairment is measured based on the fair value of collateral less costs to obtain and sell the property.

Many of the states have investment limitations on the value of mortgage loans to the property value.

In summary, the GAAP and SAP financial statements will yield fairly consistent balances for mortgage loan investments (provided the loan is within state investment limits).
REAL ESTATE

SAP requires all properties to be recorded net of any related debt. This results in the difference of $25,000 between the GAAP and SAP balance sheet.

<table>
<thead>
<tr>
<th>REAL ESTATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP Balance Sheet</td>
</tr>
<tr>
<td>Real estate</td>
</tr>
<tr>
<td>50,000</td>
</tr>
</tbody>
</table>

In summary, the valuation of real estate is fairly consistent between GAAP and SAP, while the reporting is different. GAAP (1) does not require the three classifications required by SAP; (2) does not allow netting of the related debt; and (3) does not require the use of an appraisal to support fair value estimates. GAAP and SAP are also consistent in their accounting for the impairment of real estate investments.
CASH AND SHORT-TERM INVESTMENTS

In this case, the SAP cash balance is actually lower by $20,000 because the Burning Down the House company has one negative cash account with a balance of $20,000. This $20,000 is reclassed to “Other Liabilities” on the GAAP financial statements, which explains why the “Other Liabilities” balance for GAAP is $20,000 higher than the SAP balance for “Other Liabilities.”

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>50,000</td>
</tr>
<tr>
<td>Cash and short-term investments</td>
<td>30,000</td>
</tr>
</tbody>
</table>

In summary, GAAP financial statements will only include positive cash accounts in the cash balance reported in the asset section of the balance sheet, while SAP financial statements will include both positive and negative cash accounts in their cash balance. Therefore, if a company has at least one negative cash account balance, the GAAP cash balance will always exceed the SAP cash balance.
• OTHER INVESTED ASSETS

<table>
<thead>
<tr>
<th></th>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other invested assets</td>
<td>30,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>

GAAP does not require assets to be classified as either “Other Invested Assets” or “Other Assets.” GAAP makes no distinction between these types of assets.

SAP requires certain assets (e.g., transportation equipment, mineral rights, certain fixed or variable interest rate investments, certain joint ventures and partnerships, surplus debentures, collateral loans, capital notes, etc.) to be recorded as “Other Invested Assets” separately from “Other Assets.” This is necessary because some investment law limitations are based on “invested assets” and some financial ratios use “invested assets.”

In summary, GAAP financial statements do not require the classification of assets into “Other Invested Assets” and “Other Assets.” SAP financial statements, on the other hand, do require this classification. This does not affect the valuation of such assets; rather, it simply affects the presentation and disclosure of such assets.
• **ACCRUED INTEREST**

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued interest and dividends 25,000</td>
<td>Accrued interest and dividends 25,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>25,000</td>
<td>25,000</td>
<td></td>
</tr>
</tbody>
</table>

### ACCRUED INTEREST

<table>
<thead>
<tr>
<th>GAAP</th>
<th>SAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Investment income is reported as the income is earned by the reporting entity.</td>
<td>• <strong>SSAP No. 34—Investment Income Due and Accrued</strong> requires that investment income be reported as the income is earned by the reporting entity.</td>
</tr>
</tbody>
</table>

In summary, GAAP and SAP financial statements will generally yield consistent balances for accrued interest and dividends because both GAAP and SAP report the income as it is earned, rather than as it is collected in cash, similar to what the U.S. IRS Code requires.
• **AGENTS’ BALANCES OR ACCIDENT AND HEALTH PREMIUMS DUE AND UNPAID**

In this case, it appears that there are $5,000 of agents’ balances and uncollected premiums that are more than 90 days past due.

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums receivable and agents' balances</td>
<td>Agents' balances and uncollected premium</td>
</tr>
<tr>
<td>55,000</td>
<td>55,000 5,000 50,000</td>
</tr>
</tbody>
</table>

OR

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums receivable and agents' balances</td>
<td>Accident and health premiums due and unpaid</td>
</tr>
<tr>
<td>55,000</td>
<td>55,000 5,000 50,000</td>
</tr>
</tbody>
</table>

In summary, GAAP utilizes a valuation allowance for doubtful accounts, while SAP simply requires nonadmission of those items greater than 90 days past due.

<table>
<thead>
<tr>
<th>AGENTS BALANCES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GAAP</strong></td>
</tr>
<tr>
<td>GAAP requires receivables for premiums and agents’ balances to be reported net of any allowance for doubtful accounts.</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

In summary, GAAP utilizes a valuation allowance for doubtful accounts, while SAP simply requires nonadmission of those items greater than 90 days past due.
DEFERRED ACQUISITION COSTS (DAC)

GAAP (FAS 60) allows certain acquisition costs and commissions to be deferred and amortized to expense over the life of the policy.

SSAP No. 71—Policy Acquisition Costs and Commissions requires acquisition costs and commissions to be expensed as incurred.

In summary, SAP financial statements will never show an asset for deferred acquisition costs while GAAP financial statements will show a fairly material asset for deferred acquisition costs for companies writing significant amounts of new business.

Typical deferred acquisition cost items include:
- Commissions
- State premium taxes
- Underwriting
- Issuance costs

The differences in the treatment of DAC illustrate the fundamentally different approaches that GAAP and SAP have.

GAAP requires that premium related expenses be treated as DAC and capitalized as an asset in the balance sheet. Under GAAP, DAC are amortized by periodic charges to income as premium is earned to match income and expenses.

Under SAP, all acquisition costs are charged to current operations as incurred. Premiums are recognized as income on a pro-rata basis. This is because the costs are not available to pay policyholder obligations.
DEFERRED ACQUISITION COST EXAMPLE

Assumptions:
- Annual Premium is $1,200
- Policy term is one year
- Policy is effective December 1
- Acquisition expenses for commissions, taxes, policy issue, etc., are $360

On December 31, this would be the SAP and GAAP income statements for this policy:

**SAP**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums Written</td>
<td>$1,200</td>
<td>$0</td>
</tr>
<tr>
<td>Change in UPR (see below)</td>
<td>$1,100</td>
<td>($1,100)</td>
</tr>
<tr>
<td>Premiums Earned</td>
<td>$100</td>
<td>$1,100</td>
</tr>
<tr>
<td>Acquisition Expenses</td>
<td>$360</td>
<td>$0</td>
</tr>
<tr>
<td>Net Income</td>
<td>$(260)</td>
<td>$1,100</td>
</tr>
</tbody>
</table>

**GAAP**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums Written</td>
<td>$1,200</td>
<td>$0</td>
</tr>
<tr>
<td>Change in UPR (see below)</td>
<td>$1,100</td>
<td>($1,100)</td>
</tr>
<tr>
<td>Premiums Earned</td>
<td>$100</td>
<td>$1,100</td>
</tr>
<tr>
<td>Acquisition Expenses</td>
<td>$30</td>
<td>$330</td>
</tr>
<tr>
<td>Net Income</td>
<td>$70</td>
<td>$770</td>
</tr>
</tbody>
</table>

At the end of year one, the company would show the unamortized acquisition costs of $330 as an asset on the GAAP balance sheet.

**UPR = Unearned Premium Revenue Computation:**
$1,200 (premiums written) x 11/12 (portion of premium unearned at computation date) = $1,100.
LIFE INSURANCE PREMIUMS DEFERRED

GAAP does not require the use of the mean reserve method, which is often used for SAP life insurance policy reserve calculations. Therefore, no deferred premium asset is necessary for GAAP purposes.

When the mean reserve method is used for calculating SAP reserves for life insurance policies, the reserves are overstated because this method assumes the company has collected premium through the policy’s next anniversary date (which is generally subsequent to the reporting date).

To compensate for this overstatement, SSAP No. 51—Life Contracts requires that an asset known as “deferred premiums” be recorded.

In summary, GAAP financial statements will never include an asset for deferred premiums, while SAP financial statements for life insurance companies will always include an asset for deferred premiums when the mean reserve method is used for calculating life policy reserves.
FURNITURE, FIXTURES AND EQUIPMENT

In the case of Burning Down the House, the entire $10,000 asset is nonadmitted. A $5,000 asset is capitalized for GAAP purposes (using capital lease accounting) while it cannot be capitalized for SAP purposes (using operating lease accounting).

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Furniture, fixtures and equipment</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

In summary, SAP financial statements are more conservative than GAAP in that SAP financial statements, unless permitted by the state, will never include furniture, fixtures or equipment as assets. Rather, SAP requires such assets to be nonadmitted. Additionally, GAAP financial statements allow either capital lease or operating lease accounting (subject to certain criteria), while SAP financial statements only allow operating lease accounting.
• ELECTRONIC DATA PROCESSING (EDP) EQUIPMENT

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>EDP equipment and operating software</td>
<td>25,000</td>
</tr>
<tr>
<td>EDP equipment and operating software</td>
<td>25,000</td>
</tr>
<tr>
<td>Assets</td>
<td>Not Admitted</td>
</tr>
<tr>
<td>20,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

In the case of Burning Down the House, we are assuming the previous quarter’s adjusted capital and surplus was approximately $165,000 ($165,000 * 3% = ~$5,000), resulting in only $5,000 of admitted EDP equipment.

<table>
<thead>
<tr>
<th>EDP EQUIPMENT</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP</td>
<td>SAP</td>
</tr>
<tr>
<td>• EDP equipment is capitalized and depreciated over its useful life.</td>
<td>• SSAP No. 16R—Electronic Data Processing Equipment and Accounting for Software requires that EDP equipment and operating system software that exceeds 3% of capital and surplus to be nonadmitted. The limit is calculated as 3% of the previous quarter’s capital and surplus after first deducting: (1) EDP equipment; (2) Operating system software; (3) Goodwill; and (4) Net deferred tax assets.</td>
</tr>
<tr>
<td></td>
<td>• SSAP No. 16R states that the depreciation period of EDP equipment and operating system software is the lesser of its useful life or three years.</td>
</tr>
<tr>
<td></td>
<td>• The depreciation period of nonoperating system software is the lesser of its useful life or five years.</td>
</tr>
</tbody>
</table>

In summary, SAP financial statements are more conservative than GAAP in that SAP financial statements will include a limited amount of EDP equipment as an asset. SAP requires EDP equipment in excess of 3% of capital and surplus to be nonadmitted. No such limitations are imposed by GAAP.
Health care receivables

It appears that there are $175,000 of health care receivable balances that do not meet the parameters set forth in SSAP No. 84—Certain Health Care Receivables and Receivables Under Government Insured Plans.

<table>
<thead>
<tr>
<th>HEALTH CARE RECEIVABLES</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP Balance Sheet</td>
</tr>
<tr>
<td>Health care receivables</td>
</tr>
<tr>
<td>250,000</td>
</tr>
<tr>
<td>Health care receivables</td>
</tr>
<tr>
<td>250,000</td>
</tr>
<tr>
<td>Health care receivables</td>
</tr>
<tr>
<td>250,000</td>
</tr>
</tbody>
</table>

In summary, GAAP utilizes a valuation allowance for doubtful accounts, while SAP has detailed admissibility rules for those health care receivables addressed in SSAP No. 84.
• OTHER ASSETS

As illustrated on page 4-12, SAP had reported $30,000 as other invested assets.

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other assets</td>
<td>45,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>15,000</td>
</tr>
</tbody>
</table>

Assets Not Admitted Assets

15,000

15,000

As illustrated on page 4-12, SAP had reported $30,000 as other invested assets.

<table>
<thead>
<tr>
<th>OTHER ASSETS</th>
<th>GAAP</th>
<th>SAP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GAAP does not require assets to be classified between “Other Invested Assets” and “Other Assets.”</td>
<td></td>
<td>SAP requires certain assets (e.g., transportation equipment, mineral rights, certain fixed or variable interest rate investments, certain joint ventures and partnerships, surplus debentures, collateral loans, capital notes, etc.) to be recorded as “Other Invested Assets” separately from “Other Assets.”</td>
</tr>
</tbody>
</table>

In summary, GAAP financial statements do not require the classification of assets into “Other Invested Assets” and “Other Assets.” SAP financial statements, on the other hand, do require this classification. This does not affect the valuation of such assets; rather, it simply affects the presentation and disclosure of such assets.
Liabilities

- **PROPERTY/CASUALTY RESERVES**

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve for property-liability claims</td>
<td>$800,000</td>
</tr>
<tr>
<td>Reserve for property-liability claims</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

**OR**

- **ACCIDENT AND HEALTH RESERVES**

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve for accident &amp; health claims</td>
<td>900,000</td>
</tr>
<tr>
<td>Reserve for accident &amp; health claims</td>
<td>900,000</td>
</tr>
</tbody>
</table>

**PROPERTY/CASUALTY RESERVES**

<table>
<thead>
<tr>
<th>GAAP</th>
<th>SAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>- GAAP requires a liability for claims due and unpaid, claims in the course of settlement and incurred but not reported claims to be recorded based on management’s best estimate of the liability.</td>
<td>- SAP requires a liability for claims due and unpaid, claims in the course of settlement and incurred but not reported claims to be recorded based on management’s best estimate of the liability.</td>
</tr>
<tr>
<td>- GAAP generally allows discounting of this liability.</td>
<td>- SAP does not allow discounting of this liability except in specific circumstances.</td>
</tr>
<tr>
<td>- In the case where there is a range of possible losses, where no point within the continuous range of losses is considered to be a better estimate than any other point within the range, GAAP requires the reporting entity to record the minimum point in the range as its liability.</td>
<td>- In the case where there is a range of possible losses, where no point within the continuous range of losses is considered to be a better estimate than any other point within the range, SAP requires the reporting entity to record the midpoint of the range as its liability.</td>
</tr>
</tbody>
</table>

In summary, because of the short-term nature of most property/casualty liabilities, the GAAP and SAP balances will generally be fairly equal. Differences might exist where discounting was applied to these reserves for GAAP purposes, but was not allowed for SAP purposes. Further differences will result between GAAP and SAP when management estimates a range of possible losses and records the low point of the range for GAAP purposes and the midpoint of the range for SAP purposes.
• **LIFE RESERVES**

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve for life-contingent contract benefits</td>
<td>800,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIFE RESERVES</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GAAP</strong></td>
<td><strong>SAP</strong></td>
</tr>
<tr>
<td>• <em>FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments</em> and <em>AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises</em> allows the use of assumptions in calculating life policy reserves based on a company’s experience for various types of products (e.g., investment yields, mortality, terminations and expenses), which are generally less conservative than SAP assumptions.</td>
<td>• <em>SSAP No. 51—Life Contracts</em> requires the use of specific assumptions in calculating life policy reserves that are far less subjective and far more conservative than GAAP assumptions.</td>
</tr>
</tbody>
</table>

In summary, SAP reserves for life insurance policies are generally more conservative than GAAP reserves. This is illustrated above, because GAAP reserves are $50,000 less than SAP reserves. The primary difference is most likely represented by a higher interest rate for GAAP purposes (based on the company’s experience) than for SAP purposes (generally at a lower, more conservative interest rate).
• **UNEARNED PREMIUMS OR UNEARNED PREMIUMS/ADVANCE PREMIUMS**

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unearned premiums</td>
<td>250,000</td>
</tr>
<tr>
<td>Unearned premiums</td>
<td>250,000</td>
</tr>
</tbody>
</table>

**OR**

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unearned premiums</td>
<td>250,000</td>
</tr>
<tr>
<td>Advance premiums</td>
<td>240,000</td>
</tr>
</tbody>
</table>

**UNEARNED PREMIUM OR UNEARNED PREMIUMS/ADVANCE PREMIUMS**

<table>
<thead>
<tr>
<th>GAAP</th>
<th>SAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>• GAAP (FAS 60) requires premiums to be recognized on a pro-rata basis (daily pro-rata or monthly pro-rata).</td>
<td>• SSAP No. 53—Property Casualty Contracts – Premiums requires premium to be recognized on a pro-rata basis (daily pro-rata or monthly pro-rata).</td>
</tr>
<tr>
<td>• This results in the recording of an unearned premium liability for the portion of premium received but not yet earned.</td>
<td>• This results in the recording of an unearned premium liability for the portion of premium received but not yet earned.</td>
</tr>
<tr>
<td>• GAAP does not differentiate between unearned premiums and advance premiums.</td>
<td>• SSAP No. 54—Individual and Group Accident and Health Contracts requires premium to be recognized when due.</td>
</tr>
<tr>
<td></td>
<td>• Unearned premiums represent the unused portion of premiums received during the reporting period.</td>
</tr>
<tr>
<td></td>
<td>• Advance premiums represent those premiums received by the reporting entity prior to the effective date of coverage.</td>
</tr>
</tbody>
</table>

In summary, GAAP balances will be comprised of unearned premium, while health entities for SAP purposes will primarily have advance premiums. GAAP and SAP unearned premium reserves will generally be fairly consistent. Insurers with premium due on the first of the month will likely not have unearned premiums.
ASSET VALUATION RESERVE (AVR) AND INTEREST MAINTENANCE RESERVE (IMR)

GAAP Balance Sheet

<table>
<thead>
<tr>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset valuation reserve</td>
</tr>
<tr>
<td>Interest maintenance reserve</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

6,000                                           12,000

**AVR/IMR**

<table>
<thead>
<tr>
<th>GAAP</th>
<th>SAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP does not recognize or require an asset valuation reserve or an interest maintenance reserve.</td>
<td>SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve requires the reporting entity to record an AVR and an IMR.</td>
</tr>
<tr>
<td>The AVR is intended to establish a reserve to offset potential credit-related investment losses.</td>
<td></td>
</tr>
<tr>
<td>The IMR defers recognition of realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are amortized into investment income over the expected remaining life of the investments sold.</td>
<td></td>
</tr>
</tbody>
</table>

In summary, SAP financial statements are more conservative than GAAP financial statements because SAP requires the recording of an AVR and IMR. GAAP financial statements do not require such reserves.
In the case of Burning Down the House, $25,000 of long-term debt is used to offset the related real estate investment for which the debt was obtained. Rather than presenting the $25,000 as a separate liability, the real estate investment is reduced by $25,000, which explains the difference between the GAAP and SAP balance for real estate of $50,000 and $25,000, respectively.

The remaining difference between the GAAP and SAP long-term debt balances is the $50,000 that is recorded as surplus notes in the “Surplus” section of the SAP financial statements.

**NOTE:** SAP balances of $25,000 (included as offset to real estate asset), $50,000 (included as surplus notes) and the $25,000 of borrowed money equals the GAAP long-term debt balance of $100,000.

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>100,000</td>
</tr>
<tr>
<td>Borrowed money</td>
<td>25,000</td>
</tr>
</tbody>
</table>

In summary, GAAP and SAP are generally consistent in terms of how long-term debt is recorded and valued. The primary difference between GAAP and SAP lies in the presentation of such long-term debt within the balance sheet. While GAAP generally requires long-term debt to be reported as a separate gross liability, SAP requires certain long-term debt with certain characteristics to be reported as either: (1) a contra-asset; (2) a separate liability; or (3) a surplus note included in surplus.
• **OTHER LIABILITIES**

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other liabilities</td>
<td>30,000</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>10,000</td>
</tr>
</tbody>
</table>

In the case of Burning Down the House, the GAAP liability is $20,000 higher because Burning Down the House has one negative cash account with a balance of $20,000. This $20,000 is reclassed to “Other Liabilities” on the GAAP financial statements, which explains why the “Other Liabilities” balance for GAAP is $20,000 higher than the SAP balance for “Other Liabilities.”

<table>
<thead>
<tr>
<th>OTHER LIABILITIES</th>
<th>GAAP</th>
<th>SAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>• GAAP requires other liabilities to be recorded based on whether the liability: (1) is probable; and (2) can be reasonably estimated. When both criteria are met, the liability is required to be recorded. Liabilities recorded as part of other liabilities are generally not material enough to warrant presentation in a separate line of the balance sheet.</td>
<td></td>
<td>• SAP requires other liabilities to be recorded and presented consistent with GAAP. That is, liabilities are recorded if the liability: (1) is probable; and (2) can be reasonably estimated. When both criteria are met, the liability is required to be recorded.</td>
</tr>
</tbody>
</table>

In summary, GAAP and SAP will generally yield consistent balances for other liabilities.
- **SEPARATE ACCOUNTS**

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separate Account</td>
<td>10,000</td>
</tr>
<tr>
<td>Separate Account</td>
<td>10,000</td>
</tr>
</tbody>
</table>

**SEPARATE ACCOUNTS**

<table>
<thead>
<tr>
<th>GAAP</th>
<th>SAP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GAAP requires separate account assets and liabilities to be recorded at their market value.</strong></td>
<td><strong>SAP requires separate account assets and liabilities to generally be recorded at their market value. While differences in valuation do exist, market value is used for most separate account products.</strong></td>
</tr>
<tr>
<td><strong>AICPA Statement of Position 03-1, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long Duration Contracts and Separate Accounts</strong> requires four conditions for separate account classification. Products not meeting all of the following four conditions are reported within the general account:</td>
<td><strong>SSAP No. 56—Separate Accounts</strong> does not place limits on the types of products that can be classified within separate accounts. Essentially, if a state approves a separate account classification, then that product is reported within separate accounts.</td>
</tr>
<tr>
<td>1. Separate account is legally recognized;</td>
<td></td>
</tr>
<tr>
<td>2. Separate account assets are legally insulated;</td>
<td></td>
</tr>
<tr>
<td>3. Insurer must invest separate account funds as directed by the policyholder; and</td>
<td></td>
</tr>
<tr>
<td>4. All investment performance, net of fees and assessments, must be passed to the individual contract-holder.</td>
<td></td>
</tr>
</tbody>
</table>

In summary, although both GAAP and SAP measure separate account assets at market value, fewer items are classified within separate accounts for GAAP reporting purposes.
SECTION 4 – SAP, GAAP AND IFRS

**SURPLUS**

<table>
<thead>
<tr>
<th>GAAP Balance Sheet</th>
<th>Statutory Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>12,000</td>
</tr>
<tr>
<td>Additional paid in capital</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>675,000</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>208,000</td>
</tr>
<tr>
<td></td>
<td>Common stock</td>
</tr>
<tr>
<td></td>
<td>Additional paid in capital</td>
</tr>
<tr>
<td></td>
<td>Unassigned funds</td>
</tr>
<tr>
<td></td>
<td>Surplus notes</td>
</tr>
</tbody>
</table>

### SURPLUS

**GAAP**

- GAAP does not recognize statutory surplus but rather stockholders’ equity, with adjustments for net income, unrealized gains and losses, and translation gains and losses.
- GAAP requires the reporting of “Other Comprehensive Income (OCI).”
- GAAP requires surplus notes issued by the company (which is similar to debt) to be reported as long-term debt in the liabilities section of the balance sheet.

**SAP**

- SAP requires the presentation of statutory surplus. SSAP No. 72—Surplus and Quasi-reorganizations describes changes to statutory surplus, including, but not limited to: net income, unrealized gains and losses, exchange rate fluctuations, nonadmitted assets, provision for reinsurance, asset valuation reserve, deferred tax assets and deferred tax liabilities.
- SAP does not require separate reporting of OCI.
- SSAP No. 41—Surplus Notes requires surplus notes issued by the company (which is similar to debt) to be reported as a separate component of statutory surplus.

In summary, GAAP and SAP are quite different in this case. SAP unassigned funds includes amounts that are carried in the OCI for GAAP purposes. Result yields a “clean” income statement for GAAP and a “clean” surplus account for SAP.
SURPLUS

State laws require insurers to maintain a minimum amount of surplus. Surplus equals assets less liabilities. When surplus falls below the required level, an insurer becomes impaired. Where impairment exists, corrective measures must occur within a defined period of time or the insurer faces further regulatory action. There are several surplus accounts; however, only one is used to record the usual types of changes in surplus. The other surplus accounts are special-purpose accounts.

Surplus, in the form of retained earnings, protects against adverse fluctuations in an insurer’s assets, claims, expenses and investment yields and provides a cushion against unforeseen events. Surplus also serves as a key element of an insurer’s ability to expand its operations. Therefore, statutory accounting focuses mainly on the valuation of assets and liabilities.

Surplus increases primarily by income realized from operations and is decreased primarily by dividends to stockholders. Surplus is also decreased by a loss from operations. In addition, surplus can increase or decrease due to items not considered a normal part of doing business, such as a gain or loss from the sale of an asset or unrealized gains/losses on invested assets.

IFRS IMPACT TO GAAP & SSAP

International Financial Reporting Standards (IFRS) are developed by the International Accounting Standards Board (IASB). The IASB is composed of 14 members from different countries (no one country having an undue influence) with the objective to develop, in the public interest, a single set of high-quality, understandable and enforceable global accounting standards that require high-quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world’s capital markets and other users make economic decisions.

In September 2002, the FASB and the IASB released the “Norwalk Agreement” in which they each acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. During this September 2002 meeting, the FASB and IASB pledged to use their best efforts to: (a) make their existing financial reporting standards fully compatible as soon as it is practicable; and (b) coordinate their future work programs to ensure that, once achieved, compatibility is maintained.

During an October 2005 meeting, the FASB and IASB reaffirmed their commitment to converge U.S. GAAP and IFRS, with a common set of high-quality global standards remaining the long-term strategic priority of both the FASB and the IASB. As noted on the FASB website, “The FASB believes that the ideal outcome of cooperative international accounting standard-setting efforts would be the worldwide use of a single set of high-quality accounting standards for both domestic and cross-border financial reporting.”
In 2008, the two boards updated the Memorandum of Understanding (MoU) originally drafted in 2002. June 2011 was set as the target date for completing the major projects in the MoU. This updated MoU describes project-specific milestone targets, and acknowledges the need to intensify the standard-setting efforts to meet those targets.

In response to concerns from some stakeholders regarding the volume of draft standards due for publication in close proximity, the IASB and the FASB announced in June 2010 a modification to their convergence strategy. The strategy retained the June 2011 target date to complete those projects for which the need for improvement of IFRS and US GAAP is the most urgent, while identifying those projects for which a later completion date would be appropriate because they address matters that is believed to have a lower priority or for which further research and analysis is necessary.

The convergence of U.S. GAAP and IFRS has the potential to significantly impact statutory accounting standards. In accordance with the establishment and maintenance of statutory accounting principles, all GAAP pronouncements are reviewed for statutory accounting. Several GAAP pronouncements have been utilized for the basis of statutory accounting principles. If GAAP is superseded by IFRS, consideration will need to be given to the current SAP guidelines, as well as the maintenance process. Although statutory accounting are considered special-purpose financial statements (they assist the states in assessing solvency), there is a desire to minimize differences between statutory reporting and general accounting requirements.

The NAIC, including the Statutory Accounting Principles (E) Working Group, continues to monitor the development of International Financial Reporting Standards and the FASB’s movement toward convergence to determine the impact to statutory accounting principles.
Section 4 – Review Questions

Please read Section 4 and answer the following multiple-choice questions. Answers must be entered into the “Test Answer Form” in order to obtain credit. See instructions in the Program Overview for purposes of obtaining credit.

HINT: There might be review questions from previous sections.

15. Which SSAP requires disclosure requirements for changes in accounting principles, changes in accounting estimates, corrections of an error, historical schedules and mergers?
   a. SSAP No. 3—Accounting Changes and Corrections of Errors
   b. SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers
   c. SSAP No. 5—Liabilities, Contingencies and Impairments of Assets
   d. SSAP No. 4—Assets and Nonadmitted Assets

16. A change in accounting estimate is reported in which of the following:
   a. Statement of Revenues and Expenses
   b. Surplus

17. What are some examples of nonadmitted assets?
   a. Prepaid expenses
   b. Automobiles, airplanes and other vehicles
   c. Trade names and other intangible assets
   d. All of the above

18. Goodwill from the purchase of a subsidiary is calculated for SAP purposes as purchase price less book value, while GAAP is calculated as purchase price less market value.
   a. True
   b. False

19. The valuation of real estate with SAP does not require appraisals, but GAAP does require appraisals.
   a. True
   b. False
20. A GAAP valuation allowance established for non-government receivables in excess of 90 days would be an admitted asset for SAP, because SAP does not allow for a valuation allowance.
   
a. True
b. False

21. Unearned premiums occur when a coverage period crosses over a reporting date. Advanced premiums occur when funds are received prior to the effective date of the contract.
   
a. True
b. False
At the completion of this section, you will be able to:

1. Name the four categories of insurance premiums

2. Determine which category of insurance guidance to follow for each line of business

3. Describe how written premium is recorded

4. Distinguish a retrospectively rated contract from other contracts

SSAP No. 50—Classifications and Definitions of Insurance of Managed Care Contracts in Force
SSAP No. 51—Life Contracts
SSAP No. 52—Deposit-Type Contracts
SSAP No. 53—Property Casualty Contracts – Premiums
SSAP No. 54—Individual and Group Accident and Health Contracts
SSAP No. 65—Property and Casualty Contracts
SSAP No. 66—Retrospectively Rated Contracts

A Look Back
Section 4 provided an explanation of GAAP and SAP and illustrated how variations between GAAP and SAP are reflected on the balance sheet.

A Look At This Section
This section addresses statements specific to premium and details the standards specific to different classifications of insurance, managed care contracts and retrospectively rated contracts. Also included are reserves as required by these statements.

A Look Ahead
Section 6 will detail the statutory guidance designed for the invested assets of bonds and stocks.
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This section addresses statements specific to premium.

- **SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force** provides a general framework for classifying insurance or managed care contracts.
- **SSAP No. 51—Life Contracts** establishes statutory accounting principles for income recognition and reserve requirements for all contracts classified as life contracts in SSAP No. 50.
- **SSAP No. 52—Deposit-Type Contracts** establishes statutory accounting principles for income recognition and policy reserves for all contracts classified as deposit-type contracts in SSAP No. 50.
- **SSAP No. 53—Property Casualty Contracts – Premiums** establishes statutory accounting principles for the recording and recognition of premium revenue for property and casualty contracts as classified in SSAP No. 50.
- **SSAP No. 54—Individual and Group Accident and Health Contracts** covers income recognition and policy reserves for individual and group accident and health contracts, classified as accident and health in SSAP No. 50, except credit accident and health contracts.
- **SSAP No. 65—Property and Casualty Contracts** establishes statutory accounting principles for all contracts classified as property and casualty contracts in SSAP No. 50.
- **SSAP No. 66—Retrospectively Rated Contracts** establishes statutory accounting principles for retrospectively rated life, accident and health, and property and casualty contracts.

As previously discussed, the function of insurance is one of the most significant industries within the United States and other countries, with more than $4 trillion of insurance premiums in 2010. As discussed herein, the accounting for premiums varies somewhat by the type of business to which the premium pertains.
Classifying Insurance Contracts

Reference: SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force (SSAP No. 50)

This statement is perhaps like no other within the AP&P Manual in that it provides no accounting or reporting guidance. Instead, the statement establishes a general framework for classifying insurance contracts into categories where the recognition of contract and policy reserves and related revenues, benefits and claims is fundamentally different. The categories are as follows.

1. **Life Contracts** – Contracts with any life contingencies, including, but not limited to:

   (1) Whole life contracts
   (2) Endowment contracts
   (3) Term life contracts
   (4) Supplementary contracts
   (5) Group life contracts
   (6) Franchise life contracts
   (7) Universal life-type contracts
   (8) Variable life contracts
   (9) Limited payment contracts
   (10) Credit life contracts
   (11) Annuity contracts

2. **Accident and Health Contracts** – Contracts with health benefits or disability contingencies, including, but not limited to:

   (1) Managed care contracts
   (2) Income replacement contracts
   (3) Expense reimbursement contract
   (4) Credit accident and health contracts
   (5) Continuing care contracts
   (6) Long-term care contracts
   (7) Accidental death and dismemberment contracts

3. **Property and Casualty Contracts** – Contracts including, but not limited to:

   (1) Traditional property and casualty insurance contracts.
       a. Fire and allied lines, which include coverage for fire, windstorm, hail and water damage (but not floods).
       b. Ocean marine, which includes coverage for ships and their equipment, cargos, freight or money to be paid for use of the ships, and liability to third parties for damages. This type of insurance includes inland, as well as ocean, water transportation.
       c. Inland marine, which covers property in transit. It also includes floaters, which are policies that cover movable property, such as a tourist’s personal property.
       d. Workers’ compensation, which compensates employees for injuries or illness sustained in the course of their employment.
e. Automobile, which covers personal injury or automobile damage sustained by the insured and the related liability to third parties for losses caused by the insured.
f. Multiple peril, which is a package coverage including most property and liability coverage except workers’ compensation, automobile insurance and surety bonds.
g. Professional liability, which covers physicians, surgeons, dentists, hospitals, engineers, architects, accountants, attorneys and other professionals from liability arising from error or misconduct in providing or failing to provide professional service.
h. Miscellaneous liability, which covers most other physical and property damages not included under workers’ compensation, automobile liability and multiple peril policies. Damages include death, cost of care and loss of services resulting from bodily injury, as well as loss of use of property.
i. Fidelity bonds, which cover employers against dishonest acts by employees. Blanket fidelity bonds cover groups of employees.
j. Surety bonds, which provide for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period.

(2) Title insurance contracts.
(3) Mortgage and financial guaranty contracts.

4. Deposit-Type Contracts – Contracts without any life or disability contingencies, including, but not limited to, certain types of the following policy categories:

   (1) Supplemental contracts
   (2) Lottery payouts
   (3) Structured settlements
   (4) Guaranteed interest contracts
   (5) Income settlement options
   (6) Dividend and coupon accumulations
   (7) Annuities certain
   (8) Premium and other deposit funds
   (9) Funding agreements without well-defined class-based (e.g., age, gender) annuity purchase rates defining either specific or maximum purchase rate guarantees

It is important to point out that the grouping for life contracts includes all contracts that include any life contingencies. As shown above, this includes such products as limited pay contracts and annuity contracts that, for GAAP purposes, might be determined to lack significant life contingencies and, therefore, would receive much different accounting treatment under FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments (FAS 97). Under FAS 97, a contract that does not have significant life contingencies would not report premiums and benefits in the income statement. Instead, all premiums and benefits are reported through a deposit account.
(liability) similar to how a bank reports activity for its customers’ checking and savings accounts.

Although statutory accounting principles have used some of the concepts of *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60) and FAS 97 in their revenue and reserve recognition statements, several GAAP pronouncements were rejected during codification in SSAP No. 50. This includes not only FAS 60 and FAS 97, but also *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long Duration Participating Contracts* (FAS 120).

Over the past few years, the health care market has changed drastically and continues to evolve along with the various types of contracts. The lines between risk transfer on accident and health contracts continues to become more complex and will likely evolve more within the next few years, such that changes in the accounting guidance might become necessary. The property/casualty market also is beginning to show signs of change with new types of products being introduced to share the risk between entities. In the meantime, the premium and reserve guidance for all types of contracts, including accident and health and property/casualty contracts, is fairly general to allow some change in the form of contracts without significant changes in the accounting guidance.

**Premium Data Recap**

World premiums totaled more than $4 trillion in 2010. The U.S. had more than 26% ($1.6 trillion) of these premiums.

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>2010 U.S. Direct Written Premium (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property/Casualty</td>
<td>$481,400</td>
</tr>
<tr>
<td>Life and Accident/Health</td>
<td>$720,200</td>
</tr>
<tr>
<td>Health</td>
<td>$387,800</td>
</tr>
<tr>
<td>Fraternal</td>
<td>$11,000</td>
</tr>
<tr>
<td>Title</td>
<td>$9,400</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,609,800</strong></td>
</tr>
</tbody>
</table>
Life Contracts

Reference: SSAP No. 51—Life Contracts (SSAP No. 51)

As noted above, life contracts include all contracts that contain any life contingencies. Premiums are recognized as income on the gross basis (amount charged to the policyholder) when due from the policyholder under the terms of the insurance contract. As a result, premium income includes first-year premium, renewal premiums and retrospective premium adjustments as discussed in SSAP No. 66—Retrospectively Rated Contracts (SSAP No. 66) later in this section. Premium income should also include dividends, coupons, guaranteed annual pure endowments and similar benefits provided by the insurance contract when the insurer applies such amounts by the terms of the contract to provide additional paid-up insurance or annuities or to shorten the endowment or premium-paying periods. Also, premiums are increased by reinsurance premiums assumed and reduced by reinsurance premiums ceded.

Premium Adjustments
Record the change in gross deferred and uncollected premiums as premium income on the Summary of Operations page. Because only the net premiums are included in the computation of reserves and reported as an asset, it is necessary to adjust the gross premium for an amount representing the change in loading on deferred and uncollected premiums. Include the change in loading as an expense in the Summary of Operations and not as a reduction to premium income.

**Loading:** Difference between the gross premium and the net premium. Generally includes allowances for acquisition costs and other expenses, but also includes the differences in mortality and interest assumptions utilized for pricing and statutory reserving purposes.

Uncollected Premium Balances
Classify gross premiums that are due and unpaid as of the reporting date, net of loading, as uncollected premiums. This statement provides that both uncollected premiums and deferred premiums are admitted assets, as defined within SSAP No. 4, to the extent they conform to the requirements of this statement. Uncollected premium balances must be less than 90 days past due to meet the definition of an asset, and are admitted assets to the extent they conform to the requirements of this statement.

Valuation (Reserve) Method and Deferred Premiums
SSAP No. 51 requires that reserves for all benefits guaranteed under the terms of the policy be established as of the reporting date using the appropriate valuation methods, interest rates, mortality rates and morbidity rates. However, as a practical matter, insurers have generally calculated reserves as of the policy anniversary (i.e., terminal reserves), not the reporting date. As a result, it is necessary to adjust the terminal reserve back to the reporting date, using either the mean reserve method or the mid-terminal reserve method. Insurers must establish the deferred premium asset referred to above when using
the mean reserve method to offset the overstatement of reserves that takes place when assuming all premiums have been collected through the next premium anniversary date in developing the mean reserves.

**Advance Premiums**

Advance premiums are those premiums that the reporting entity has received before the valuation date, but that are due on or after the next policy (effective) date. At the premium due date, the amount received from the policyholder plus the accumulated interest equals the gross premium necessary to fund the policy. The total amount of such advance premiums (gross premiums), less any discount as of the valuation date, is reported as a liability (advance premiums) in the statutory financial statement and is not considered premium income until due. This reporting process recognizes the reporting entity’s liability to refund such premiums in the event the policy is terminated.

**Change in Valuation Basis**

Life companies that file the “blue blank” are currently required to record a change in the interest rate, mortality assumption or reserving method directly to surplus as a “change in valuation basis,” rather than as part of the reserve change recognized in the Summary of Operations. This statement adopts this requirement and further extends the requirement for companies to calculate the amount as of the beginning of the year based on the change in surplus under the old method and the new method at that time. This is consistent with the requirements of SSAP No. 3—Accounting Changes and Correction of Errors (SSAP No. 3) for a change in accounting principle and prevents companies from managing earnings (which are often used as a base for dividend restrictions) by recording a change calculated as of the middle of the year.

**Unearned Income**

This statement adopts the provisions of SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R) for certain fees received on some life insurance contracts that meet the definition of a liability. SSAP No. 5R defines a liability as probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction or event. Amounts assessed that represent compensation to the reporting entity for services to be provided in future periods and that are required to be refunded upon policy termination, if not earned by the reporting entity in the period assessed, meet the above definition. Therefore, insurers shall report such amounts, if not already considered in the policy reserve, as unearned income and recognized as income as the insurer provides the related services.
Illustration

#5-1

Unearned income can be recognized in many forms. Read the illustration below to learn the recording of unearned management fees and related change in accounting principle.

In connection with the company’s 20-year pay universal life insurance products, the insurer charges certain investment management fees to the policyholder’s account balance in the first year of the policy.

However, under the policy, these management fees are due to the policyholder upon termination of the policy on a pro-rata basis of the number of months the policy was in force compared to the 240 months of the full policy period. As of December 31, 20X1, the company had received $126,000 in management fees that it had not earned.

In 20X2, the company received an additional $20,000 in management fees and earned a total of $12,000 in management fees. As of December 31, 20X2, the company should record a liability for $134,000, calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management Fees @ 12/31/X1</td>
<td>$ 126,000</td>
</tr>
<tr>
<td>Plus: Additional Unearned Fees Collected</td>
<td>20,000</td>
</tr>
<tr>
<td>Less: Fees Earned During the Year</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Unearned Management Fees @ 12/31/X2</td>
<td>$134,000</td>
</tr>
</tbody>
</table>

The insurer would post the following journal entry during 20X2 to record the unearned management fees (we are assuming the company did not record these fees at 12/31/X1):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>20,000</td>
</tr>
<tr>
<td>Change in Accounting Principle</td>
<td>126,000</td>
</tr>
<tr>
<td>Unearned Management Fees</td>
<td>134,000</td>
</tr>
<tr>
<td>Management Fee Income</td>
<td>12,000</td>
</tr>
</tbody>
</table>

**Accelerated Benefits**

Due to the increase in the viatical settlements that are occurring in the life insurance industry, the Statutory Accounting Principles (E) Working Group added accounting guidance regarding accelerated benefits. Accelerated benefits are benefits payable under a life insurance contract to a policyholder or certificate holder during the lifetime of the insured, in anticipation of death or upon the occurrence of specified life-threatening or catastrophic conditions as defined by the policy or rider. These benefits reduce the death benefit otherwise payable under the life insurance contract and are payable upon the occurrence of a single qualifying event, which results in the payment of a benefit amount fixed at the time of acceleration. The insurer shall not defer accelerated benefit payments that are other than policy loans, but shall charge these payments to the Summary of Operations as a benefit expense when paid to the policyholder.
Individual and Group Accident and Health Contracts

Reference: SSAP No. 54—Individual and Group Accident and Health Contracts (SSAP No. 54)

This statement establishes accounting principles for income recognition and reserves for all accident and health contracts, except credit accident and health contracts. Under this statement, premiums shall be recognized as income on the gross basis when due from policyholders or subscribers and shall exclude advance premiums. However, the reporting entity shall not report income received on uninsured accident and health plans or the uninsured portion of partially insured plans as premium income. (In accordance with SSAP No. 47—Uninsured Plans (SSAP No. 47), uninsured plans are defined when the reporting entity is an administrator of a plan for a third party that carries the insurance risk; thus, the reporting entity has not issued an insurance policy.) The insurer shall deduct from general expenses the administrative fees for servicing uninsured plans. If the insurer insures a portion of an otherwise uninsured plan, the insurer shall report as premium income the portion of income received attributed to this insured aspect.

Reserve Requirements

The aggregate reserves for accident and health contracts consist primarily of a policy reserve and a claim reserve. The policy reserve consists primarily of the unearned premium reserve. The claim reserve includes reserves established for estimated costs of future health care services to be rendered that the reporting entity is currently obligated to provide or reimburse as a result of premiums earned to date. Claim reserves (sometimes referred to as disabled life reserves) are required on claims that involve continuing loss. The claim reserve shall consist of a reserve for the present value of amounts not yet due. Claim liabilities, such as unpaid claims and incurred but not reported (IBNR) claims, are addressed in SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses (SSAP No. 55). The insurer shall establish statutory policy reserves for all unmatured contractual obligations arising out of the provisions of the contract. A prospective gross premium valuation is the ultimate test of reserve adequacy as of a given valuation date. Statutory reserves meet the definition of liabilities as defined in SSAP No. 5R.

Premium Deficiency Reserves

When the expected claims payments or incurred costs, claim adjustment expenses and administration costs exceed the premiums to be collected for the remainder of a contract period, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. For purposes of determining if a premium deficiency exists, the insurer shall group contracts in a manner consistent with how policies are marketed, serviced and measured. Insurers shall recognize a liability for each grouping where a premium deficiency is indicated. Insurers shall not offset deficiencies by anticipated profits in other policy groupings. Insurers shall make such accruals for any loss contracts, even if the contract period has not yet started.
Supplemental Benefits
In addition to the basic policy benefit, the contract may provide supplemental benefits. Supplemental benefits include, but are not limited to, accidental death benefits, dental and waiver of premium benefits. If the terms of the contract provide for these benefits, insurers shall establish appropriate reserves in accordance with the applicable standards within the AP&P Manual.

<table>
<thead>
<tr>
<th>Illustration</th>
</tr>
</thead>
<tbody>
<tr>
<td>#5-2</td>
</tr>
<tr>
<td>As of December 31, 20X1, it appears that one of the company’s current accident and health contracts is in a position where the future premiums collected will not be adequate to cover the future claims and administrative expenses. For the one contract, management has estimated that it will collect $500,000 in premiums and pay $600,000 in claims, claims adjustment expenses and other policy-related administrative expenses. Should the company record a liability if it has not incurred the future claims referred to above as of the balance sheet date?</td>
</tr>
</tbody>
</table>

Solution
Yes, the company should record a liability for $100,000 in anticipation of the future losses that are likely to occur based on the current deficiency in the pricing of the premiums on this contract. If the future losses and expenses can be reasonably estimated, it appears evident that, based on the current pricing (premiums cannot be increased during the period), a loss will ultimately be incurred. Because the loss is the result of deficiencies that currently exist in the pricing of the policy, the loss should be accrued once the loss is probable and reasonably estimated.

Contracts Subject to Redetermination by Other Entities
This statement also deals with contracts subject to redetermination by other entities, including the U.S. Office of Personnel Management (OPM) and other governmental bodies. The insurer shall record accrued premium adjustments (amounts receivable from the insurer when the initial premium charged on the contract was too low) as a write-in for other-than-invested assets and shall record accrued return premium adjustments (amounts payable to the insured when the initial premium charged on the contract was too high) as a liability, both with a corresponding entry to premiums. If, in accordance with SSAP No. 5R, it is probable that the additional premium adjustment is uncollectible, the insurer shall write off any uncollectible premium against operations in the period it made this determination and it shall provide the disclosure requirements outlined in SSAP No. 5R. If the insurer does not bill premiums in accordance with the policy provisions or contract provisions, or the policy provisions or contract provisions do not address the due date of such premiums, the accrual shall be nonadmitted. This is consistent with the guidance for audit premiums established in SSAP No. 6—Uncollected
Premium Balances, Bills Receivable for Premiums, and Amounts Due from Agents and Brokers (SSAP No. 6).

Quick Check

1. How do the requirements of SSAP No. 54 impact health entities?

Unearned premium reserves are required for all accident and health contracts where premiums have been reported for a period beyond the date of valuation, other than premiums paid in advance. The amount reported represents the unused portion of premiums received during the reporting period. Care should be taken to promote consistency between unearned premium reserves and premiums reported as due and paid. Health entities are required to record a liability when premium deficiencies exist that result in a loss contract.

Deposit-Type Contracts

Reference: SSAP No. 52—Deposit-Type Contracts (SSAP No. 52)

Deposit-type contracts include those contracts that contain no mortality or morbidity risks. Insurers shall not report amounts received as payment under these types of contracts as revenues, but shall record these amounts directly to an appropriate policy reserve account. Likewise, insurers shall not record payments that represent a return of policyholder balances (e.g., surrender benefits, annuity benefits, etc.) as expenses.

To the extent that such payments differ from the recorded reserve, the insurer shall record the difference in the Summary of Operations as a benefit expense.

The most significant risk that companies face under these types of contracts is investment risk. The elimination of considerations and benefits for deposit-type contracts from the income statement reduces the amount that the insurer reports in the income statement to the interest credited and surrender charges on the contracts.
During 20X1, ABC Company received $18,000,000 of premiums, paid $3,500,000 of annuity benefits and paid $1,900,000 in surrender benefits on annuity certain contracts. Additionally, ABC credited contract holders’ accounts with interest of $1,100,000.

1. What would ABC record as premium revenue in 20X1?
2. What would ABC record as annuity benefits and surrender benefits expense in 20X1?
3. What would ABC record as interest-credited expense in 20X1?

Solution
1. ABC would not record any premium revenue in 20X1. Rather, the amounts received would be recorded as an increase in the reserve liability for annuity certain contracts.
2. ABC would not record any annuity benefit or surrender benefit expenses in 20X1. Rather, ABC would record the annuity and surrender benefits paid as a decrease in the reserve liability.
3. Insurers record interest credited to liabilities for funds held on deposit by the company where the deposits, withdrawals or other payments between the policyholder and the company as balance sheet transactions. ABC would record $1,100,000 of interest through the income statement and in the Cash Flow.

Structured Settlements
Reporting entities that have accepted an assignment of obligations under structured settlements must record them in accordance with SSAP No. 65—Property and Casualty Contracts (SSAP No. 65).

In accordance with SSAP No. 65, structured settlements are periodic fixed payments to a claimant for a determinable period, or for life, for the settlement of a claim. Frequently, a reporting entity will purchase an annuity to fund the future payments. Reporting entities may purchase an annuity in which the entity is the owner and payee, or an annuity in which the claimant is the payee. When annuities are purchased to fund periodic fixed payments they shall be accounted for as follows.

a. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves. The insurer shall record the annuity at its present value and report the annuity as a non-invested asset. The insurer shall record income from the annuities as miscellaneous income. The insurer shall obtain the present value of the annuity and the related amortization schedule from the issuing life insurance company at the time the annuity is purchased.
b. When the claimant is the payee, the reporting entity shall reduce loss reserves to the extent that the annuity provides for funding of future payments. The reporting entity shall record the cost of the annuities as paid losses.

**Unearned Income**

The insurer shall report unearned income, if not already included in the policy reserve, as a liability and recognize the income as the insurer provides related services. This guidance is consistent with the guidance in SSAP No. 51.

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**Quick Check**

2. *Why is there a different accounting basis for deposit-type contracts?*

Deposit-type contracts do not contain insurance risk; therefore, the insurer should not record the premiums received and benefits paid in the Summary of Operations. Instead, they should record these amounts as an increase or decrease to a liability account. Keep in mind, the only expense that the insurer will record in the income statement is the expense for interest credited to policyholder accounts and the only income that the insurer will record in the income statement is income for surrender charges and other policy surcharges.

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**Property and Casualty Contracts**

**Reference:** *SSAP No. 65—Property and Casualty Contracts* (SSAP No. 65)

SSAP No. 65 is similar to SSAP No. 50 in that it lays the groundwork for some of the other statements within the AP&P Manual, specifically *SSAP No. 53—Property Casualty Contracts — Premiums* (SSAP No. 53). SSAP No. 65 does not address title insurance, mortgage guaranty insurance or financial guaranty insurance, which are addressed in *SSAP No. 57—Title Insurance*, SSAP No. 58—*Mortgage Guaranty Insurance* and SSAP No. 60—*Financial Guaranty Insurance*, respectively. These statements are not addressed within this program because their application is narrow. If the reporting entity you are involved with sells these products, we recommend that you review these SSAPs.

**Reporting Types of Property/Casualty Contracts**

SSAP No. 65 describes three reporting bases or methods that property and casualty contracts recognize when risks attach.

1. **Occurrence type policies** are the most common and are policies that are written to cover insured events that occur within the effective dates of the policy, regardless of when they are reported to the reporting entity. Liabilities for losses on these policies shall be recorded when the insured event occurs.
2. **Claims-made type policies** are less common but are beginning to become more prevalent in the workers’ compensation line to decrease the cost of the policies to the insured. These policies cover insured events that are reported (as defined in the policy) within the effective dates of the policy, subject to retroactive dates when applicable. The reporting entity shall record liabilities for losses on these policies when notified of the event.

3. **Extended reporting policies** are endorsements to claims-made policies covering insured events reported after the termination of a claims-made contract, but subject to the same retroactive dates where applicable. Insurers may write extended reporting policies for an indefinite period or a fixed period. For indefinite reporting period policies, premium should by fully earned and losses recognized, and the insurer should expense the liabilities associated with unreported claims immediately. For fixed period policies, premiums should be earned over the term of the fixed period and the reporting entity should record an unearned premium reserve for the unexpired portion of the premium and shall record losses as reported.

**Discounting**

This statement provides that, with the exception of fixed and reasonably determinable payments such as those emanating from workers’ compensation tabular indemnity reserves, and long-term disability claims, property and casualty loss reserves and loss adjustment expense reserves should not be discounted. This guidance is similar to what most of the states currently prescribe for discounting. However, the statement also includes an exhibit that provides guidelines for those states that prescribe or permit discounting on a non-tabular basis. Additionally, tabular reserves should not include medical loss reserves or loss adjustment expense reserves.

**Structured Settlements**

*Guidance for structured settlements within SSAP No. 65 was addressed within the prior discussion pertaining to SSAP No. 52.*

**High-Deductible Policies**

Guidance has been added to SSAP No. 65 to address high-deductible policies. These are different from self-insurance combined with an excess of loss policy, in that, under a high-deductible policy, state laws generally require the reporting entity to fund the deductible. It is this credit exposure that requires guidance to be addressed for these types of policies.

Because the risk of loss is present from the inception date, the reporting entity shall reserve losses throughout the policy period, not over the period after the deductible has been reached. Reserves for claims arising under high-deductible plans shall be established net of the deductible; however, no reserve credit shall be permitted for any claim where any amount due from the insured has been determined to be uncollectible.
Reimbursement of the deductible shall be accrued and recorded as a reduction of paid losses, simultaneously with the recording of the paid loss by the reporting entity. However, 10% of deductible recoverable in excess of collateral specifically held and identifiable on a per-policy basis shall be reported as a nonadmitted asset. If amounts in excess of the 10% are uncollectible, those amounts shall also be nonadmitted.

**Excess Statutory Reserves**

This statement eliminates the requirement to record excess statutory reserves. These reserves were previously required to be recorded on certain lines of business when minimum loss ratios were expected to be seen. These reserves were considered an extra layer of protection on these specific lines of business, but were eliminated by the Statutory Accounting Principles (E) Working Group because they did not meet the definition of a liability, as established in SSAP No. 5R. Additionally, the actuaries testified that these reserves were generally redundant in today’s regulatory environment.

**Policies with Coverage Periods Equal to or in Excess of Thirteen Months**

Some property and casualty insurance contracts are written for coverage periods that equal or exceed 13 months. The most common policies with such coverage periods are home warranty and mechanical breakdown policies. Revenues are generally not received in proportion to the level of exposure or period of exposure. In order to recognize the economic results of the contract over the contract period, a liability is required to be established for the estimated future policy benefits, while taking into account estimated future premiums to be received.

**Quick Check**

3. Why can insurers only discount reserves with “fixed and reasonably determinable” payments?

Basically, it is more conservative to limit discounting to fixed and reasonably determinable payments. Discounting variable cash flows introduces volatility and increased judgment. Most of the states require actuarial certifications of reported reserves for losses and loss adjustment expenses.
Property Casualty Contracts – Premiums

Reference: SSAP No. 53—Property Casualty Contracts – Premiums (SSAP No. 53)

SSAP No. 53 defines written premium, with the exception of workers’ compensation contracts, as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits and expenses associated with the coverage provided by the terms of the insurance contract. For workers’ compensation policies, which are subject to adjustment for the actual amount of exposure, the written premium may not be ultimately determined until the end of the exposure period.

Premium Recognition

For workers’ compensation contracts only, written premiums may be recorded on an installment basis to match the billing to the policyholder. For all other contracts, premiums shall be recorded as of the effective date of the contract. Upon recording written premium as of the effective date (or billing date for workers’ compensation policies), an unearned premium reserve should be established to reflect the amount of the premium for the portion of the insurance coverage that has yet to expire. Under this statement, the unearned premium reserve is usually recognized using either the daily pro-rata method or the monthly pro-rata method.

Certain SSAPs provide for different methods of recognizing premium in the Statement of Operations for specific types of contracts. For contracts not separately identified in specific SSAPs where the reporting entity can demonstrate the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

Additional premiums charged to policyholders for endorsements and changes in coverage under the contract shall be recorded on the effective date of the endorsement. This is done so that, at any point in time, a liability is accrued for unearned premium related to the unexpired portion of the policy endorsement.

Earned but Unbilled Premium

Adjustments to the premium charged for changes in the level of exposure to insurance risk (e.g., audit premiums and workers’ compensation policies) shall be estimated and the earned but unbilled (EBUB) premium shall be recorded either through written premium or as an adjustment to earned premium. The estimate for EBUB may be determined using actuarially or statistically supported aggregate calculations using historical company unearned premium data, or per policy calculations.

Ten percent of the EBUB in excess of collateral specifically held and identifiable on a per policy basis shall be reported as a nonadmitted asset. This practice is conservative and appropriate based on experience in collecting these amounts. To the extent that amounts in excess of the 10% are not anticipated to be collected, they shall be written off against operations in the period that determination is made.
INT 02-11: Recognition of Amounts Related to Earned but Unbilled Premium addresses the following question.

If a reporting entity has accrued earned but unbilled (EBUB) premiums, should the entity record the accrual of the related liabilities such as commissions and reserves, etc., or should the reporting entity book the liabilities when the premiums are collected?

The Emerging Accounting Issues (E) Working Group reached a consensus that the reporting entity’s treatment of these transactions should follow the conservatism and recognition concepts found in the AP&P Manual’s Preamble. If an entity feels comfortable enough in their ability to collect the premium that an asset is recorded, then it appears that they should also book the associated liabilities. Further, the Working Group concluded that the definition of “liability” had indeed been met, because the transaction or event (i.e., the earning of the premium rather than the collection of it) obligating the entity had occurred.

Premium Deficiency Reserve
The concept of premium deficiency reserves is one that is not new to insurance accounting, but is still relatively new for property and casualty entities. Under FAS No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), reporting entities are required to record reserves for a probable loss on insurance contracts when a deficiency exists due to the pricing of premiums. This pricing deficiency meets the definition of a loss contingency as defined in SSAP No. 5R and entities should record this liability when the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, and any future installment premiums on existing policies. The reserve is required because the future losses are likely to occur based on the current pricing of the policies. If the losses are likely and the amount of the losses can be estimated, the reserve should be recorded in accordance with SSAP No. 5R. As noted before, the requirement to record premium deficiency reserves is also required for health insurance companies and a similar concept exists for life insurance companies. In this respect, the extension of premium deficiency reserves to property and casualty entities provides consistency among all reporting entities.
Quick Check

4. Why was the concept of premium deficiency reserves extended to property and casualty entities?

The concept of premiums deficiency reserves: (1) requires premiums to be recorded based on the effective date of the policy or endorsement; (2) requires an unearned premium reserve; and (3) requires reporting entities to record a premium deficiency reserve, if needed. In addition, it is consistent with the requirements for life insurance companies. It meets the definition of a contingent liability in SSAP No. 5R and the recording of this liability is consistent with the recognition concept.

Retrospectively Rated Contracts

Reference: SSAP No. 66—Retrospectively Rated Contracts (SSAP No. 66)

A retrospectively rated contract is one that has the final policy premium calculated based on the loss experience of the insured during the term of the policy (including loss development after the term of the policy) and the stipulated formula set forth in the policy. Insurers commonly use retrospectively rated contracts in certain types of property and casualty and health insurance contracts and can use them for life insurance contracts. Additionally, the statement has adopted the impairment guidance as described in SSAP No. 5R.

SSAP No. 66 establishes some guidelines for insurers to follow when establishing amounts under retrospectively rated contracts. Assumptions used in estimating retrospective premium adjustments shall be consistent with the assumptions made in recording other assets and liabilities necessary to reflect the underwriting results of the reporting entity such as claim and loss reserves (including IBNR) and contingent commissions. The method used to estimate the liability shall be reasonable based on the reporting entity’s procedures and consistent among reporting periods.

The reporting entity estimates retrospective premium adjustments for the portion of the policy period that has expired and it shall consider an immediate adjustment to premium.

- Property and casualty reporting entities should record the accrued retrospective premiums (amounts receivable from the insured when the initial premium charged on the contract was too low) as a receivable, consistent with current reporting, and accrued return retrospective premiums (amounts payable to the insured when the initial premium charged on the contract was too high) should be recorded as a write-in liability, instead of being recorded with unearned premiums. The reporting entity should offset both amounts with a corresponding entry to written
premiums or as an adjustment to earned premiums. Detailed nonadmission criteria is also within SSAP No. 66 for property and casualty companies.

- Accident and health reporting entities should record accrued additional retrospective premiums as a write-in for other-than-invested assets, while accrued return retrospective premiums should be recorded as a liability, provision for experience rating refunds, with a corresponding entry to premiums.

- Life and accident and health reporting entities should record accrued additional retrospective premiums (amounts receivable from the insured when the initial premium charged on the contract is too low) as a write-in for other-than-invested assets, with a corresponding entry to premiums and should record accrued return retrospective premiums (amounts payable to the insured when the initial premium charged on the contract was too high) as a liability, provision for experience rating refunds, with a corresponding entry to premiums. Life and accident and health reporting entities shall nonadmit any accrued retrospective premium that is more than 90 days due.

**SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due from Agents and Brokers** (SSAP No. 6) governs the due date once the reporting entity bills accrued retrospective premium. If a reporting entity has issued more than one policy to the same insured, the reporting entity must net retrospective balances in accordance with **SSAP No. 64—Offsetting and Netting of Assets and Liabilities** (SSAP No. 64). Uncollectible amounts are written off to operations.

**Case Study**

Please turn to the Premium and Reserves section of the case study and complete. When finished with the case study, complete the review questions that follow.
Section 5 – Review Questions

Please read Section 5 and answer the following multiple-choice questions. Answers must be entered into the “Test Answer Form” in order to obtain credit. See instructions in the Program Overview for purposes of obtaining credit.

HINT: There might be review questions from previous sections.

22. Extended reporting policies are:
   a. Policies covering insured events, regardless of when they are reported
   b. Endorsements to claims-made policies
   c. Endorsements to occurrence policies
   d. None of the above

23. Discounting is allowed for all types of contracts under SSAP No. 65.
   a. True
   b. False

24. Under high-deductible policies, the reporting entity should:
   a. Reduce the reserves by an uncollectible deductible amount
   b. Reserve losses throughout the policy period
   c. Reserve losses once the deductible is met
   d. Nonadmit the entire receivable in excess of collateral

25. Workers’ compensation contracts can only be recorded on an installment basis.
   a. True
   b. False

26. Under SAP, unearned premiums on property and casualty contracts:
   a. Should be established when the premium written is recorded
   b. Can be calculated using the daily pro-rata method
   c. Can be calculated using the monthly pro-rata method
   d. All of the above
27. Which of the following statements broadly defines the four types of insurance contracts within SAP?

a. SSAP No. 50  
b. SSAP No. 51  
c. SSAP No. 52  
d. None of the above

28. Which of the following is not one of the types of contracts defined within SAP?

a. Property and casualty contract  
b. Accident and health contract  
c. Investment type contract  
d. Deposit-type contract

29. SSAP No. 50 rejects which of the following GAAP pronouncements?

a. FAS 60  
b. FAS 97  
c. FAS 120  
d. All of the above

30. Amounts assessed that represent compensation to the reporting entity for services to be provided in future periods should be reported as:

a. Revenue  
b. Unearned income  
c. A direct increase to surplus  
d. None of the above

31. Amounts received as consideration under deposit-type contracts should be recorded as:

a. Premium  
b. Revenue (not premium)  
c. A direct increase to surplus  
d. A liability
32. Which of the following liabilities is not specifically required under SSAP No. 54 for health entities, but is required under SSAP No. 55?

a. Policy reserve  
b. Claim reserve  
c. Premium deficiency reserve  
d. Incurred but not reported (IBNR) claims

33. Which of the following should be included in the calculation of premium deficiency reserves under SSAP No. 54?

a. Expected claim payments  
b. Expected claim adjustment expenses  
c. Expected administration expenses  
d. All of the above
At the completion of this section, you will be able to:

1. Explain when bonds and stocks are reported as admitted assets and how to determine their reported amount at initial recognition and for subsequent reporting.

2. Explain guidance to determine whether an investment has an “other-than-temporary” impairment.

3. Describe the disclosure requirements for investments held by reporting entities.

SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities

SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, and affiliated entities)

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

SSAP No. 100—Fair Value Measurements

INT 06-07—Definition of Phrase “Other-Than-Temporary”

Appendix A-001—Investments of Reporting Entities

A Look Back
Section 5 detailed the statutory guidance designed for premium and reserves.

A Look At This Section
This section explains the basics in statutory accounting for a reporting entity’s invested assets in bonds and stocks.

A Look Ahead
Section 7 addresses the accounting and reporting for invested assets in mortgage loans, real estate, leases and surplus notes.
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SECTION PREVIEW

This section addresses several SSAPs with guidance on the accounting for bonds and stocks of insurance companies. The following is a listing of the most significant statements covered in this statement:

- SSAP No. 26: Defines bonds and establishes statutory accounting principles for such investments.
- SSAP No. 30: Establishes statutory accounting principles for common stock.
- SSAP No. 32: Establishes statutory accounting principles for preferred stock.
- SSAP No. 100: Discusses fair value measurements.
- INT 06-07: Interprets the phrase “other-than-temporary.”
- Appendix A-001: Outlines the disclosure requirements for investments held by reporting entities.

SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities

This SSAP establishes statutory accounting principles for bonds, excluding loan-backed and structured securities. Bonds are defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments. Bonds meet the definition of assets and are admitted to the extent they conform to the requirements of this SSAP. They include U.S. Treasuries, U.S. government agency securities, municipal securities, corporate bonds, bank participations, convertible debt, certificates of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition, commercial paper, exchange-traded funds that qualify for bond treatment and class 1 bond mutual funds as identified in the Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO). Loan-backed and structured securities also meet this definition, but are excluded from the scope of this SSAP, and are addressed in SSAP No. 43R—Loan-backed and Structured Securities.

Securities that meet the definition above, but have a maturity date of one year or less from the date of acquisition, are addressed in SSAP No. 2—Cash, Drafts, and Short-term Investments. Mortgage loans and other real estate-lending activities made in the ordinary course of business meet the definition above, but are not addressed in this statement; rather, they are addressed in SSAP No. 37—Mortgage Loans and SSAP No. 39—Reverse Mortgages. The significant guidance for bonds is summarized as follows.
Acquisitions and Sales
A bond acquisition or disposal is to be recorded on the trade date, not the settlement date, except for the acquisition of private placement bonds. Bonds are to be reported at their cost, which includes brokerage and other related fees. If interest maintenance reserves (IMR) are required, the realized capital gains and losses must be reported in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an IMR, realized gains and losses on sales of bonds shall be reported as net realized capital gains or losses in the statement of income.

Balance Sheet Amount
At acquisition, bonds shall be reported at their cost, including brokerage and other related fees. After the date of acquisition, bonds shall be valued and reported in accordance with SSAP No. 26, the Purposes and Procedures Manual of the NAIC Securities Valuation Office, and the designation included in the Automated Valuation System or the Valuation of Securities on CD-ROM prepared by the SVO.

For reporting entities that maintain an Asset Valuation Reserve (AVR), the bonds with NAIC designations of 1 through 5 shall be reported at amortized cost, and those with a designation of NAIC 6 shall be reported at the lower of amortized cost or fair market value.

For reporting entities that do not maintain an AVR, bonds that are designated highest quality and high quality (designations of NAIC 1 and NAIC 2, respectively) shall be reported at amortized cost; with all other bonds (designations of NAIC 3 through NAIC 6) reported at the lower of amortized cost or fair market value.

Impairment
An other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. A decline in fair value that is other-than-temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value. If it is determined that a decline in the fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bond’s carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date.

For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. Credit-related other-than-temporary impairment losses shall be recorded through the AVR; interest-related other-than-temporary impairment losses shall be recorded through the IMR.
In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the bond on the measurement date shall become the new cost basis of the bond, and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value that are determined to be other-than-temporary shall be recorded as realized losses.

Quick Check

1. When reporting the book/adjusted carrying value of a bond in Schedule D, Part 1, what is to be included in this column?

This should be the amortized value or the lower of amortized or fair value, depending on the designation of the bond (adjusted for any other-than-temporary impairment) as of the end of the current reporting year. Include: 1) the original cost of acquiring the bond, including brokerage and other related fees; 2) amortization of premium or accrual of discount, but not including any accrued interest paid thereon; and 3) amortization of deferred origination and commitment fees. Deduct a direct write-down for a decline in the fair value of a bond that is other-than-temporary.
Quick Check

2. In that same book/adjusted carrying value column of Schedule D, Part 1, how is an other-than-temporary impairment reported?

The reduced value becomes the new cost basis. Although this cost basis is not written back up for subsequent recoveries of fair value, the cost basis does subsequently change for the continued amortization of a premium or discount. Example:

Company A purchased a $100, 10-year bond on December 31, 20X1 for $70 (discount of $30). On December 31, 20X3, this bond was noted to be other-than-temporarily impaired, with a fair value of $60.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cost Basis</th>
<th>Par</th>
<th>Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X1</td>
<td>70</td>
<td>100</td>
<td>30</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>73</td>
<td>100</td>
<td>27</td>
</tr>
<tr>
<td>12/31/20X3</td>
<td>60</td>
<td>100</td>
<td>40</td>
</tr>
</tbody>
</table>

Entry at 12/31/20X3:

Realized Loss 13
Bond Discount 13

On December 31, 20X4, Company A would continue to accrete the discount over the term of the bond. Thus, the December 31, 20X4, cost basis could exceed the fair value at December 31, 20X3. However, Company A should continue to assess impairment, and additional write-downs would be necessary if future declines in fair value are determined to be other-than-temporarily impaired. If not considered other-than-temporarily impaired, the cost basis would continue to increase over the life of the bond, as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Cost Basis</th>
<th>Par</th>
<th>Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X4</td>
<td>66</td>
<td>100</td>
<td>34</td>
</tr>
<tr>
<td>12/31/20X5</td>
<td>72</td>
<td>100</td>
<td>28</td>
</tr>
<tr>
<td>12/31/20X6</td>
<td>78</td>
<td>100</td>
<td>22</td>
</tr>
<tr>
<td>12/31/20X7</td>
<td>82</td>
<td>100</td>
<td>18</td>
</tr>
<tr>
<td>12/31/20X8</td>
<td>88</td>
<td>100</td>
<td>12</td>
</tr>
<tr>
<td>12/31/20X9</td>
<td>94</td>
<td>100</td>
<td>6</td>
</tr>
<tr>
<td>12/31/20X0</td>
<td>100</td>
<td>100</td>
<td>0</td>
</tr>
</tbody>
</table>
Prepayment Penalties
Prepayment penalties and acceleration fees are to be recorded as investment income when received. Prepayment fees are those fees charged to the borrower when the bond is repaid prior to its maturity date.

Origination Fees
Origination fees are split into two categories, as follows:

1. Origination fees intended to compensate the reporting entity for interest rate risk (e.g., points) are deferred and amortized into income over the term of the bond. This occurs when the borrower pays the investor a fee (generally, interest rate points) in order to obtain a lower interest rate on their borrowing.

2. Other origination fees are recognized as income upon receipt. These include loan origination fees and other nonrefundable fees paid by the borrower that do not compensate the reporting entity for interest rate risk.

Other Expenses
All origination, acquisition and commitment costs are expensed as incurred. Such costs include those origination, acquisition and commitment costs incurred to purchase the bond. Examples include internal investment advisory analysis or investment advisory fees paid to asset managers, among others. Commitment fees are sometimes paid to the reporting entity to obtain a commitment to make funds available at some time in the future, and generally are refundable only if the bond is issued. If the bond is not issued, then the fees are recorded as investment income when the commitment expires.
Illustration

#6-1

On December 30, 20X1, ABC Company purchased $50,000,000 of 8.0%, 30-year U.S. Treasury Bonds. On January 3, 20X2, the transaction was settled with ABC’s broker for $50,000,000 and the bonds were deposited in ABC’s custodial account. On what date should this purchase transaction be recorded?

Solution

SSAP No. 26 provides that a bond acquisition or disposal shall be recorded on the trade date (date of agreement), not the settlement date, except for the acquisition of private placement bonds, which shall be recorded on the funding date. The following journal entries illustrate this treatment:

<table>
<thead>
<tr>
<th>Journal Entries</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>December 30, 20X1</td>
<td>U.S. Treasury Bonds</td>
<td>50,000,000</td>
<td>Due to Broker</td>
</tr>
<tr>
<td></td>
<td>Due to Broker</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entry to record purchase of U.S.</td>
<td></td>
<td></td>
<td>January 3, 20X2</td>
</tr>
<tr>
<td>Treasury Bonds on the trade date.</td>
<td></td>
<td></td>
<td>Due to Broker</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td>Entry to record the settlement</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of the purchase.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Illustration

#6-2

On June 15, 20X1, ABC Company purchased a $5,000,000 par value bond of Cook the Books Company and paid $5,000,000 in cash for the bond. On November 15, 20X1, the CFO of Cook the Books Company and the company’s CPAs were charged with fraud. The CFO had been paying off the company’s CPAs to sign unqualified audit opinions when they were fully aware that the value of Cook the Books Company was grossly misstated. On November 30, 20X1, ABC became aware that Cook the Books’ bond rating was downgraded and that the fair market value of the bond was $2,500,000.

How should ABC Company record these circumstances in their financial statements?
Solution #6-2
If it is determined that a decline in the fair value of a bond is other-than-temporary, the cost of the bonds shall be written down to the fair value as a new cost basis and the write-down shall be accounted for as a realized loss. Therefore, ABC Company would record the following in their financial statements.

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>November 30, 20X1</th>
<th>Realized Loss</th>
<th>2,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Corporate Bonds</td>
<td>2,500,000</td>
</tr>
</tbody>
</table>

Entry to record the realized loss on other-than-temporary declines in fair value.

SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated companies)

SSAP No. 30 establishes statutory accounting principles for common stock investments. Common stocks (excluding investments in affiliates) are securities that represent a residual interest ownership in a corporation and shall include: publicly traded common stocks; master limited partnerships trading as common stock and American deposit receipts only if the security is traded on the New York, American or NASDAQ exchanges, publicly traded common stock warrants, shares of mutual funds, except for certain money market funds and Class 1 bond funds as designated in the Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO), regardless of the types or mix of securities owned by the fund (e.g., bonds, stocks, money market instruments or other types of investments), common stocks that are not publicly traded and common stocks that are restricted as to transfer of ownership. Restricted stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral), except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year.

Any portion of the security that can reasonably be expected to qualify for sale within one year is not considered restricted. NOTE: Investments in common stock of subsidiaries, controlled or affiliated entities (investments in affiliates) are not within the scope of this statement. These investments are addressed in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88 (SSAP No. 97).

Acquisitions and Sales
At acquisition, common stocks shall be reported at their cost, including brokerage and other related fees. Common stock acquisitions and dispositions shall be recorded on the trade date, except for those private placement stock transactions, which shall be recorded on the funding date of the transaction.
SECTION 6 – INVESTED ASSETS: BONDS AND STOCKS

It is common in the formation of corporations to subscribe for the purchase of stock, but not be required to make payment until a later time. These conditional transactions are settled if and when the actual security is issued and the exchange or Financial Industry Regulatory Authority (FINRA) rules that the transactions are to be settled. This subscribed common stock shall be recorded as an admitted asset when the reporting entity takes delivery of the security, on the settlement date.

Balance Sheet Amount
Investments in common stocks shall be valued and reported at fair value.

For reporting entities required to maintain an AVR, the accounting for unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus.

Quick Check
3. Is unaffiliated common stock carried at cost or fair value in the “Book/Adjusted Carrying Value” column of Schedule D, Part 2, Section 2?

Unaffiliated common stock is carried at fair value (adjusted for any other-than-temporary impairment) as of the end of the current reporting year, except for common stock in subsidiary, controlled or affiliated (SCA) companies accounted for under another valuation method (e.g., equity method).

Impairment
An impairment is considered to have occurred if it is probable the investor will be unable to collect all amounts due according to the contractual terms of the investment. For any decline in the fair value of a common stock that is determined to be other-than-temporary, the common stock 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. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7. Subsequent fluctuations in market value shall be recorded as unrealized gains or losses. Future declines in market value which are determined to be other-than-temporary shall be recorded as realized losses. A decline in fair value that is other-than-temporary includes situations where a reporting entity has made a decision to sell a security at an amount below its carrying value.
INTERPRETATION 06–07: Definition of Phrase “Other-Than-Temporary”

It is increasingly important to understand the definition of “other-than-temporary” impairments for various invested assets. The AP&P Manual makes reference to an “other-than-temporary” decline in fair value in several different SSAPs. The SSAPs stipulate that if the impairment is judged to be other-than-temporary, the cost basis of the individual assets shall be written down to a new cost basis and the amount of the write-down shall be accounted for as a realized loss. The fair value of assets may decline for various reasons.

The decision for determining when an investment is considered impaired is dictated by the applicable SSAP and the respective impairment indicators included in each of the SSAPs. If the impairment indicator is present, the determination of an impairment shall be assessed at the individual security or investment level as reported in the annual statement and supporting schedules. Once a reporting entity has determined that an impairment indicator is present, the reporting entity shall continue to evaluate whether the investment is impaired each subsequent reporting period until either (a) the investment experiences a recovery of the fair value up to (or beyond) its carrying value; or (b) the investor recognizes an other-than-temporary impairment loss.

In developing INT 06-07, discussions occurred as to whether the interpretation meant “permanent” and the appropriateness to apply predefined thresholds to the phrase “other-than-temporary.” It was noted that the phrase “other-than-temporary” was consciously chosen to not require determination of whether an investment is “permanently impaired.” The fair value of assets may decline for various reasons. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the fair value of its investment.

The following three items are a few examples of factors that indicate a security decline is specific to the issuer’s fundamental credit difficulties, or that a non-interest related decline is other-than-temporary and that a write-down of the carrying value is required.

   a) Length of time and extent to which the fair value has been less than cost.
   b) Financial condition and short-term prospects of the issuer.
   c) Intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in value.

Unless evidence exists to support the assertion that the decline in fair value below carrying value is temporary, a write-down, accounted for as a realized loss, should be recorded.

Although some insurers, independent auditors and state examiners have developed quantitative thresholds as “rules of thumb” to assist in the evaluation of asset impairment, INT 06-07 cautions against reliance on such numerical thresholds. Although such thresholds may provide the basis for a preliminary assumption on an other-than-temporary
impairment, the ability of management to apply judgment is a concept inherent to the impairment model.

Quick Check

4. Why are common stock equities valued at market, whereas most bonds are valued at amortized cost?

This is a two-fold question, with a two-fold answer. Traditionally, bonds are held to maturity, which is the date bond issuers repay the face amount loaned, including interest. As such, the bonds will mature at their face value, which will equal cost, once the discount or premium is amortized over the life of the bond. Common stock equities are traded and sold to maximize their value, and that value could potentially include an other-than-temporary portion. The Financial Accounting Standards Board (FASB) used the same rationale when it issued FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115). FAS 115 expands the use of fair value accounting for those securities, but retains the use of the amortized cost method for investments in debt securities that the reporting entity has the positive intent and ability to hold to maturity.

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

SSAP No. 32 establishes statutory accounting principles for preferred stock, including investments in preferred stock of subsidiary, controlled or affiliated entities (investments in affiliates).

Acquisitions and Sales

At acquisition, preferred stock shall be reported at cost, including brokerage and other related fees. Payment-in-kind (PIK) preferred stock received as dividends shall be recorded at fair value. Acquisitions and dispositions shall be recorded on the trade date, except for private placement stock transactions, which shall be recorded on the funding date.

Amortization

Redeemable preferred stock purchased at a premium shall be amortized to reduce the carrying value to the call or redemption value over the period to the call or earliest redemption date, whichever produces the lowest asset value (yield to worst). Redeemable preferred stock purchased at a discount shall be amortized to increase the carrying value to par value over the period to maturity or the latest redemption date.
Balance Sheet Amount
The SVO classifies preferred stocks into six redeemable preferred stock quality categories and six perpetual preferred stock quality categories. Preferred stock is valued based on three criteria: (1) the underlying characteristics of the security; (2) the quality rating as defined in the Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO); and (3) whether an AVR is maintained by the reporting entity.

For companies required to maintain an AVR, unrealized gains and losses shall be amortized into investment income for the expected remaining life of the disposed investments. For companies not required to maintain an AVR, unrealized gains and losses on perpetual preferred stock are included as a direct credit or charge to unassigned funds (surplus).

Reporting Entities That Do Not Maintain an AVR
Highest-quality or high-quality redeemable preferred stocks (designations of NAIC 1 and NAIC 2) that have characteristics of debt securities shall be valued at cost or amortized cost. All other redeemable preferred stocks (designations of NAIC through 6) shall be reported at the lower of cost, amortized cost or fair value.

Highest-quality or high-quality perpetual preferred stocks (designations of NAIC 1 and NAIC 2) that have characteristics of equity securities shall be reported at fair value. All other perpetual preferred stocks (designations NAIC 3 through NAIC 6) shall be reported at the lower of cost or fair value.

Reporting Entities That Maintain an AVR
Highest-quality, high-quality or medium-quality redeemable preferred stocks (designations of NAIC 1 through NAIC 3) that have characteristics of debt securities shall be valued at cost or amortized cost. All other redeemable preferred stocks (designations of NAIC 4 through NAIC 6) shall be reported at the lower of cost, amortized cost or fair value.

Highest-quality, high-quality or medium-quality perpetual preferred stocks (designations of NAIC 1 through NAIC 3) that have characteristics of equity securities shall be valued at cost. All other perpetual preferred stocks (designations of NAIC 4 through NAIC 6) shall be reported at the lower of cost or fair value.

Impairment
If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the preferred stock’s carrying value and its fair value at the balance sheet date for which the assessment is made. An impairment is considered to have occurred if it is probable the investor will be unable to collect all amounts due according to the contractual terms of the investment. Measurement of impairment loss shall not include recoveries of fair value subsequent to the balance sheet date.
For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.

For periods subsequent to the other-than-temporary recognized loss, the reporting entity shall account for the security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the preferred stock on the measurement date shall become the new cost basis and should not be adjusted for subsequent recoveries in fair value. The discount or premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life based on the amount and timing of the estimated future cash flows. The security shall continue to be subject to impairment analysis each subsequent reporting period. Future other-than-temporary declines shall be recorded as realized losses.

**Dividends**

SSAP No. 32 provides that dividends on preferred stock (whether cumulative or noncumulative), other than on mandatorily redeemable preferred stock, shall be recorded as investment income on the ex-dividend date (i.e., dividend income shall be recorded on preferred stock declared to be ex-dividend on or prior to the statement date).

Also, dividends on mandatorily redeemable preferred stock shall be accrued to the redemption price, even if not declared, using the interest method over the period ending on the redemption date. Cash dividends paid on PIK stock during the stock dividend period shall be accounted for as a reduction in the investment.

**Exchanges and Conversions**

If preferred stock is exchanged or converted into other securities, the fair value of the preferred stock surrendered at the date of the exchange or conversion shall become the cost basis for the new securities, with any gain or loss realized at the time of the exchange or conversion. However, if the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the preferred stock surrendered, then it shall become the cost basis for the new securities.

**Quick Check**

5. *Why is redeemable preferred stock valued at amortized cost, whereas perpetual preferred stock is valued at the lower of cost or market?*

Redeemable preferred stocks have characteristics of debt securities and should, therefore, be valued at cost or amortized cost, whereas perpetual preferred stocks have characteristics of equity securities and should, therefore, be valued at fair value. This requirement is in harmony with the Statement of Concepts and the principle of consistency within the Accounting Practices & Procedures Manual.
SSAP No. 100—Fair Value Measurements

SSAP No. 100 defines fair value, establishes a framework for measuring fair value and addresses disclosure requirements. This standard applies under other statutory accounting pronouncements that require or permit fair value measurements, except it does not eliminate the practicality exceptions to fair value measurements in accounting pronouncements within the scope of this standard; it does not apply under SSAP No. 22—Leases (SSAP No. 22) and other accounting pronouncements that address fair value measurements for purposes of lease classification to measurement under SSAP No. 22; and it does not apply to assets acquired or liabilities assumed in a business combination that are required to be measured at fair value under SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68), regardless of whether those assets and liabilities are related to leases.

Fair value is defined as the price that would be received to sell an asset (exit price) or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Within that definition are several components as follows:

Asset/Liability: A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability.

Price: An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities. It is not a forced transaction.

Principal (or Most Advantageous) Market: A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s).

Market Participants: Market participants are: (1) buyers and sellers in the principal (or most advantageous) market for the asset or liability that are independent of the reporting entity; (2) knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary; (3) able to transact for the asset or liability; and (4) willing and motivated
to transact for the asset or liability, but are not forced to do so. The fair value of the asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability.

**Application to Assets:** A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date.

**Application to Liabilities:** Consideration of non-performance risk (own credit risk) should not be reflected in the fair value calculation for liabilities (including derivative liabilities) at subsequent measurement. At initial recognition, it is perceived that the consideration of own credit risk may be inherent in the contractual negotiations resulting in the liability (modification from FAS 157).

In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. However, a transaction price might not represent the fair value of an asset or liability at initial recognition. Factors include:
- The transaction is between related parties.
- The transaction occurs under duress or the seller is forced to accept the price in the transaction.
- The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability; i.e., the principal or most advantageous market.
- For liabilities, differences may exist as non-performance risk (own credit risk) is not reflected in the fair value (i.e., exit price) determination of all liabilities (including derivatives).

**Valuation Techniques**
Valuation techniques consistent with the market approach, income approach and/or cost approach shall be used to measure fair value.

**Market Approach:** The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities’ relationship to other benchmark-quoted securities.

**Income Approach:** The income approach uses valuation techniques to convert future amounts (e.g., cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model); and a binomial model (a lattice model), which incorporates present value
techniques; and the multi-period excess earnings method, which is used to measure the fair value of certain intangible assets.

Cost Approach: The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost).

In some cases, a single valuation technique will be appropriate (e.g., when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (e.g., as might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (respective indications of fair value) shall be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

Valuation techniques used to measure fair value shall be consistently applied. However, a change in a valuation technique or its application (e.g., a change in its weighting when multiple valuation techniques are used) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, new markets develop, new information becomes available, information previously used is no longer available or valuation techniques improve. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate pursuant to SSAP No. 3—Accounting Changes and Corrections of Errors. The disclosure provisions of SSAP No. 3 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

Inputs to Valuation Techniques
Inputs refer to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk; e.g., the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. Observable inputs are inputs that reflect the assumptions that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Unobservable inputs are inputs that reflect the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. Valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the use of unobservable inputs.
Fair Value Hierarchy
To increase consistency and comparability in fair value measurements and related
disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to
measure fair value into three broad levels. Level 1 inputs are quoted prices (unadjusted) in
active markets for identical assets or liabilities that the reporting entity has the ability to
access at the measurement date. Level 2 inputs are inputs other than quoted prices
included within Level 1 that are observable for the asset or liability, either directly or
indirectly. Level 3 inputs are unobservable inputs for the asset or liability.

Appendix A-001—Investments of Reporting Entities
Appendix A-001 outlines the disclosure requirements for the investments held by
reporting entities, which are fairly consistent with the disclosures required of banking and
other financial institutions. These disclosures are aimed at measuring the investment risk
to which the reporting entity is subject and is intended for the use of state insurance
regulators for solvency analysis. There are three sections to the appendix, as follows.

Section 1. Reporting Requirements: This section outlines where the disclosures shall be
included. It states that a Summary Investment Schedule (see Section 3 below) shall be
included in the annual statement. It also states that the Investment Risk Interrogatories
(see Section 2 below) shall be filed as a supplement to the annual statement, filed by April
1. Finally, the Investment Risk Interrogatories and the Summary Investment Schedule
shall be included in the audited statutory financial statements.

Section 2. Investment Risk Interrogatories: These interrogatories are a series of
questions aimed at understanding the underlying investments of the reporting entity, as
well as the underlying risks associated with those investments.

Section 3. Summary Investment Schedule: This schedule summarizes a reporting
entity’s gross investment holdings by investment category (e.g., bonds, equity interests,
mortgage loans, etc.), as well as each investment category’s percentage of gross
investment holdings. It also summarizes the admitted asset balance by investment
category and each investment category’s percentage of total admitted assets as reported in
the annual statement.

Case Study
Please turn to the Invested Assets section of the case study and complete. When finished
with the case study, complete the review questions that follow.
Section 6 – Review Questions

Please read Section 6 and answer the following multiple-choice questions. Answers must be entered into the “Test Answer Form” in order to obtain credit. See instructions in the Program Overview for purposes of obtaining credit.

_HINT: There might be review questions from previous sections._

34. The application of statutory accounting principles makes changes to the way bonds and stocks are valued by the NAIC Securities Valuation Office (SVO).
   a. True
   b. False

35. If it is determined that a decline in the fair value of a bond is other-than-temporary, the reporting entity shall:
   a. Record a valuation allowance for the amount of the impairment as a contra-asset to the bond account
   b. Record a nonadmitted asset for the impaired portion of the security
   c. Write down the cost basis of the bond to fair value and account for the write down as a realized loss
   d. All of the above

36. An impairment of a bond investment shall be considered to have occurred if:
   a. And only if, the SVO is aware of the impairment and has downgraded the bond
   b. It is probable that the investor will be unable to collect all amounts due according to the contractual terms of the bond
   c. Any interest or principal payment is more than 90 days past due
   d. Any interest or principal payment is more than 30 days past due

37. Assume that ABC Company entered into an agreement to purchase a publicly traded bond on December 1, 20X1. The bond was delivered to the broker on December 3, 20X1, and the broker delivered the bond to ABC Company on December 4, 20X1. Finally, ABC Company paid the broker for the bond on December 6, 20X1. On what date would ABC record the bond purchase?
   a. December 1, 20X1
   b. December 3, 20X1
   c. December 4, 20X1
   d. December 6, 20X1
38. Prepayment penalties are to be recorded as:
   a. Realized capital gain
   b. Investment income
   c. Both a and b
   d. Neither a nor b

39. On September 15, 20X1, ABC Company became aware that Standard & Poor’s had downgraded a bond it purchased earlier in the year, due to the fact that the bond offering documents were fraudulently prepared. On October 15, 20X1, the bond defaulted on its second interest payment and, on October 30, 20X1, the SVO changed the bond’s designation from an NAIC 1 to an NAIC 6. On what date should the company record the other-than-temporary impairment of the bond?
   a. September 15, 20X1
   b. October 15, 20X1
   c. October 30, 20X1
   d. December 31, 20X1

40. For any decline in the fair value of a common stock that is determined to be other-than-temporary, the common stock 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. Future increases in the common stock are:
   a. Recorded as a direct increase in the cost basis of the common stock
   b. Recorded as unrealized gain on the common stock
   c. Recorded as a realized gain on the common stock
   d. All of the above

41. Common stock acquired under a subscription shall be recorded as an admitted asset on:
   a. The trade date of the transaction
   b. The date that the common stock is offered to the public
   c. The settlement date of the transaction
   d. Any of the above

42. Dividends on preferred stock, other than mandatorily redeemable preferred stock, shall be recorded as investment income on:
   a. The ex-dividend date
   b. The dividend declaration date
   c. The date cash is received by the company
   d. Either a or c
43. Redeemable preferred stocks that have characteristics of debt securities shall be valued at cost or amortized cost, whereas perpetual preferred stocks that have characteristics of equity securities shall be valued at fair value. Such accounting treatment is the result of which of the following fundamental concepts?

a. Comparability
b. Consistency
c. Recognition
d. Matching

44. The valuation techniques used to measure fair value include:

a. Market, income and investment approaches
b. Asset, liability and investment approaches
c. Market, income and cost approaches
d. Asset, liability and cost approaches

45. Level 3 inputs of the fair value hierarchy are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

a. True
b. False
At the completion of this section, you will be able to:

1. State the accounting for investments in mortgage loans
2. Explain the impairment guidance for investments in real estate
3. Describe the accounting and reporting guidelines for leases
4. State the specialized accounting rules for surplus notes

SSAP No. 17—Preoperating and Research and Development Costs
SSAP No. 22—Leases
SSAP No. 37—Mortgage Loans
SSAP No. 40—Real Estate Investments
SSAP No. 41—Surplus Notes
SSAP No. 76—Reporting on the Costs of Start-Up Activities
SSAP No. 77—Real Estate Sales — An Amendment to SSAP No. 40, Real Estate Investments
SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments

A Look Back
Section 6 explained the basics in statutory accounting for investments in bonds and stocks.

A Look At This Section
This section explains the basics in statutory accounting for a reporting entity’s invested assets in mortgage loans, real estate investments and sales, leases and surplus notes.

A Look Ahead
Section 8 provides guidance for investments in related parties and partnerships. Also covered is goodwill.
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SECTION PREVIEW

This section addresses several SSAPs with guidance on the accounting for invested assets of insurance companies. The following is a list of the most significant statements covered in this section.

- SSAP No. 17: Establishes statutory accounting principles for organizational costs, research and development costs, and start-up costs for new and existing entities.
- SSAP No. 22: Establishes principles for leases by lessors and lessees, including accounting and reporting, sale-leaseback transactions, leveraged leases and related party leases.
- SSAP No. 37: Establishes statutory accounting principles for the accounting and reporting of mortgage loans and related fees.
- SSAP No. 40: Defines real estate investments and establishes statutory accounting principles for such investments.
- SSAP No. 41: Establishes principles for issuers and holders of surplus notes.
- SSAP No. 77: Addresses statutory accounting for real estate sales.
- SSAP No. 90: Establishes impairment rules for real estate investments.

SSAP No. 37—Mortgage Loans

SSAP No. 37 establishes statutory accounting principles for the accounting and reporting of mortgage loans and related fees. A mortgage loan is defined as a debt obligation that is not a security, which is secured by a mortgage on real estate.

Commitment Fees

A fee paid to a reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment shall be deferred, with amortization dependent on whether the commitment is exercised. If the commitment is exercised, then the fee shall be amortized over the life of the loan as an adjustment to the investment income on the loan. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Loan Origination Fees

Nonrefundable loan origination fees shall not be recorded until received in cash. Nonrefundable fees representing points shall be deferred as part of the loan balance and amortized over the life of the loan. Nonrefundable fees other than points shall be recorded in income upon receipt. This guidance for loan origination fees is consistent with the guidance found in SSAP No. 26—Bonds, excluding Loan-Backed and Structured Securities.
Loan Origination, Acquisition and Commitment Costs
All costs incurred in connection with originating a loan, acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

Initial Investment
Where mortgage loans are originated by the reporting entity, the initial investment in mortgage loans shall be recorded at the principal amount of the loan net of any amounts deferred (e.g., points). For mortgage loans purchased by a reporting entity, the initial investment shall be recorded as the amount paid to the seller. Consequently, there may be a premium or discount on such loans resulting from a difference between the amount paid and the principal amount of the mortgage loan.

Amortization
Premiums and discounts on acquired loans, and mortgage interest points and commitment fees shall be recognized as an adjustment of yield over the life of the mortgage loan to produce a constant effective yield each year to maturity.

Prepayments
Payments received in advance of due dates may produce prepaid interest that shall be recorded as a liability (unearned investment income) on the reporting entity’s balance sheet until the interest is earned by the reporting entity. A mortgage loan may provide for a prepayment penalty or acceleration fee in the event the loan is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

Interest Income
Interest income shall be recorded as earned and shall be included in investment income in the Summary of Operations.

Accrued Interest
Reporting entities that use servicing agents for their mortgage loans shall report the interest due and accrued asset on the balance sheet consistent with the income statement treatment of the charge for servicing costs. When a loan is determined to be in default (per the contractual terms of the loan), the accrued interest on the loan shall be recorded as investment income due and accrued if deemed collectible.

If a loan in default has any investment income due and accrued that is 180 days past due and collectible, the investment income shall continue to accrue, but all interest related to the loan is to be reported as a nonadmitted asset. If accrued interest on a mortgage loan in default is not collectible, the accrued interest shall be written off immediately and no further interest accrued.

Contingent Interest
Contingent interest may be reported as income when received or accrued. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.
**Construction Loans**
A construction loan is defined as a mortgage loan of less than three years in term, made for financing the cost of construction of a building or other improvement to real estate, which is secured by the real estate. The principal amount of a construction loan shall be the amount of funds disbursed to the borrower. If, in accordance with the terms of the contract, interest is deferred until the maturity of the loan, the accrued interest shall be included in the balance of the loan outstanding.

**Impairments**
A mortgage loan shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the mortgage agreement. The reporting entity may record a valuation allowance for the difference between the net value of the collateral and the recorded investment in the mortgage loan with a corresponding charge to unrealized loss. Other-than-temporary impairments are recorded as realized losses by establishing a new cost basis in the mortgage loan.

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### Illustration

**Illustration #7-1**

*During the year-ended December 31, 20X1, ABC Company received nonrefundable loan origination fees of $100,000 and nonrefundable fees representing points in the amount of $50,000. Assuming ABC amortized the points over the remaining five-year life (beginning January 1, 20X1) of the respective loans, how much would ABC record as income during the year?*

**Solution #7-1**

ABC would record income for the year 20X1 in the amount of $110,000, which is calculated as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonrefundable loan origination fees</td>
<td>$100,000</td>
</tr>
<tr>
<td>Points earned in current year</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$110,000</strong></td>
</tr>
</tbody>
</table>

Additionally, ABC would record a contra-asset for the portion of the points collected, but not yet earned, as follows.

**Journal Entry**

*December 31, 20X1*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>50,000</td>
</tr>
<tr>
<td>Investment Income</td>
<td>10,000</td>
</tr>
<tr>
<td>Mortgage Loan – Points (contra-asset)</td>
<td>40,000</td>
</tr>
</tbody>
</table>

*Entry to record contra-asset for points received and unearned.*
Quick Check

1. When is a mortgage loan considered to be impaired?

A mortgage loan shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the mortgage agreement. According to the contractual terms means that both the contractual principal payments and contractual interest payments of the mortgage loan will be collected as scheduled in the mortgage agreement.

**SSAP No. 40—Real Estate Investments**

SSAP No. 40 establishes statutory accounting principles for real estate investments. There are three balance sheet classifications for all reporting entities. The classification of the real estate then drives the accounting and reporting requirements. SSAP No. 40 provides that real estate investments shall be reported net of encumbrances in the following balance sheet categories, with parenthetical disclosure of the amount of related encumbrances.

a. **Properties Occupied by the Company:** Any real estate that is owned by and is more than 50% occupied by the reporting entity and its affiliates shall be considered property occupied by the company.

   “More than 50% occupied” shall mean that the square footage occupied by the reporting entity and its affiliates totals more than 50% of the rentable square footage of the property, including common areas. Property occupied by the company shall be carried at depreciated cost less encumbrances.

b. **Properties Held for the Production of Income:** Any real estate occupied by the reporting entity that does not meet the definition of “more than 50% occupied” and which the reporting entity does not intend to sell shall be classified as properties held for the production of income. Properties held for the production of income shall be carried at depreciated cost less encumbrances.

c. **Properties Held for Sale:** Properties that the reporting entity has the intent to sell or is required to sell shall be classified as properties held for sale and shall be carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property.


**Initial Investment**
The cost of real estate represents the fair value of the consideration exchanged plus costs incurred to place the real estate asset in usable condition. These costs can include brokerage fees, legal fees, demolition, clearing and grading, and fees of architects and engineers, among others. The cost shall be depreciated over the estimated useful life, not to exceed 50 years.

**Impairment**
Originally, the statutory impairment rules for real estate were based on the requirements set forth in paragraph 5 of *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FAS 121). FAS 121 was superseded by *FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144). As a result, the Statutory Accounting Principles (E) Working Group changed its guidance for impairment of real estate by issuing *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments* (SSAP No. 90), which will be discussed later in this section.

**Fair Value**
The current fair value of real estate shall be determined on a property-by-property basis (i.e., increase in the fair value of one property shall not be used to offset declines in fair value of another). SSAP No. 100 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party).

Note that the Statutory Accounting Principles (E) Working Group included the term “internal appraisal.” This term was added so that any appraisal that is based upon an evaluation of all relevant data about the market, be it an internal or third-party appraisal, could be used to support estimates of fair value. There are specific factors to consider when performing an appraisal. Please refer to SSAP No. 100 for details.

Appraisals shall be no more than five years old as of the reporting date; otherwise, the property shall be nonadmitted until an updated appraisal is obtained. However, if conditions indicate there has been a significant decrease in the fair market value of a property, a current appraisal shall be obtained.

**Investment Income and Related Expenses**
Rental income shall be included in investment income. Expenses shall be expensed as incurred and charged to investment expenses. Such expenses include, but are not limited to: real estate taxes, utilities, and ordinary repair and maintenance. Rental amounts shall be recorded at a rate comparable to rent received from others and/or rental rates of like property in the same area.
**Profit from Sales of Real Estate**

*SSAP No. 77—Real Estate Sales – An Amendment to SSAP No. 40, Real Estate Investments* (SSAP No. 77) supersedes two paragraphs in SSAP No. 40 and should be followed when accounting for the sales of real estate.

Recognition of profit on sales of real estate investments shall be accounted for in accordance with FAS No. 66, except as modified in SSAP No. 77. This SSAP applies to all sales of real estate, including real estate with property improvements or integral equipment. The terms “property improvements” and “integral equipment” refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant costs, such as an office building.

Profit shall be recognized in full when real estate is sold, provided: (a) the profit is determinable; that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated; and (b) the earnings process is nearly complete; that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met.

a. A sale is consummated;
b. The buyer’s initial and continuing investments are adequate to demonstrate a commitment to pay for the property;
c. The seller’s receivable is not subject to future subordination; and
d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property after the sale.

The calculation of the buyer’s initial investment specified in FAS 66 shall be modified to reflect that buyer’s notes must be supported by letters of credit from institutions that are listed by the NAIC Securities Valuation Office as meeting credit standards to be included in determining the buyer’s initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.
### Quick Check

2. **What expenses are reported as rent expenses?**

SSAP No. 40 indicates that a reporting entity should report rent expense relating to the occupancy of its own building, as well as amounts for light, heat, water, fuel, interest, taxes and building maintenance related to the reporting entity’s building.

3. **Why is there a different value assigned to properties held for sale?**

Properties that the reporting entity has the intent to sell or is required to sell shall be classified as properties held for sale and carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property. The decision to value the property at fair value is consistent with the requirement to record equity securities at fair value as it provides a more conservative value that could be obtained under current market conditions. This also aligns with the Statement of Concepts in the Preamble.

4. **How do you determine if an internal appraisal is proper?**

The determination of a proper internal appraisal is left to the discretion of the insurer or regulating entity. Additionally, SSAP No. 40 provides that appraisals shall be based on an evaluation of all relevant data about the market, considering the following:

a. A physical inspection of the premises;

b. The present value of future cash flows generated by the property (Discounted Cash Flows), or capitalization of stabilized net operating income (Direct Capitalization);

c. Current sales prices of similar properties with adjustments for differences in the properties (Sales Comparison Approach);

d. Costs to sell the property if the reporting entity does not have the intent or ability to hold the real estate as an investment; and

e. Replacement costs of the improvements, less depreciation, plus the value of the land (Cost Approach).
**Quick Check**

5. What happens to the valuation basis if you decide not to sell a property and transfer it back to property occupied by the company?

A decision to sell the property is an event or circumstance that could indicate the carrying amount of the assets might not be recoverable. Therefore, if the fair value of the asset is less than depreciated cost, then the asset would be transferred back to property occupied by the company (i.e., its original classification in this case) at fair value. As the circumstances indicate that it is no longer the plan to sell the property, selling costs would no longer be included in the estimate of the fair value of the property.

6. There are two conditions that must be fulfilled prior to a reporting entity being allowed to recognize profit in full on sales of real estate. What are they?

(1) The profit must be determinable. That is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated.

(2) The earnings process must be nearly complete. That is, the seller is not obliged to perform significant activities after the sale to earn the profit.

**SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments**

The primary subject of SSAP No. 90 is the impairment of real estate. Under SSAP 90, an impairment has occurred when the carrying amount of a long-lived asset is not recoverable and exceeds fair value. The asset is considered not recoverable if the book value exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset.

SSAP No 90 indicates that a reporting entity must test for recoverability when any of the following exists.

(1) A significant decrease in the fair value.

(2) An adverse change in the extent or manner in which a long-lived asset is being used or in its physical condition.

(3) A significant adverse change in legal factors or in the business climate.

(4) It is under construction or acquisition and costs are significantly higher than expected.

(5) A current-period operating or cash flow loss combined with prior losses or forecasted losses from the use of the asset.
(6) The expectation that, more likely than not, a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

Properties occupied by the company are generally not subject to recoverability testing. However, if any of the following conditions are present, the property is subject to immediate recoverability testing.

1. Financial condition of the reporting entity is in question.
2. Property is held for sale.
3. There has been a significant adverse change in the physical condition of the property.
4. Management has determined a need for testing.

For testing a property occupied by the company, this statement indicates to use the criteria in SSAP No. 40, to determine the fair value of the property; i.e., market quotes or appraisals.

It is interesting to note here that SSAP No. 40 discusses the need for appraisals for properties held for the production of income and held for sale, but not properties occupied by the company. SSAP No. 90 indicates properties occupied by company are to be carried at depreciated cost. SSAP No. 90 says that “properties occupied by the company that are determined to be subject to recoverability testing, as discussed in paragraphs 6 and 7, are to follow the guidance in SSAP No. 40, paragraph 11,” which is the appraisal criteria. Therefore, only if the conditions described in SSAP No. 90 are present (i.e., recoverability testing criteria) would the properties occupied by the company need to have an appraisal.

SSAP No. 40 also gives a few examples of factors that would indicate the financial condition of the reporting entity is in question: (1) regulatory action has taken place; (2) any action or control level under RBC; (3) grounds exist for conservation, receivership, rehabilitation or liquidation; or (4) CPAs issue a going concern opinion, adverse opinion or disclaimer of opinion.
The ABC Company owns and occupies a large warehouse that it purchased in 19X5 for $12,000,000. The warehouse carries accumulated depreciation in the amount of $2,400,000 for a depreciated cost of $9,600,000. In November 20X1, ABC Company decided to sell the warehouse. On November 15, 20X1, ABC obtained an appraisal of $9,000,000 and estimated selling costs of the warehouse at $450,000. Should ABC record an impairment on this warehouse based on this new information?

Solution #7-2
We must perform an impairment test in conjunction with SSAP No. 90 because conditions exist that indicate there has been a decrease in the fair value of the property.

As the facts demonstrate that the carrying amount of the warehouse may not be recoverable, we must recognize an impairment. If the fair value of the asset [$8,550,000; ($9,000,000 – $450,000)] is less than the carrying value ($9,600,000), the asset shall be written down to fair value, thereby establishing a new cost basis. Therefore, ABC should record the following:

<table>
<thead>
<tr>
<th>Journal Entry</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 15, 20X1</td>
</tr>
<tr>
<td>Property Held for Sale</td>
</tr>
</tbody>
</table>

*Entry to record realized loss on other-than-temporary declines in market value.*
SSAP No. 17—Preoperating and Research & Development Costs

SSAP No. 17 establishes statutory accounting principles for organizational costs, research and development costs, and start-up costs for new and existing entities. SSAP No. 17 requires that all preoperating and research and development costs be expensed as incurred. New projects for which such costs are incurred include: (a) arranging operations for a new entity; (b) establishing production, sales or service facilities at a new site; (c) changing operations or production significantly; and (d) developing and producing a new product, adopting a new process or offering a new service. These costs specifically exclude tangible assets acquired in connection with such activities.

SSAP No. 76—Reporting on the Costs of Start-Up Activities

SSAP No. 76 requires that all costs of start-up activities be expensed as incurred. Start-up activities are defined broadly as one-time activities related to: (a) opening a new facility; (b) introducing a new product or service; (c) conducting business in a new territory; (d) conducting business with a new class of customer or beneficiary; (e) initiating a new process in an existing facility; and (f) commencing some new operation. The cost of start-up activities incurred in an accounting period shall be disclosed in the annual audited statutory financial report only.

SSAP No. 22—Leases

This statement establishes statutory accounting principles for leases by lessors and lessees. A lease is defined as an agreement conveying the right to use property, plant or equipment usually for a stated period of time. This definition does not include agreements that are contracts for servicing that do not transfer the right to use property, plant or equipment from one contracting party to another.

All leases shall be considered operating leases. Rent on an operating lease shall be charged to expense over the lease term as it becomes payable.

Sale-Leaseback Transactions

This statement also provides guidance for sale-leaseback transactions. Such transactions involve the sale of property by the owner and a lease of the property back to the seller. A sale of property that is accompanied by a sale-leaseback shall be accounted for as a purchase/operating lease and a sale/operating lease by the lessee and lessor respectively. Statutory accounting principles for sale-leaseback accounting follow the recognition criteria of FASB Statement No. 28, Accounting for Sales with Leasebacks (FAS 28) unless the sale is settled entirely in cash. For transactions settled entirely in cash, any gain or loss is recognized directly to special surplus funds (vs. being deferred under GAAP), and subsequently amortized to unassigned funds over the lease term.
Leveraged Leases for Lessors
Generally, leveraged leases are those in which the lessor acquires, through the incurrence of debt (such that the lessor is substantially “leveraged” in the transaction), property, plant or equipment with the intentions to lease the asset(s) to the lessee. Leveraged leases are defined as those leases that meet the criteria set forth in paragraph 42.a. through 42.d. (and the related paragraphs to which 42 refers) of FASB Statement No. 13, Accounting for Leases (FAS 13). Leases that meet the preceding definition shall be accounted for in accordance with paragraphs 43 through 47 (and the related paragraphs to which 43–47 refer) of FAS 13. Pursuant to paragraph 46 of FAS 13, as updated by FSP FAS 13, any estimated residual value and all other important assumptions affecting estimated total net income shall be reviewed at least annually. The projected timing of income tax cash flows generated by the lease is an important assumption and shall be reviewed annually, or more frequently, if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. The lessor shall record its investment net of the nonrecourse debt. In cases where the asset being leased is a nonadmitted asset, any net leveraged lease asset shall be nonadmitted.

#7-3
On January 1, 20X1, ABC Company entered into a 27-month leasing agreement for EDP equipment. ABC is the lessee under this lease and is getting EDP equipment for use in its operations. The equipment has an estimated useful life of three years and, although it has no residual value, ABC will obtain title to the equipment upon completion of the lease terms.

Questions:
1) How should ABC classify and account for this lease?
2) What journal entries would be recorded on ABC’s books related to this lease?

Solution #7-3
(1) Under the requirements of SSAP No. 22, all leases shall be considered operating leases.

(2) To record this lease as an operating lease, the following journal entries would be posted on a monthly basis.

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>XX</th>
<th>XX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent Expense</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Cash (or Accounts Payable)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
DEF Company is currently leasing — at $4,750 a month — a facility that it held the mortgage on and subsequently foreclosed on years ago. DEF is the lessor under this lease and is giving the rights to use this facility to the lessee. The property was originally appraised January 1, six years ago, for $350,000; has an estimated life of 20 years; and has no residual value. As of December 20X1, the property had accumulated depreciation of $105,000. The lease contains a bargain purchase option and was recorded as a capital lease at the end of 20X0. As of December 31, 20X1, DEF had a lease receivable of $102,000 and unearned income of $8,400. For the year ended December 31, 20X1, DEF received 12 lease payments in accordance with the lease terms, including $6,300 in interest income. Assume the DEF has no limit to the time it can hold property that it obtained via foreclosure.

Question:
How should DEF classify and account for this lease?

Solution #7-4
Under SSAP No. 22, all leases, except leveraged leases, shall be considered operating leases.

SSAP No. 41—Surplus Notes

SSAP No. 41 establishes statutory accounting principles for issuers and holders of surplus notes. Surplus notes are instruments issued by reporting entities that have characteristics of both debt and equity. These notes are issued and used for a variety of reasons, including to: (a) provide regulators with flexibility in dealing with problem situations to attract capital to reporting entities whose surplus levels are deemed inadequate to support their operations; (b) provide a source of capital to mutual and other types of non-stock reporting entities that do not have access to traditional equity markets for capital needs; and (c) provide an alternative source of capital to stock reporting entities, although not for the purpose of initially capitalizing the reporting entity.
Surplus notes that have been approved by the domiciliary state’s commissioner shall be reported as surplus and not as debt if the following provisions are met:

1) Subordination to policyholders;
2) Subordination to claimant and beneficiary claims;
3) Subordination to all other classes of creditors other than surplus note holders; and
4) Interest payments and principal repayments require prior approval of the commissioner of the state of domicile

Interest payments owed on surplus notes shall not be recorded as a liability or an expense until approval of payment has been granted by the domiciliary state commissioner. All interest, including interest in arrears, shall be expensed when approved for payment. Unapproved interest shall not be reported in operations, shall not be represented as an addition to the principal or notional amount of the instrument, and shall not accrue further interest.

When approved for principal repayment by the domiciliary state commissioner, the issuer shall reclassify such approved payments from surplus to liabilities. Costs of issuing surplus notes shall be expensed when occurred.

For holders of surplus notes, these investments are considered admitted assets, if conforming to SSAP No. 41. These investments shall be accounted for in accordance with SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities (SSAP No. 26) and are valued in accordance whether they are rated or non-rated surplus notes in accordance with the guidance in the AP&P Manual.

Case Study
Please turn to the Invested Assets section of the case study and complete. When finished with the case study, complete the review questions that follow.
Section 7 – Review Questions

Please read Section 7 and answer the following multiple-choice questions. Answers must be entered into the “Test Answer Form” in order to obtain credit. See instructions in the Program Overview for purposes of obtaining credit.

HINT: There might be review questions from previous sections.

46. Which of the following represents a fee paid to a reporting entity in order to be able to borrow funds at a specified rate with specified terms?

   a. Interest rate points
   b. Nonrefundable loan origination fee
   c. Prepaid interest
   d. Commitment fee

47. Which type of fee shall be deferred as part of the loan balance and amortized over the life of the loan?

   a. Interest rate points
   b. Nonrefundable loan origination fee
   c. Prepaid interest
   d. Unexercised commitment fee

48. At what point in time is accrued interest receivable on a mortgage loan required to be recorded as a nonadmitted asset if it is still deemed collectible?

   a. 30 days past due
   b. 90 days past due
   c. 180 days past due
   d. 360 days past due

49. During the year ended December 31, 20X1, ABC Company received (1) nonrefundable loan origination fees of $50,000; and (2) nonrefundable fees representing points in the amount of $30,000. Assuming ABC amortized these points over the remaining three-year life (beginning January 1, 20X1) of the respective loans, how much should ABC record as income during the year ended December 31, 20X1?

   a. $30,000
   b. $50,000
   c. $60,000
   d. $80,000
50. All real estate shall be reported in the following balance sheet categories:
   
a. Properties occupied by the company, property acquired in satisfaction of debt and property held for sale
b. Properties occupied by the company, other properties and investments in real estate
c. Properties occupied by the company, property held for the production of income and property held for sale
d. Properties occupied by the company, other properties and property acquired in satisfaction of debt

51. Appraisals must be obtained to support the fair value recorded for which of the following categories of real estate?
   
a. Properties occupied by the company
b. Property held for the production of income
c. Both a and b, or those properties for which conditions indicate a significant decrease in the fair value of the property
d. Appraisals are required for all real estate

52. Appraisals obtained to support the fair value of real estate can be no more than _____ years old; otherwise, the property must be recorded as a nonadmitted asset.
   
a. Three
b. Four
c. Five
d. Six

53. The cost of real estate shall be depreciated over the estimated useful life, not to exceed how many years?
   
a. 10 years
b. 40 years
c. 50 years
d. There is no limit. It is simply depreciated over its estimated useful life.
54. Assume ABC Company owns and occupies 100% of its home office space. The property was purchased in 19X5 for $50,000,000 and has an estimated market value of $59,000,000 and a depreciated cost of $42,000,000 at December 31, 20X1. There are no conditions indicating that the carrying amount of the property might not be recoverable; however, no appraisal has been obtained since the building was purchased in 19X5. There is no outstanding debt on the building. At December 31, 20X1, the building should be recorded as an admitted asset in the amount of:

a. $50,000,000  
b. $59,000,000  
c. $42,000,000  
d. $0, because the appraisal is too old

55. Research and development costs and start-up costs are expensed when incurred.

a. True  
b. False

56. For leases, the determination of whether the lease represents 90% of the useful life of the asset is a key factor in determining whether a lease is a capital or operating lease similar to GAAP.

a. True  
b. False

57. In 20X0, Company A issued a $100,000 surplus note to Company B with terms representing a 3% annual interest rate. No interest was paid in 20X1. Company A has not discussed interest with their domiciliary commissioner. As of December 31, 20X2, Company A recorded surplus note interest payable as:

a. $3,000  
b. $3,090  
c. $6,090  
d. $0

58. Assume that Burning Down the House holds Mortgage Loans on real estate of $500,000. The mortgage loans are collateralized by the applicable real estate. The fair value of the real estate is $900,000. The cost to obtain and sell the property is $300,000. What value should be recorded for mortgage loans on real estate for SAP purposes? The state of domicile limits mortgage loans to the property value.

a. $300,000  
b. $600,000  
c. $500,000  
d. $900,000
At the completion of this section, you will be able to:

1. Describe the accounting for transactions with affiliates and other related parties

2. Describe investments in joint ventures, partnerships and limited liability companies

3. Identified statutory accounting principles for business combinations, including accounting for goodwill and mergers

A Look Back
Section 7 provided guidance for investments in mortgage loans and real estate, leases and surplus notes.

A Look At This Section
This section explains the basics in statutory accounting for reporting and disclosure of transactions with affiliates and other related parties. It also addresses goodwill and partnerships.

A Look Ahead
Section 9 identifies nonadmitted assets and addresses disclosures for these items. It also includes discussion of operating and non-operating system software.

SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
SSAP No. 48—Joint Ventures, Partnerships, and Limited Liability Companies
SSAP No. 68—Business Combinations and Goodwill
SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments
SECTION PREVIEW

This section addresses several SSAPs with guidance on the accounting for invested assets of insurance companies. The following is a list of the most significant statements covered in this statement.

- SSAP No. 25: Establishes statutory accounting principles and disclosure requirements for related party transactions.
- SSAP No. 48: Defines investments for joint ventures, partnerships and limited liability companies and establishes statutory accounting principles for them. SSAP No. 93 clarifies that low-income housing tax credits are excluded from this treatment.
- SSAP No. 68: Defines business combinations as either a statutory purchase or a statutory merger and establishes the accounting guidance for such transactions, including goodwill.

SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

SSAP No. 25 establishes statutory accounting principles for transactions with related parties. Related parties are defined as entities that have common interests as a result of ownership, control, affiliation or by contract. Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities, or may not be fair and reasonable to the reporting entity or its policyholders. The significant guidance from this statement is summarized below.

Definition of Affiliate
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. The key word is “control.” 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 interest of the entity. The 10% ownership threshold shall be measured at the holding company level. This means that if Subsidiary A, Subsidiary B and Subsidiary C (all 100% owned by the same holding company) each own a 5% interest in Company D, then Company D would be considered an affiliate of A, B and C, as ownership at the holding company level is at least 10% (5% + 5% + 5%).
Related Party Transactions
This statement establishes specialized accounting rules for related party transactions:

1. **Related party loans:** Loans or advances made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner’s independent payment ability. For loans or advances made by a reporting entity to all other related parties, such loans or advances must constitute arm’s-length transactions in order to be reported as admitted assets of the reporting entity.

2. **Transactions involving the exchange of assets or liabilities:** A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. The determination of economic vs. non-economic transaction drives the accounting treatment provided for the transaction. Examples of transactions 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.

3. **Transactions involving services:** 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—Insurance Holding Companies may result in: (a) amounts charged being re-characterized as dividends or capital contributions; (b) transactions being reversed; (c) receivable balances being nonadmitted; or (d) other regulatory action.

All transactions between related parties must be in the form of a written agreement. Such written agreement must provide for the timely settlement of amounts owed with a specified due date. Amounts owed to the reporting entity that are 90 days past due from the specified due date are nonadmitted. Furthermore, any amounts owed that are not addressed by written agreements with a specified due date are also nonadmitted.

Disclosures
The financial statements shall include disclosures of all material related party transactions. This statement expands the disclosure requirements for such transactions based on the fact that such disclosure provides the statutory financial statement user information necessary in evaluating a reporting entity’s dependence on such relationships to continue operations.
Quick Check

1. Why does the definition of related parties include the phrase “or by contract”?

The phrase “or by contract” was added to this definition due to the fact that a contract can be a more powerful controlling interest than ownership or affiliation. An example of this is Wal-Mart. Do you think that Wal-Mart can influence the business decisions of some of its suppliers, even though Wal-Mart might not own stock in the supplier?

Sure they can, based simply on the significance of Wal-Mart’s business with the suppliers. Therefore, it becomes important to recognize this influence when analyzing relationships with business partners.

2. Name some transactions or characteristics that would be defined as “non-arm’s-length” or “non-economic.”

Examples of “non-arm’s-length” and “non-economic” transactions include: (1) bargain purchase price; (2) favorable credit terms; (3) lower than market interest rates; (4) transactions that artificially inflate the surplus of one entity at the expense of another entity, etc.

SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies

SSAP No. 48 establishes statutory accounting principles for all investments in joint ventures, partnerships and limited liability companies, whether or not the entity is controlled by or affiliated with the reporting entity. SSAP No. 48 defines a joint venture, general partnership and limited liability company as follows.

**Joint Venture:** Investments in joint ventures shall include investments in corporate joint ventures and unincorporated joint ventures (also referred to as undivided interest in ventures). A corporate joint venture is defined as a corporation owned and operated by a small group (joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group.

**General Partnership:** Investments in partnerships shall include investments in general partnership interests and limited partnership interests. A general partnership is defined as an association in which each partner has unlimited liability (each partner assumes joint and several liability for all partnership debts). A limited partnership shall be defined as a partnership having two classes of partners: (a) general partners; and (b) limited partners.
**Limited Liability Company:** A limited liability company is defined as a business combination that 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.

This statement provides that investments in joint ventures, partnerships and limited liability companies shall be reported in “Other Invested Assets” in the financial statements.

**Valuation**
Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest (i.e., less than 10%), shall be reported using an equity method as defined in SSAP No. 97. Joint ventures, partnerships and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 10 and 11 of SSAP No. 97, shall be recorded based on the underlying audited GAAP equity, U.S. tax basis or audited foreign GAAP/IFRS equity basis of the investee, in accordance with restrictions identified within SSAP No. 48. Examples of situations where the presumption of control may be in doubt include:

a) Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

b) An entity where the insurer owns less than 50% of the entity and there is an unaffiliated individual or group of investors who own a controlling interest.

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.

**Impairment**
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 that are determined to be other-than-temporary shall be recorded as realized losses.
SSAP No. 68—*Business Combinations and Goodwill*

SSAP No. 68 establishes statutory accounting principles for business combinations. It addresses: (a) accounting for purchases of subsidiary, controlled and affiliated (SCA) investments, as defined in SSAP No. 97; (b) accounting for purchases of partnerships, joint ventures, and limited liability companies, as defined in SSAP No. 48; (c) accounting for goodwill; and (d) accounting for mergers. The significant guidance is summarized below.

**Types of Business Combinations**

A business combination shall be accounted for as either a statutory purchase or a statutory merger. Business combinations that create a parent-subsidiary relationship shall be accounted for as a statutory purchase. Business combinations where equity of one entity is issued in exchange for the equity of another entity, which is then canceled and prospectively only one entity exists, shall be accounted for as a statutory merger.

**Goodwill**

For those acquired SCA entities accounted for in accordance with SSAP No. 97, goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity’s share of the book value of the acquired entity. Keep in mind the difference between SAP and GAAP goodwill:

<table>
<thead>
<tr>
<th>Purchase Price – Book Value</th>
<th>Purchase Price – Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory Goodwill</td>
<td>GAAP Goodwill</td>
</tr>
</tbody>
</table>

When the cost of the acquired entity is greater than the reporting entity’s share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity’s share of the book value, negative goodwill exists. Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other than invested assets. All other goodwill shall be reported in the carrying value of the investment. (This paragraph is actually contained within SSAP No. 97, not SSAP No. 68, but is being presented herein for this education program.)

Positive goodwill from all sources, including life, accident and health, and deposit-type assumption reinsurance, is limited in the aggregate to 10% of the reporting entity’s capital and surplus, as required to be shown on the statutory balance sheet for the most recently filed financial statement with the domiciliary insurance commissioner, adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets. Negative goodwill is recorded as a contra-asset. Positive or negative goodwill resulting from the purchase of an SCA entity shall be amortized to unrealized capital gains and losses on investments over the period in which the acquiring entity benefits economically, not to exceed 10 years. Positive or negative goodwill resulting from life, accident and health, and deposit-type assumption reinsurance shall be
amortized to operations as a component of general insurance expenses over the period in which the assuming entity benefits economically, not to exceed 10 years.

**Impairment**
For any decline in the fair value of an entity acquired through a purchase 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., nonadmitted goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value that are determined to be other-than-temporary shall be recorded as realized losses.

**Disclosures**
Various disclosures are necessary concerning the type of business combination and the related goodwill. Additionally, an 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 charged to realized capital gains and losses and how fair value was determined.
At September 30, 20X1, ABC Company had statutory capital and surplus of $28,000,000. The company also owned EDP equipment, operating system software, goodwill and net deferred tax assets of $800,000, $200,000, $1,750,000 and $75,000, respectively. If ABC acquired goodwill during the fourth quarter of 20X1 for a total of $4,000,000 in goodwill at December 31, 20X1, how much goodwill could the company report as an admitted asset in the December 31, 20X1, financial statements? How much of this goodwill would be recorded as a nonadmitted asset at December 31, 20X1?

Solution #8-1

The maximum admitted goodwill at December 31, 20X1, can be calculated under the provisions of SSAP No. 68 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital and Surplus at 9/30/X1</td>
<td>$28,000,000</td>
</tr>
<tr>
<td>Less: EDP Equipment</td>
<td>800,000</td>
</tr>
<tr>
<td>Operating System Software</td>
<td>200,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>1,750,000</td>
</tr>
<tr>
<td>Net Deferred Tax Assets</td>
<td>75,000</td>
</tr>
<tr>
<td><strong>Adjusted Capital and Surplus</strong></td>
<td><strong>$25,175,000</strong></td>
</tr>
</tbody>
</table>

Maximum Limit of 10%         $  2,517,500

Therefore, the maximum amount of admitted goodwill is $2,517,500 at December 31, 20X1. The remaining amount of $1,482,500 must be recorded as a nonadmitted asset.

Quick Check

3. How is the calculation of goodwill different between using the GAAP method vs. the statutory accounting method?

Under GAAP accounting, goodwill is calculated as purchase price; i.e., market value of assets acquired. Conversely, under statutory accounting, goodwill is calculated as purchase price; i.e., book value of assets acquired.
Quick Check

4. Why is there a limit on the admissibility of goodwill?

This is a case where the Statutory Accounting Principles (E) Working Group was sensitive to the impact of applying SAP and its impact on the surplus of insurers. Although goodwill meets the definition of an asset, it cannot be used to fulfill policyholder obligations when due. Prior statutory accounting guidance allowed goodwill up to 10% of capital and surplus; therefore, the Working Group was sensitive to the fact that many companies could be materially and negatively impacted if required to eliminate goodwill from their financial statements.

Case Study
Please turn to the Invested Assets section of the case study and complete. When finished with the case study, complete the review questions that follow.
Section 8 – Review Questions

Please read Section 8 and answer the following multiple-choice questions. Answers must be entered into the “Test Answer Form” in order to obtain credit. See instructions in the Program Overview for purposes of obtaining credit.

HINT: There might be review questions from previous sections.

59. Related parties are defined as entities that have common control as a result of various relationships. Examples of such relationships could include:
   a. Management agreement
   b. Ownership
   c. Subsidiaries
   d. All of the above

60. Investments of greater than 10% in joint ventures, partnerships and limited liability companies can be recorded using which one of the following methods?
   a. Market valuation method without application of discount
   b. Statutory equity method
   c. Net worth excluding nonadmitted assets
   d. Cost

61. Business combinations shall be accounted for as one of the following:
   a. Statutory purchase
   b. Statutory merger
   c. Quasi-reorganization
   d. Either a or b

62. Goodwill can result from which of the following transactions?
   a. Purchase price is greater than acquired entity’s book value
   b. Purchase price is less than the acquired entity’s book value
   c. Assumption reinsurance agreements
   d. All of the above
63. On December 31, 20X1, ABC Company purchased a subsidiary for $80,000,000. The subsidiary’s market value and net book value at date of purchase were $78,000,000 and $74,000,000, respectively. How much goodwill resulted from the purchase of this subsidiary?

   a. $2,000,000
   b. $4,000,000
   c. $6,000,000
   d. $74,000,000

64. Assuming ABC chose to amortize the goodwill calculated in the question above over the maximum period allowed under SAP, what percentage of goodwill should be amortized for the year ended December 31, 20X2?

   a. 5%
   b. 10%
   c. 15%
   d. 20%

65. At June 30, 20X1, ABC Company had statutory capital and surplus of $150,000,000. The company also owned EDP equipment, operating system software, health care delivery assets, goodwill, and net deferred tax assets of $5,800,000, $1,700,000, $12,000,000, $6,200,000 and 25,000,000, respectively. If ABC had a gross goodwill balance of $16,000,000 at September 30, 20X1 (prior to calculating admitted limits), how much goodwill could the company report as an admitted asset in the September 30, 20X1 financial statements?

   a. $15,000,000
   b. $11,130,000
   c. $9,930,000
   d. $0

66. The nonadmitted goodwill from the question above should be written off to operations during the third quarter of 20X1.

   a. True
   b. False
At the completion of this section, you will be able to:

1. Determine whether uncollected premium balances meet the definition of an asset

2. Identify if EDP equipment and operating system software are allowed as admitted assets

3. Explain the depreciation periods for EDP equipment and system software

4. Apply statutory accounting principles to the costs of computer software and website development

5. Define the statutory capitalization policy requirements

A Look Back
Section 8 addressed statements specific to related parties, goodwill and partnerships.

A Look At This Section
This section identifies nonadmitted assets and addresses disclosures for those items. It also includes discussion of operating and nonoperating system software.

A Look Ahead
Section 10 addresses the liabilities and contingencies common to most companies. A liability and a loss contingency are specifically defined as well as other specific requirements, which are recognized for their uniqueness in other SSAPs.
SECTION PREVIEW

This section addresses assets and nonadmitted assets, which are basic financial statement elements for insurance companies. SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4) specifically defines assets and nonadmitted assets and is one of the fundamental SSAPs discussed previously. Some items meet the definition of an asset and a nonadmitted asset; however, some assets that current statutory accounting guidance generally nonadmit have some economic value that insurers can use in fulfilling policyholder obligations. The admitted value of these assets is limited to specific amounts. The most common type of asset that typically results in nonadmitted amounts entails uncollected premium balances, which are addressed in SSAP No. 6.

SSAP No. 16R addresses electronic data processing (EDP) equipment and accounting for software and provides an example of an instance where a nonadmitted asset does have some economic value that may be used to fulfill policyholder obligations.

SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers

One of the most common types of assets that members of the insurance industry generally associate with nonadmitted assets is that of overdue uncollected premium balances. In the past, most of the states only allowed companies to include in capital and surplus those receivables that were less than 90 days past due. The rationale for this formula for nonadmitting all receivables more than 90 days past due is based on the premise that, once a receivable reaches this point, its collectibility becomes questionable. After consideration of nonadmitted amounts, the insurer must write off any remaining receivables that it considers being uncollectible. In contrast, GAAP requires companies to establish an allowance for doubtful accounts to reduce the amount of inherent exposure that exists in the collectibility of balances receivable.

SSAP No. 6 provides a look at the type of language found in most of the asset statements within the AP&P Manual and includes the following:

Uncollected premium balances, bills receivable for premiums, and amounts due from agents meet the definition of an asset as defined in SSAP No. 4—Assets and Nonadmitted Assets, and are admitted assets to the extent they conform to the requirements of this statement.

This statement allows the insurer to record each of the above items as an admitted asset, assuming that all requirements of the SSAP are met.
SECTION 9 – PREMIUM RECEIVABLES AND NONADMITTED ASSETS

SSAP No. 6 establishes statutory accounting principles for direct and group billed uncollected premiums, bills receivable for premiums and amounts due from agents. Bills receivable for items other than premiums are not addressed in this guide, but are nonadmitted assets under SSAP No. 20—Nonadmitted Assets. SSAP No. 6 also addresses balances resulting from advances to agents, which are primarily encountered in the life insurance industry and are nonadmitted if: (a) the amounts are in the form of unsecured loans or advances; (b) the contractual terms for repayment are through application of future renewal commissions and/or other credits; or (c) the terms of repayment do not provide readily available cash for the satisfaction of policyholder liabilities.

Determination of Due Date
SAP provides the following guidance for the aging of premium balances subject to SSAP No. 6.

- **Original and Deposit Premiums**: Governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship.
- **Endorsement Premiums**: Governed by the effective date of the insurance policy endorsement.
- **Installment Premiums**: Governed by the contractual due date of the installment from the insured.
- **Audit Premiums and Retrospective Premiums**: Governed by insurance policy or insurance contract provisions. If insurance policy provisions or insurance contract provisions do not address the due date for receivables relating to these policies, any uncollected audit premium (either accrued or billed) is nonadmitted.

Nonadmitted Amounts
Under SSAP No. 6, nonadmitted amounts are determined as follows.

- **Uncollected Premium**: To the extent that there is no related unearned premium, any uncollected premium balances that are over ninety days due shall be nonadmitted. If an installment premium is over ninety days due, the amount over ninety days due, plus all future installments that have been recorded on that policy, shall be nonadmitted.

- **Bills Receivable**: Bills receivable shall be nonadmitted if either of the following conditions are present.
  (a) If any installment is past due, the entire bills receivable balance from that policy is nonadmitted.
  (b) If the bills receivable balance due exceeds the unearned premium on the policy for which the note was accepted, the amount in excess of the unearned premium is nonadmitted.
Agents’ Balances: On a policy-by-policy basis, the uncollected agent’s receivable that is over ninety days due shall be nonadmitted, regardless of any unearned premium.

Impairment
The impairment concept, as previously discussed in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets, has been incorporated into SSAP No. 6. This guidance requires an evaluation of all remaining admitted assets after calculating any nonadmitted amounts, as described above. If it is probable that, if any balance is uncollectible, the uncollectible receivable shall be written off and charged to income in the period the determination is made.

Insurers shall not use nonadmitted amounts collected subsequent to the date of the statutory financial statements to adjust the nonadmitted asset at the statement date. For example, if a company receives a check on January 10, 20X2, for a $50,000 receivable balance that was 95 days past due as of December 31, 20X1, the $50,000 could not be used to adjust the nonadmitted balance as of December 31, 20X1, even though the company received the check before the financial statements were issued. This rule provides a bright-line test for admission of premium receivable balances.

Wash Transactions
The following guidance is also included in SSAP No. 6 to prevent companies from avoiding the nonadmitted asset principle set forth above:

Amounts due from agents (affiliated or nonaffiliated) that are collected prior to the date of the financial statements and then repaid to the agent by the reporting entity, or one of the reporting entity’s affiliates, subsequent to the date of the financial statements shall be accounted for in accordance with the substance of the transaction (a wash transaction) and not its form. Accordingly, the payments received shall be accounted for as deposits and a liability shall be established for the same amount. The amounts due shall be reestablished as an asset and subjected to asset collectibility and nonadmitted asset calculations using the original due date of the receivable.
During the year ended December 31, 20X1, ABC Life Insurance Company advanced $100,000 to one of its major agents to assist the agent in expanding his office space. Additionally, for the year ended December 31, 20X1, ABC was due the following non-installment premium receivable amounts from this agent:

<table>
<thead>
<tr>
<th>Premium Receivables:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$200,000</td>
</tr>
<tr>
<td>30–60 Days</td>
<td>100,000</td>
</tr>
<tr>
<td>60–90 Days</td>
<td>50,000</td>
</tr>
<tr>
<td>&gt; 90 Days</td>
<td>50,000</td>
</tr>
</tbody>
</table>

Under SSAP No. 6, what would ABC record as an admitted and nonadmitted asset in the December 31, 20X1, balance sheet?

**Solution #9-1**

ABC would record $350,000 as admitted assets and $150,000 (agent advance plus items > 90 days past due) as nonadmitted assets. **NOTE:** Although, in theory, life insurance companies can admit premium receivables, in actuality, because many whole-life insurance entities offer agents advances and commission draws, agents’ balances/premiums receivables are often not a material amount for direct life writers.

**INTERPRETATION 02-02: SSAP No. 6 and Billing of Premium Before Effective Date**

A premium billing in advance of the effective date should not produce an asset/receivable on the financial statement until the effective date of the underlying policy/contract, nor should it produce a liability for advance premiums. An insurer only recognizes advanced premiums when it receives cash payment for premiums prior to the effective date of the contract.
Example
Policy Effective Date: 4/1–30
Premiums Billed: 2/25 Nothing recorded
Premiums Received: 3/15 Debit Cash received and credit Advanced Premiums (Liability)
Premiums Due: 4/1 If payment has not been received, debit Premiums Receivable and credit Unearned Income

Quick Check

1. How is the decision to age premiums receivable as of the effective date of the policy consistent with the Statement of Concepts?

The decision is in line with the Statement of Concepts because it provides consistency in the way premiums receivable are aged across all companies and all policy types. Prior to codification, property/casualty companies often aged premiums based on the due date from the agent to the insurer. This meant that, sometimes, policy premiums were more than four or five months overdue when the insurer first recognized it as overdue. Regulators were concerned that insurers had unrecognized insurance exposures that were not funded. Therefore, changing the aging date for premiums is also consistent with the recognition concept.
SSAP No. 16R—Electronic Data Processing Equipment and Accounting for Software

SSAP No. 16R was revised to consolidate the guidance from SSAP No. 79, SSAP No. 81 and SSAP No. 82. SSAP No. 16R covers EDP equipment and operating/nonoperating software, research and development costs incurred to obtain or develop computer software, accounting for costs of computer software to be sold, software revenue recognition and the costs of computer software developed or obtained for internal use and website development costs.

EDP Equipment and Operating/Nonoperating Software
SSAP No. 16R allows electronic data processing (EDP) equipment and operating system software to be admitted assets, subject to a limitation. Nonoperating system software is a nonadmitted asset and is often characterized as application system software (e.g., an accounting package or claims processing software). EDP equipment and operating system software that exceeds 3% of adjusted capital and surplus is required to be nonadmitted. The adjusted capital and surplus limit is calculated as 3% of the previous quarter’s capital and surplus after first deducting: (1) EDP equipment; (2) operating system software; (3) goodwill; and (4) net deferred tax assets.

The use of the previously filed financial statement is necessary to perform such a calculation without the complication of circular mathematical logic. Codification added the exclusion of EDP equipment, operating system software, net deferred tax assets and net positive goodwill to provide an extra layer of conservatism in the limitation of admissible EDP equipment and operating system software. The following illustration provides an example of this limitation.

Illustration

#9-2

At September 30, 20X1, ABC Life Insurance Company had statutory capital and surplus of $32,000,000. ABC also owned EDP equipment, operating system software, goodwill and net deferred tax assets of $950,000, $100,000, $1,500,000 and $300,000, respectively. How much EDP equipment and operating system software could ABC report as an admitted asset in the December 31, 20X1, financial statements, assuming gross EDP equipment and operating systems software of $1,050,000 at December 31, 20X1?
**Solution #9-2**

The maximum EDP equipment and operating system software at December 31, 20X1, is calculated as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital and Surplus at 9/30/X1</td>
<td>$32,000,000</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>EDP Equipment</td>
<td>$950,000</td>
</tr>
<tr>
<td>Operating System Software</td>
<td>$100,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Net Deferred Tax Asset</td>
<td>$300,000</td>
</tr>
<tr>
<td>Adjusted Capital and Surplus</td>
<td><strong>$29,150,000</strong></td>
</tr>
<tr>
<td>3% limit</td>
<td><strong>874,500</strong></td>
</tr>
</tbody>
</table>

Total EDP Equipment & operating system software: $1,050,000

Admitted asset: $874,500

Nonadmitted asset: $175,500

As a result, ABC can only admit up to $874,500 and would nonadmit the remaining $175,500 at 12/31/X1.

**Depreciation**

EDP equipment and operating system software are depreciated over the lesser of its useful life or three years. Similarly, nonoperating system software is depreciated over the lesser of its useful life or five years. In either case, insurers shall use the methods detailed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements.

**Quick Check**

2. Which of the following is operating system software?

   (a) Windows
   (b) DOS
   (c) Microsoft Excel
   (d) a and b
   (e) a, b and c

Both Windows and DOS are considered operating system software. Microsoft Excel is nonoperating system software.
Research and Development Costs
Guidance on the accounting for research and development costs is provided in SSAP No. 17—Preoperating and Research and Development Costs (SSAP No. 17), and requires all research and development costs to be expensed when incurred. Guidance in SSAP No. 16R identifies specific instances and whether the costs are considered research and development costs.

Research and development costs are costs incurred during all phases of software development for internal use in its research and development activities.

Not considered research and development costs are: the acquisition, development or improvement of a process by an enterprise for use in its selling or administrative activities includes costs for computer software; and costs incurred to purchase or lease computer software developed by others, unless the software is for use in research and development activities.

Costs for computer software determined to be research and development costs shall be accounted for and disclosed in accordance with SSAP No. 17. Software costs not considered to be research and development costs shall be accounted for in accordance with SSAP No. 16R.

Accounting for the Costs of Computer Software to be Sold
SSAP No. 16R adopts FASB Codification 985-20, Software – Costs of Software to be Sold, Leased or Marketed (ASC 985-20) with modification to preclude the capitalization of software development costs and to reject guidance regarding the treatment of capitalized costs. Additionally, SSAP No. 16R rejects FASB Codification 985-330, Software – Inventory (ASC 985-330). Statutory modifications to ASC 985-20 and rejection of ASC 985-330 precludes capitalization of costs, and requires such costs to be expensed for: (a) costs of producing product masters incurred subsequent to establishing technological feasibility (including coding and testing performed subsequent to establishing technological feasibility); (b) software production costs for computer software that is to be used as an integral part of a product or process; (c) all indirect costs, including overhead related to programmers and the facilities they occupy; and (d) costs incurred for duplicating computer software, documentation and training materials from product masters and for physically packaging the product for distribution.

Software Revenue Recognition
SSAP No. 16R adopts FASB Codification 985-605, Revenue Recognition (ASC 985-605), as revised by ASU 2009-14, Certain Revenue Arrangements That Include Software Elements (ASU 2009-14), with the following modifications for statutory accounting.
(a) References to GAAP guidance outside FASB Codification topic 985-605 shall be followed only to the extent in which that specific GAAP guidance has been adopted\(^1\) for statutory accounting. The guidance within the applicable SSAP or statutory interpretation shall be considered the authoritative statutory guidance.

(b) Any references to the accounting for capitalized development costs is rejected, as all development costs are required to be expensed when incurred.

**Costs of Computer Software Developed or Obtained for Internal Use and Website Development Costs**

SSAP No. 16R adopts *FASB Codification 350-40, Internal Use Software* (ASC 350-40) with modification for statutory accounting terms and concepts. SSAP No. 16R also adopts *FASB Codification 350-50, Website Development Costs* (ASC 350-50) in its entirety.

11. The modifications to ASC 350-40 are as follows:

(a) Costs of reengineering activities, which often are associated with new or upgraded software applications, are to be expensed as incurred.

(b) Entities that license internal-use computer software follow the operating lease provisions outlined in *SSAP No. 22—Leases*.

(c) Follow the amortization guidelines as established in paragraph 9 of *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) As previously discussed, capitalized operating system software shall be depreciated for a period not to exceed three years. Capitalized nonoperating system software shall be depreciated for a period not to exceed five years.

(e) If, during the development of internal use software, an entity decides to market the software to others, the entity shall immediately expense any amounts previously capitalized.

(f) Follow the disclosure provisions provided in paragraph 13 and paragraph 4 of SSAP No. 17.

(g) Any software costs capitalized in accordance with the paragraphs related to software revenue recognition and internal use software/website development shall be deemed either operating or nonoperating system software costs. Entities shall make this determination in accordance with the definitions of operating and nonoperating system software contained in the Glossary of the AP&P Manual. As noted above, nonoperating system software is a nonadmitted asset.

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\(^1\) If statutory accounting principles do not address the FASB Codification reference, consideration of whether the GAAP guidance is adopted for statutory accounting shall be determined in accordance with the respective pre-codification GAAP guidance.
Capitalization
In accordance with the reporting entity’s written capitalization policy, amounts less than a predefined threshold of costs incurred within the scope of paragraphs above (software revenue recognition and internal use software/website development) shall be expensed when incurred.

The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance. If an entity demonstrates a pattern of varying its capitalization policy from period to period without sufficient evidence (as determined by the reporting entity’s domestic regulator), such action would call into question both the entity’s ability to accurately establish a predefined threshold and the propriety of expensing or capitalizing certain assets.

Case Study
Please turn to the Invested Assets section of the case study and complete. When finished with the case study, complete the review questions that follow.
Section 9 – Review Questions

After covering Section 9, please answer the following multiple-choice questions. Answers must be entered into the “Test Answer Form” in order to obtain credit. See instructions in the Program Overview for purposes of obtaining credit.

HINT: There might be review questions from previous sections.

67. A nonadmitted amount collected after the statement date of the financial statements may be used to adjust the nonadmitted asset amount.
   
   a. True
   b. False

68. An asset is defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
   
   a. True
   b. False

69. Which of the following represents an admitted asset under statutory accounting principles?

   a. Bills receivable past due
   b. Premium due from an agent more than 90 days past due from the effective date
   c. Nonoperating system software
   d. Health care delivery assets used for administrative purposes

70. Original premiums due from an agent for contracts should be aged as of the:

   a. Effective date of the insurance contract
   b. Contractual due date with the agent
   c. Date of application
   d. Effective date of the installment
71. Insurers can use amounts collected subsequent to the balance sheet date that represent nonadmitted receivables at the balance sheet date to adjust amounts nonadmitted as of the balance sheet date.

   a. True
   b. False

72. A transaction wherein amounts due from agents that are collected prior to the date of the financial statements and then repaid to the agent is referred to as a(n):

   a. Active transaction
   b. Wash transaction
   c. Contingent transaction
   d. Pending transaction

73. The maximum number of years over which EDP equipment and operating system software can be depreciated under statutory accounting is:

   a. Seven years
   b. Five years
   c. Four years
   d. Three years

74. Nonoperating system software, such as application software and claims system software, is a nonadmitted asset under SSAP No. 16R.

   a. True
   b. False

75. EDP equipment is an admitted asset under SSAP No. 16R, provided it does not exceed 3% of adjusted capital and surplus.

   a. True
   b. False
Other Liabilities and Contingencies

At the completion of this section, you will be able to:

1. Report liabilities and loss contingencies according to statutory accounting principles

2. Discuss the accounting and reporting for pensions

3. Define postretirement benefits other than pensions

4. Discuss the accounting for guaranty fund assessment

SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8
SSAP No. 14—Postretirement Benefits Other Than Pensions
SSAP No. 35R—Guaranty Fund and Other Assessments

A Look Back
Section 9 identified nonadmitted assets and addressed disclosures for these items. It also included discussion of operating and nonoperating system software.

A Look At This Section
This section addresses the other liabilities and contingencies common to most companies. A liability and a loss contingency are specifically defined, as well as other specific requirements that are recognized for their uniqueness in other SSAPs.

A Look Ahead
Section 11 addresses health care.
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SECTION 10 – OTHER LIABILITIES AND CONTINGENCIES

SECTION PREVIEW

This section addresses liabilities and contingencies, which are basic financial statement elements for reporting entities. A liability and a loss contingency are defined specifically within SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets, which was one of the fundamental SSAPs previously discussed. Some items meet the definition of a liability as defined within SSAP No. 5R and have specific requirements for recognizing the amounts in the financial statements. Examples of these types of liabilities are pensions and other postretirement benefits, which are addressed in SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8 and SSAP No. 14—Postretirement Benefits Other Than Pensions, respectively. Additionally, SSAP No. 35R—Guaranty Fund and Other Assessments provides guidance on accruing contingencies for guaranty funds and other assessments, adopting GAAP guidance, with modification, from Accounting Standard Codification 405-30, Insurance-Related Assessments (ASC 405-30).

SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8

SSAP No. 89 supersedes the conclusions reached in SSAP No. 8 and establishes statutory accounting principles and related reporting for employers’ pension obligations.

Balance Sheet Amount
Obligations under pension plans generally meet the definition of a liability as established in SSAP No. 5R and should be recognized in the financial statements. This statement adopts FASB Statement No. 87, Employers’ Accounting for Pensions (FAS 87), with modification to exclude nonvested employees. GAAP requires all “plan participants” (vested and nonvested) to be included within the liability calculation.

NOTE: This is one area where GAAP is more conservative than SAP. The SAP Working Group is reviewing FAS 158–Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—An Amendment of FASB Statements No. 87, 88, 106 and 132(R) to update guidance for pensions and other postretirement plans. Check the Statutory Accounting Principles (E) Working Group’s page on the NAIC website for current information.

Defined Benefit Plans
The projected benefit obligation (PBO) as of a date is the actuarial present value of all benefits attributed by the plan’s benefit formula to employee service rendered prior to that date. The PBO is measured using an assumption as to future compensation levels if the pension benefit formula is based on those future compensation levels. The PBO is a measure of benefits attributed to service to date assuming that the plan continues in effect.
and that estimated future events (including compensation increases, turnover and mortality) occur.

The accumulated benefit obligation (ABO) as of a date is the actuarial present value of benefits attributed by the pension benefit formula to employee service rendered prior to that date and based on current and past compensation levels. The accumulated benefit obligation differs from the projected benefit obligation in that it includes no assumption about future compensation levels. Hence, the PBO will be greater than the ABO.

If the ABO exceeds the fair value of plan assets, the reporting entity shall recognize a liability (including unfunded accrued pension cost) that is at least equal to the unfunded ABO. Recognition of an additional minimum liability is required if an unfunded ABO exists and: (a) a prepaid pension cost asset has been recognized as a nonadmitted asset; (b) the liability already recognized as unfunded accrued pension cost is less than the unfunded accumulated benefit obligation; or (c) no accrued or prepaid pension cost has been recognized.

If an additional minimum liability is recognized, an equal amount shall be recognized as an intangible asset, provided that the asset recognized shall not exceed the amount of unrecognized prior service cost (unrecognized prior service cost shall include unamortized incremental liability). If an intangible asset generated by the additional minimum liability is recognized, only that portion in excess of the unamortized incremental liability associated with the transition shall be nonadmitted. If an additional liability required to be recognized exceeds unrecognized prior service cost, the excess (which would represent a net loss not yet recognized as net periodic pension cost) shall be reported as a component of unassigned funds (surplus), net of any tax benefits that result from considering such losses as temporary differences for purposes of applying the provisions of SSAP No. 10R—Income Taxes.

Settlements and Curtailments
Consistent with SSAP No. 5R regarding contingencies, the following two concepts are established for settlements and curtailments.

A settlement is a transaction that is irrevocable and releases the employer from responsibility for the pension obligation by eliminating the risks relative to the obligation and the assets associated with the plan (e.g., making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits or purchasing nonparticipating annuity contracts to cover vested benefits). If a settlement occurs and the net result is a loss, such loss is recognized at the time of the settlement. If the net result is a gain, such gain is not recognized until the proceeds are received by the reporting entity.

A curtailment is an event that significantly alters the makeup of the pension plan. If a curtailment occurs, there are generally two components to any gain or loss (e.g., a reduction in the years of service required or the employees covered). Any unrecognized prior service cost shall be recognized as a loss. An increase or decrease in pension benefit
obligations due to the curtailment will also result in a gain or loss, and is combined with the prior service cost loss. If the net result of the curtailment is a loss, such loss shall be recognized when it is probable that the curtailment will occur and that the effects can be reasonably estimated. If the net result is a gain, such gain shall not be recognized in earnings until the employees terminate or the plan suspension or amendment is adopted and the proceeds are received by the reporting entity.

**Defined Contribution Plans**

A defined contribution plan defines the amount of the employer’s contributions to the plan and its allocation to plan participants. The pension benefit provided to the participant at retirement or termination depends on the amount of employer and employee contributions, earnings on plan investments and, in some cases, other participant forfeitures.

**Nonadmitted Assets**

Amounts paid to the plan for nonvested employees represent a prepaid item and are recorded as a prepaid expense and nonadmitted, because the cash is not readily available to meet policyholder obligations. Likewise, any intangible asset resulting from the application of this statement for defined benefit plans shall be considered a nonadmitted asset.

**Consolidated/Holding Company Plans**

As often is the case, the pension plan may not be held at the insurance company level, but instead may be held at the holding company level. A reporting entity that participates in these plans and is not directly liable for obligations under the plan shall recognize pension expense equal to its allocation from the holding company or parent company of the required contribution to the plan for the period. A liability shall be established for any such contributions due and unpaid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation.

**Disclosures**

Extensive disclosures are included within SSAP No. 89 to ensure that users of the financial statements have the information needed about pension plan assets, obligations, benefit payments, contributions and net benefit costs.

**Interpretations**

*INT 04-03: Clarification for Calculating the Additional Minimum Pension Liability Under SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8,* paragraph 16f. INT 04-03 provides guidance on the calculation of additional minimum liabilities when the actuarial information used in the calculation is dated prior to the financial statement date.

*INT 04-12: EITF 03-4: Determining the Classification and Benefit Attribution Method for a “Cash Balance” Pension Plan.* INT 04-12 provides accounting and reporting guidance for “cash balance” pension plans.
INT 04-17: Impact of Medicare Modernization Act on Postretirement Benefits. INT 04-17 provides accounting and reporting guidance for subsidies received under the federal Medicare Prescription Drug, Improvement and Modernization Act of 2003 (also called the Medicare Modernization Act) for providing postretirement prescription drug coverage.

**SSAP No. 14—Postretirement Benefits Other Than Pensions**

SSAP No. 14 adopts, with modification, *FASB Statement No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions*. Similar to SSAP No. 89, this statement also includes transition rules to allow companies to recognize the effects of adopting this statement over a period of time. However, unlike SSAP No. 89 (which became effective in 2003), SSAP No. 14 guidance has been required since 1993. As a result, the most noticeable difference between these two SSAPs is the transition rules that exist.

**Nonadmitted Assets**
Consistent with SSAP No. 89, any prepaid expense or intangible asset resulting from application of the provisions of SSAP No. 14 shall be considered a nonadmitted asset, as such an asset cannot be readily converted to cash to satisfy policyholder obligations.

**Plan Amendments**
Plan amendments may include provisions that increase or reduce benefits to retirees and fully eligible employees. The cost of benefit improvements is the increase in the postretirement benefit obligation as a result of the plan amendment, measured at the date of the amendment. That increase shall be amortized over the average life expectancy of the employer’s fully vested retiree group.

**Consolidated/Holding Company Plans**
Consistent with SSAP No. 89, a reporting entity that participates in these plans and is not directly liable for obligations under the plan, shall recognize pension expense equal to its allocation from the holding company or parent company of the required contribution to the plan for the period. A liability shall be established for any such contributions due and unpaid.

**Disclosures**
Similar to SSAP No. 89, extensive disclosures are included within SSAP No. 14 to ensure that users of the financial statements have the information needed about pension plan assets, obligations, benefit payments, contributions and net benefit costs.
SSAP No. 35R—Guaranty Fund and Other Assessments

SSAP No. 35R establishes statutory accounting principles for guaranty fund and other assessments. Guaranty fund assessments represent a funding mechanism employed by the states to provide funds to cover policyholder obligations of insolvent reporting entities. Other assessments include workers’ compensation second injury funds; and funds that pay operating costs of an insurance department, a state guaranty fund and/or the workers’ compensation board. Also included are health-related assessments, including (but not limited to) state health insurance high-risk pools, health insurance small group and individual reinsurance pools, and state health demographic or risk-adjustment assessments. SSAP No. 35R adopts, with modification, guidance from Accounting Standard Codification 405-30, Insurance-Related Assessments (ASC 405-30).

Consistent with ASC 405-30-25-1, entities subject to assessments shall recognize liabilities for insurance-related assessments when all of the following conditions are met.

(a) An assessment has been imposed or information available prior to issuance of the statutory financial statements indicates that it is probable that an assessment will be imposed,

(b) The event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements, and

(c) The amount of the assessment can be reasonably estimated.

Guaranty fund and other assessments shall be expensed (Taxes, licenses and fees line) and a liability shall be accrued when the above criteria are met, except for certain health-related assessments that shall be reported as a part of claims.

For premium-based guaranty fund assessments (except those that are prefunded), subparagraph (a) above is met when the insolvency has occurred. For purposes of applying this guidance, the insolvency shall be considered to have occurred when a reporting entity meets a state’s (ordinarily the state of domicile of the insolvent reporting entity) statutory definition of an insolvent reporting entity. In most of the states, the reporting entity must be declared to be financially insolvent by a court of competent jurisdiction. In some of the states, there must also be a final order of liquidation. Prefunded guaranty fund assessments and premium-based administrative-type assessments are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

Subparagraph (b) above requires that the event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements.

Subparagraph (c) above requires that the amounts can be reasonably estimated. For retrospective premium-based guaranty fund assessments, a reporting entity’s estimate of the liability shall reflect an estimate of its share of the ultimate loss expected from the insolvency, and any applicable premium tax credits and policy surcharges. An entity need
not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability.

Based on the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (e.g., an insolvency) might not be the event that obligates an entity. The following information defines the events that obligate an entity to pay an assessment:

1. For premium-based assessments, the event that obligates the entity is generally writing the premiums or becoming obligated to write or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some of the states, through law or regulatory practice, provide that an insurance entity cannot avoid paying a particular assessment, even if that insurance entity reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. For example, in certain states, an insurance entity may remain liable for assessments, even though the insurance entity discontinues the writing of premiums. In this circumstance, the underlying cause of the liability is not the writing of the premium, but the insolvency. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

2. For loss-based assessments, the event that obligates an entity is that entity incurring the losses on which the assessments are expected to be based.

The liability for accrued assessments shall be established gross of any probable and estimable recoveries from premium tax credits and premium surcharges. When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset shall be recognized for that recovery in an amount that is determined based on current laws, projections of future premium collections or policy surcharges from in-force policies, and as permitted in accordance with subparagraphs 1, 2 and 3 below. Any recognized asset from premium tax credits or policy surcharges shall be re-evaluated regularly to ensure recoverability. Upon expiration, tax credits no longer meet the definition of an asset and shall be written off.

1. For assessments paid before premium tax credits are realized or policy surcharges are collected, an asset results, which represents a receivable for premium tax credits that will be taken and policy surcharges which will be collected in the future. These receivables, to the extent it is probable they will be realized, meet the definition of assets, as specified in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement. The asset shall be established and reported independent from the liability (not reported net).

2. Assets recognized from accrued liability assessments shall be determined in accordance with the type of guaranty fund assessment as detailed in the following subparagraphs. Assets recognized from accrued liability
assessments meet the definition of an asset under SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement.

(a) For retrospective-premium-based and loss-based assessments, to the extent that it is probable that accrued liability assessments will result in a recoverable amount in a future period from business currently in-force considering appropriate persistency rates for long-duration contracts, an asset shall be recognized at the time the liability is recorded. (In-force policies do not include expected renewals of short-term contracts.)

(b) For prospective-premium-based assessments, the recognition of assets from accrued liability assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. This SSAP requires reporting entities to recognize prospective-based-premium assessments as the premium is written or obligated to be written by the reporting entity. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments shall be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

3. An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.

Primary Methods of Guaranty Fund Assessments

✓ Retrospective premium-based assessments: Guaranty funds covering benefit payments of insolvent life, annuity and health insurance entities typically assess entities based on premiums written or received in one or more years before the year of insolvency. Assessments in any year are generally limited to an established percentage of an entity’s average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.

✓ Prospective premium-based assessments: Guaranty funds covering claims of insolvent property/casualty insurance entities typically assess entities based on premiums written in one or more years after the insolvency. Assessments in any year are generally limited to an established percentage of an entity’s premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.

✓ Prefunded premium-based assessments: This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed before any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.
SECTION 10 – OTHER LIABILITIES AND CONTINGENCIES

✓ Administrative-type assessments: These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency.

✓ Other premium-based assessments: Entities are subject to a variety of other insurance-related assessments. Many of the states and a number of local governmental units have established other funds supported by assessments. The most prevalent uses for such assessments are to fund: (a) operating expenses of state insurance regulatory bodies (e.g., the state insurance department or workers’ compensation board); and (b) second-injury funds.

i. Premium-based: The assessing organization imposes the assessment based on the entity’s written premiums. The base year of premiums is generally either the current year or the year preceding the assessment.

ii. Loss-based: The assessing organization imposes the assessment based on the entity’s incurred losses or paid losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.

Case Study
Please turn to the Liabilities section of the case study and complete. When finished with the case study, complete the review questions that follow.
Section 10 – Review Questions

Please read Section 10 and answer the following multiple-choice questions. Answers must be entered into the “Test Answer Form” in order to obtain credit. See instructions in the Program Overview for purposes of obtaining credit.

HINT: There might be review questions from previous sections.

For Questions 76 and 77:

On March 1, 20X2, a press release was issued by the State Insurance Department stating that It’s A Hard Knock Life Insurance Company was in liquidation and that the company was in the process of determining the amount that would be funded by the state guaranty fund. Shortly thereafter, ABC Company received a formal notice from the state guaranty fund association that included specifics regarding the insolvency. However, the notice did not include the exact amount of the insolvency but, rather, an estimate based on what had been reviewed by the state team in determining the insolvency. It was noted that the assessments would not be mailed until the following March. The insolvency was estimated at $60 million and was to be assessed based on year 20X1 premium volume. Using internal budgeted premium volume and data obtained from an independent organization, ABC estimated that the state guaranty association would ultimately assess the company approximately $75,000. In addition, based on correspondence with the state, it believes that the assessment can result in premium tax offsets of approximately $10,000 under SSAP No. 35R. ABC Company believes it is probable that they will realize the benefit of the premium tax credits over the next four years.

76. Based on the information given, what would ABC record as expense for the period ended March 31, 20X1?
   a. $0; the assessments are based on future written premiums
   b. $0; ABC would not record the expense until it received the assessment
   c. $75,000; ABC is not allowed to net premium tax credits with expense under SAP
   d. $65,000 (after recording a $10,000 premium tax credit)

77. The $10,000 in premium tax credit is an admitted asset under SSAP No. 35R.
   a. True
   b. False
For Questions 78 and 79:

A company sponsors for all of its employees, a defined contribution plan that provides for a 100% match on all contributions made by employees up to 3% (made each pay period by the company), as well as a 25% match on all contributions made by employees in excess of 3% up to 5%. At December 31, 20X1, the vested employer contributions equaled 75% of gross employer contributions. The following information is available for the plan year ending December 31, 20X1:

<table>
<thead>
<tr>
<th>Gross Employee Contributions</th>
<th>Employee Contributions (Equal to 3%)</th>
<th>Employee Contributions (&gt;3% and &lt;5%)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>80,000</td>
<td>80,000</td>
<td>40,000</td>
<td>120,000</td>
</tr>
</tbody>
</table>

78. What would the company record as a pension expense under SSAP No. 89 for the year ended December 31, 20X1?

   a. $ 67,500
   b. $ 80,000
   c. $ 90,000
   d. $120,000

79. How much would the company record as a prepaid asset and how much of it is admitted under SSAP No. 89?

   a. $10,000 recorded as prepaid and $10,000 admitted
   b. $10,000 recorded as prepaid and $0 admitted
   c. $22,500 recorded as prepaid and $0 admitted
   d. $40,000 recorded as prepaid and $40,000 admitted
80. Under SAP, a loss contingency should be recorded if the amount:
   a. Is reasonably possible
   b. Can be estimated
   c. Is probable and reasonably estimated
   d. Is reasonably possible and can be estimated

81. Under SAP, pension liabilities should be recorded under:
   a. A full FAS 87 approach
   b. A pay-as-you-go method
   c. A FAS No. 87 approach modified to exclude nonvested employees
   d. SSAP No. 14

82. A reporting entity that is not directly liable for the obligations of a parent company’s postretirement benefit plan should:
   a. Not recognize any expense in its financial statements
   b. Recognize half of its employees expenses
   c. Recognize expense equal to its allocation of its required contribution to the plan for the period
   d. Not recognize any expense until it is paid to the parent company
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At the completion of this section, you will be able to:

1. Identify health care delivery assets
2. Distinguish between health care receivables and receivables under government insured plans
3. Demonstrate an understanding of the SSAP No. 84 illustration
4. Identify claims adjustment expenses and cost containment expenses

A Look Back
Section 10 addressed other liabilities.

A Look At This Section
This section provides detailed guidance for standards specific to health care and addresses the unique situations of health care delivery assets and health care receivables.
SSAP No. 73—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities

SSAP No. 73 is consistent with SSAP No. 16R and allows admission of specific types of assets to the extent that they conform to requirements of the statement. The reporting entities that fall under SSAP No. 73 acquire and retain assets commonly referred to as “health care delivery assets” used in connection with the direct delivery of health care services in facilities owned or operated by the reporting entity. Health care delivery assets include supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements in health care facilities. Furniture, medical equipment and fixtures used in connection with the direct provision of health care services include diagnostic equipment, laboratory equipment, patient monitoring equipment, hospital beds, examining tables and operating room equipment. SSAP No. 73 describes the types of assets that are included in its scope and categorizes them in one of the following three classifications: (1) supplies; (2) pharmaceuticals and surgical supplies and durable medical equipment; and (3) furniture, medical equipment and fixtures.

Pharmaceuticals and surgical supplies and durable medical equipment held by reporting entities and used for the direct delivery of health care services are assets that are used to fulfill policyholder obligations within the meaning of SSAP No. 4 and are admitted assets to the extent that they conform to the requirements of SSAP No. 73. Similarly, furniture, medical equipment and fixtures, and leasehold improvements held by health reporting entities and used for the direct delivery of health care services are admitted assets to the extent they conform to the requirements of SSAP No. 73.

Supplies other than pharmaceuticals and surgical supplies used directly in the treatment of medical conditions (e.g., drugs, surgical items such as implants, and medical dressings)
SECTION 11 – HEALTH CARE DELIVERY ASSETS

shall be nonadmitted assets. Examples of these types of supplies include, but are not limited to: linens, uniforms and garments, food and other commodities, and housekeeping, maintenance and office supplies.

Durable medical equipment that is generally classified as inventory includes consumable or salable equipment (such as wheelchairs, crutches and braces) and is of a nature that it may be reused. Subscribers, members or policyholders may utilize durable medical equipment on a temporary basis and later return the equipment to the provider. The provider shall recognize the diminution in value, if any, because of the use of such equipment.

A health entity may admit furniture, medical equipment and fixtures, and leasehold improvements, but they shall be depreciated over their estimated useful lives for a period not to exceed three years, except for a leasehold improvement, which shall be amortized against net income over the shorter of its estimated useful life or the remaining life of the original lease excluding renewal or option periods, using methods detailed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements.

In accordance with the reporting entity’s written capitalization policy, it shall expense amounts less than a predefined threshold of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements when purchased.

Conceptually, SSAP No. 73 admits health care delivery assets because, without these assets, the insurer could not provide the care. Because these entities are in the business of providing care to their members, it makes sense to admit such assets in the statutory financial statements.
1. Joe HMO has $90,000 in operating room equipment that qualifies as a health care delivery asset. For book purposes, the asset is depreciated over three years in accordance with SSAP No. 73. For tax purposes, the asset is depreciated over five years. Is the difference in the depreciation term considered a deferred tax asset or a deferred tax liability?

This type of instance is considered a temporary difference that results initially as a deferred tax asset. A temporary difference occurs when there is a difference between the tax basis of an asset or liability and its book amount that will result in taxable or deductible amounts in future years. In our example (for financial reporting purposes), Joe HMO has taken $30,000 of depreciation expense. For tax purposes, Joe HMO has taken $18,000 of depreciation expense. Therefore, for income tax purposes, a higher amount is being paid in taxes for the first year. In year four, the effect will reverse and the deferred tax asset will dwindle to zero at the end of year five. Conversely, a deferred tax liability is generated when an item is taken as a deduction on the tax return before the deduction is allowed for financial reporting purposes; or, an item of income is included for financial reporting before it is included as income on the tax return.

2. Explain the conceptual basis behind admitted equipment in SSAP No. 73 vs. the accounting treatment required by life and property/casualty entities.

SSAP No. 73 assets are used to directly fulfill policyholder obligations and, without these assets, the care could not be provided.
SSAP No. 84—Certain Health Care Receivables and Receivables Under Government Insured Plans

Pharmaceutical rebates are arrangements between pharmaceutical companies and reporting entities in which the reporting entities receive rebates based on the drug utilization of its subscribers at participating pharmacies. The reporting entity sometimes records these rebates as receivables using estimates based on historical trends, which should be adjusted to reflect significant variables involved in the calculation (e.g., number of prescriptions written/filled, type of drugs prescribed, use of generic vs. brand-name drugs, etc). In other cases, the reporting entity determines the amount of the rebate due based on the actual use of various prescription drugs during the accumulation period and then bills the pharmaceutical company.

Claim overpayments may occur because of several events, including (but not limited to) claim payments made in error to a provider. Reporting entities often establish receivables for claim overpayments.

A reporting entity may make loans or advances to large hospitals or other providers. Such loans or advances are supported by legally enforceable contracts and are generally at the request of the provider.

A capitation arrangement is a compensation plan used in connection with some managed care contracts in which a physician or other medical provider is paid a flat amount, usually on a monthly basis, for each subscriber who has elected to use that physician or medical provider. In some instances, the insurer makes advances to a provider under a capitation arrangement in anticipation of future services.

Risk sharing arrangements are contracts between reporting entities and providers with a risk sharing element based on utilization. The insurer typically estimates monthly and settles annually compensation payments for risk sharing agreements. These agreements can result in receivables due from the providers if annual utilization is different than that used in estimating the monthly compensation.

Pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers, capitation arrangement receivables, risk sharing receivables, and amounts receivable under government-insured plans meet the definition of assets as set forth in SSAP No. 4, and are admitted assets to the extent that the requirements for admission defined in this statement are met.
Pharmaceutical Rebate Receivables

Pharmaceutical rebate receivables consist of reasonably estimated amounts and billed amounts. Both the billed amount and the estimated amount shall be admitted assets subject to the conditions specified below.

(a) Estimated amounts shall be related solely to actual prescriptions filled during the three months immediately preceding the reporting date.

(b) Billed amounts represent pharmaceutical rebate receivables that have been invoiced or confirmed in writing but not collected as of the reporting date. Billed amounts for an estimated amount under paragraph (a) above shall be admitted only if the determination of the rebate, based on actual prescriptions filled, occurs and is invoiced or confirmed in writing within the two months following the reporting date of the estimated amount. Adjustments to previously billed amounts related to prior periods shall be nonadmitted until invoiced or confirmed in writing. Pharmaceutical rebates that have not been collected within 90 days of the invoice date or confirmation date shall be nonadmitted. Furthermore, if accrued pharmaceutical rebate receivables are not invoiced or confirmed in writing in accordance with the contract provisions, the accrual shall be nonadmitted.

(c) Evaluation of the collectibility of pharmaceutical rebate receivables shall be made periodically. If, in accordance with SSAP No. 5R, it is probable that the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

The method used to reasonably estimate the receivable shall be consistent from period to period and the insurer shall adjust the receivable periodically for any changes in the underlying pharmaceutical rebate contract provisions. The financial statements shall disclose information regarding the reporting entity’s pharmaceutical rebates in accordance with this statement.

Income from pharmaceutical rebates of insured plans shall be reported as a reduction to claims expense on the Summary of Operations.

The reporting entity shall record receivable and payable balances related to uncollected pharmaceutical rebates of uninsured plans on the financial statements. Any pharmaceutical rebates earned by the reporting entity that are in excess of the amounts to be remitted to the uninsured plan pursuant to an administrative services agreement shall be determined consistent with the requirements of this statement and shall be reported on the balance sheet as an amount receivable relating to uninsured accident and health plans, and as a reduction to general expenses on the Statement of Operations.
Claim Overpayment Receivables

A claim overpayment shall not be recorded as a receivable until invoiced. To the extent that the claim overpayment meets the setoff conditions in SSAP No. 64 and the overpayment is a specific identifiable payment and not an estimate, the reporting entity may admit the receivable up to the amount of the payable to the provider for reported claims; i.e., excluding incurred but not reported (IBNR) claims. The reporting entity shall report the receivable and payable gross (rather than net) on the balance sheet. The insurer shall evaluate the collectibility of claim overpayment receivables periodically. If, in accordance with SSAP No. 5R, it is probable that the balance is uncollectible, the reporting entity shall write off any uncollectible receivable and charge this to income in the period that the entity makes the determination. Amounts in excess of that written off that do not meet the right of offset conditions shall be nonadmitted, as they are not available to satisfy policyholder obligations.

Loans and Advances to Providers

Loans or advances to providers who meet the definition of related parties in SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties shall follow the guidance in SSAP No. 25. To the extent that a loan or advance to a non-related party provider meets the setoff conditions in SSAP No. 64, the loan or advance may be admitted up to the amount of the payable to the provider for reported claims (i.e., excluding IBNR claims).

In addition, the reporting entity shall admit a loan or advance to a non-related party hospital up to the amount of claims incurred and payable to the hospital if all of the following conditions are met.

(a) The loan or advance meets the setoff conditions in SSAP No. 64;
(b) The loan or advance is supported by a legally enforceable contract;
(c) The loan or advance is administered pursuant to contractual terms;
(d) The contractual terms of the agreement provide for separate quarterly reconciliations;
(e) Each quarterly reconciliation shall be completed within nine months of the end of such quarter; and
(f) A quarterly reconciled difference shall be settled within 90 days of the date the reconciliation is completed.

If a quarterly reconciliation is not performed or settled in accordance with subparagraphs (e) and (f) above, all assets for loans or advances to that hospital shall be nonadmitted.

The insurer shall report the receivable and payable gross (rather than net) on the balance sheet. The reporting entity shall periodically evaluate the collectibility of loans and
advances to providers. If, in accordance with SSAP No. 5R, it is probable that the balance is uncollectible, the reporting entity shall write off any uncollectible receivable and charge this to income in the period that the entity makes this determination. Amounts in excess of that written off that do not meet the right of offset conditions shall be nonadmitted, as they are not available to satisfy policyholder obligations.

**Capitation Arrangement Receivables**

Advances to providers under capitation arrangements that are made under the terms of an approved provider services contract in anticipation of future services shall be admitted to the extent that the advanced amount does not exceed one month of average capitation payments for the subject provider during the preceding 12 months, and provided that the contract cannot be terminated before the end of the month for which the advanced amount was paid. The reporting entity shall periodically evaluate the collectibility of capitation arrangement receivables. If, in accordance with SSAP No. 5R, it is probable that the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

**Risk Sharing Receivables**

Risk sharing receivables may consist of reasonably estimated amounts and billed amounts. Both the billed amount and the estimated amount shall be admitted assets subject to the conditions specified below.

(a) Risk sharing receivables and payables shall only be recorded when reasonably estimated. Estimates of risk sharing receivables may be admitted if they are based on at least six months of actual claims experience for each risk sharing contract. The contractual terms of any risk sharing agreement shall provide for evaluation of the experience under the contract at least annually. The determination of the risk sharing balance shall commence no later than six months following the close of such annual period, and the balance shall be invoiced no later than eight months following close of the annual period;

(b) Billed amounts represent risk sharing receivables that have been invoiced but not collected as of the reporting date. Risk sharing receivables and payables shall be invoiced or refunded in accordance with the contractual provisions of the risk sharing agreement. Adjustments resulting in increases to previously billed amounts related to prior periods shall be nonadmitted until invoiced. Adjustments resulting in decreases to previously billed amounts shall be recognized immediately. Risk sharing receivables that have not been collected within 90 days of the date of billing shall be nonadmitted;

(c) Risk sharing receivables and payables shall be reported gross (rather than net) on the balance sheet. However, if a reporting entity has both a
receivable and payable balance with the same provider and the balances meet the setoff conditions in SSAP No. 64, those balances shall be netted in accordance with SSAP No. 64; and

(d) Evaluation of the collectibility of risk sharing receivables shall be made quarterly. If, in accordance with SSAP No. 5R, it is probable that the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

The method used to reasonably estimate the receivable shall be consistent from period to period and the reporting entity shall periodically adjust for any changes in the underlying risk sharing contract. The financial statements shall disclose information regarding the reporting entity’s risk sharing receivables in accordance with SSAP No. 84. Income/expense from risk sharing contracts shall be reported as a component of claims expense on the Summary of Operations.

**Amounts Receivable Under Government Insured Plans**

Amounts receivable under government insured plans, including amounts more than 90 days due, that qualify as accident and health contracts in accordance with SSAP No. 50 shall be admitted assets. Amounts receivable under government insured plans include (but are not limited to) receivables under Medicare, Medicaid and similarly funded government insured plans. The reporting entity shall periodically evaluate the collectibility of amounts receivable under government insured plans. If, in accordance with SSAP No. 5R, it is probable that the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.
Quick Check

3. XYZ HMO has the following premium receivable accounts on their books. Using the information below, what is the total amount of nonadmitted premium receivables?

<table>
<thead>
<tr>
<th></th>
<th>1–30 Days</th>
<th>31–60 Days</th>
<th>61–90 Days</th>
<th>&lt; 90 Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>KS Medicaid</td>
<td>258,452</td>
<td>50,678</td>
<td>12,587</td>
<td>10,589</td>
</tr>
<tr>
<td>123 Corp.</td>
<td>50,335</td>
<td></td>
<td>2,378</td>
<td></td>
</tr>
<tr>
<td>890 Inc.</td>
<td>125,000</td>
<td>12,580</td>
<td>9,358</td>
<td>55,234</td>
</tr>
<tr>
<td>$%^ Company</td>
<td>25,126</td>
<td>7,584</td>
<td>2,456</td>
<td>978</td>
</tr>
<tr>
<td>!!! Ltd.</td>
<td>35,123</td>
<td>4,859</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

There could be several different answers. The most obvious is to nonadmit the < 90 days due amount of $66,801. However, that could be questioned because of the amounts receivable from 890 Inc., KS Medicaid and $%^ Company. The receivable due from KS Medicaid could qualify as a government insured plan and, therefore, the amount more than 90 days past due would not be required to be nonadmitted if deemed collectible.

Another question here would be whether the amounts more than 90 days past due from 890 Inc. and $%^ Company represent de minimus amounts of the total amount due from installment receivables for group accident and health contracts. If the reporting entity decides this is not a de minimus amount, then the entire amount of each company’s installment receivables becomes nonadmitted. That would result in a nonadmitted amount of $238,316 (assuming KS Medicaid is admitted).

Disclosures

The financial statements shall disclose the method used by the reporting entity to estimate pharmaceutical rebate receivables. Furthermore, for the most recent three years and for each quarter therein, the reporting entity shall also disclose the following.

(a) Estimated balance of pharmacy rebate receivables as reported on the financial statements;

(b) Pharmacy rebates as invoiced or confirmed in writing; and

(c) Pharmacy rebates collected.
The financial statements shall also disclose the method used by the reporting entity to estimate its risk sharing receivables. If the reporting entity nets any receivable and payable balances with the same provider, it shall disclose the gross receivable and payable balances in the notes to the financial statements. Furthermore, for the most recent three years, the reporting entity shall also disclose the following.

(a) Risk sharing receivables as estimated and reported on the prior-year financial statements for annual periods ending in the current year;

(b) Risk sharing receivables as estimated and reported on the financial statements for annual periods ending in the current year and the following year;

(c) Risk sharing receivables invoiced as determined after the annual period;

(d) Risk sharing receivables not yet invoiced; and

(e) Amounts collected from providers as payments under risk sharing contracts.

**EXHIBIT A – ILLUSTRATION OF PHARMACEUTICAL REBATE RECEIVABLES**

(000 omitted)

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Estimated Pharmacy Rebates as Reported on Financial Statements</th>
<th>Pharmacy Rebates as invoiced/confirmed</th>
<th>Actual Rebates Collected Within 90 Days of Invoicing/Confirmation</th>
<th>Actual Rebates Collected Within 91 to 180 Days of Invoicing/Confirmation</th>
<th>Actual Rebates Collected More Than 180 Days After Invoicing/Confirmation</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X3</td>
<td>$150</td>
<td>$147</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9/30/20X3</td>
<td>130</td>
<td>133</td>
<td>$62</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6/30/20X3</td>
<td>142</td>
<td>143</td>
<td>70</td>
<td>$55</td>
<td></td>
</tr>
<tr>
<td>3/30/20X3</td>
<td>157</td>
<td>152</td>
<td>65</td>
<td>42</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>125</td>
<td>132</td>
<td>70</td>
<td>27</td>
<td>20</td>
</tr>
<tr>
<td>9/30/20X2</td>
<td>123</td>
<td>129</td>
<td>62</td>
<td>31</td>
<td>14</td>
</tr>
<tr>
<td>6/30/20X2</td>
<td>112</td>
<td>120</td>
<td>54</td>
<td>20</td>
<td>16</td>
</tr>
<tr>
<td>3/31/20X2</td>
<td>110</td>
<td>118</td>
<td>57</td>
<td>39</td>
<td>20</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>68</td>
<td>75</td>
<td>34</td>
<td>20</td>
<td>10</td>
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<tr>
<td>9/30/20X1</td>
<td>60</td>
<td>59</td>
<td>27</td>
<td>17</td>
<td>10</td>
</tr>
<tr>
<td>6/30/20X1</td>
<td>57</td>
<td>60</td>
<td>31</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>3/31/20X1</td>
<td>45</td>
<td>50</td>
<td>25</td>
<td>18</td>
<td>7</td>
</tr>
</tbody>
</table>
If there were only one contract, or if all contracts have the same experience period, then there would only be an entry in either the “Invoiced” or “Not Invoiced” column for the current year. This example assumes varying dates on experience periods for multiple contracts. Assumptions: Two risk sharing contracts are in place, one with an experience period that ends March 31, 20X3, and one with an experience period that ends October 31, 20X3.

The $155,000 receivable for the contract period that ends March 31, 20X3, would be invoiced no later than November 30, 20X3 (or eight months following close of the contract period) and could be collected no later than February 28, 20X4. Therefore, the $155,000 would appear in the “Invoiced” column in 20X3, but not be shown as collected in 20X3. Further, the $189,000 estimate for the experience period that ends March 31, 20X4, could be recorded on the December 31, 20X3, financial statement because there is more than six months of experience under the contract.

The contract with the experience period that ends October 31, 20X3 (with an estimated $77,000 receivable) would be invoiced by June 30, 20X4, and collected by September 30, 20X4. Therefore, it would appear in the “Not Invoiced” column and not be shown as collected in 20X3. However, no estimate could be reported on the December 31, 20X3, financial statement for the experience period that ends October 31, 20X4, because there is less than six months of experience under the contract.

---

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Evaluation Period Year Ending</th>
<th>Risk Sharing Receivable as Estimated and Reported in the Prior Year</th>
<th>Risk Sharing Receivable as Estimated and Reported in the Current Year</th>
<th>Risk Sharing Receivable Invoiced</th>
<th>Risk Sharing Receivable Not Invoiced</th>
<th>Actual Risk Sharing Amounts Collected in Year Invoiced</th>
<th>Actual Risk Sharing Amounts Collected First Year Subsequent</th>
<th>Actual Risk Sharing Amounts Collected Second Year Subsequent</th>
<th>Actual Risk Sharing Amounts Collected (All Other)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X3</td>
<td>20X3</td>
<td>$245</td>
<td>$232</td>
<td>$155</td>
<td>$77</td>
<td>$0</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>20X4</td>
<td>XXX</td>
<td>$189</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>20X2</td>
<td>20X2</td>
<td>$223</td>
<td>$225</td>
<td>$203</td>
<td>$22</td>
<td>$0</td>
<td>$200</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>20X3</td>
<td>XXX</td>
<td>$245</td>
<td>XXX</td>
<td>$245</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>20X1</td>
<td>20X1</td>
<td>$190</td>
<td>$178</td>
<td>$174</td>
<td>$4</td>
<td>$0</td>
<td>$170</td>
<td>$5</td>
<td>XXX</td>
</tr>
<tr>
<td>20X2</td>
<td>XXX</td>
<td>$223</td>
<td>XXX</td>
<td>$223</td>
<td>$XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
</tbody>
</table>
EXHIBIT C – IMPLEMENTATION GUIDE

The purpose of this guide is to assist regulators and reporting entities in the practical application of SSAP No. 84.

Pharmaceutical Rebate Receivables

1. What is a reasonable method of determining receivables for estimated amounts?

   Answer: At any one reporting date, a reporting entity’s receivable for pharmaceutical rebates can consist of two distinct amounts: (1) an estimated amount; and (2) a billed amount (that can include adjustments to previously billed amounts). The estimated amount represents the reporting entity’s best estimate of the rebates it expects to receive for those prescription drugs filled during the most recent quarter; i.e., at December 31, 20X1, the estimate would relate to those prescriptions filled during the fourth quarter of 20X1. Estimated rebate amounts for prescription drugs filled in any other quarter must be nonadmitted.

   When determining its estimate, the reporting entity should use the most accurate methods possible that utilize historical information relative to pharmaceutical rebates received. The reporting entity should use methods that consider contractual changes in rebate amounts, seasonality differences, changes in membership or premium revenue, changes in utilization of drugs with varying rebate levels, etc.

2. SSAP No. 84, paragraph 10.b, states: “Billed amounts for an estimated amount under paragraph 10a. above shall be admitted only if the determination of the rebate, based on actual prescriptions filled, occurs and is invoiced or confirmed in writing within the two months following the reporting date of the estimated amount.” What is meant by the phrase “within two months following the reporting date of the estimated amount?” Why does the SSAP make a distinction between those rebates that are invoiced and those that are confirmed in writing?

   Answer: This sentence is worded in this fashion in order to show the relationship between an estimated amount and the related billed amount. At any reporting date, a billed amount will qualify as an admitted asset only if it was invoiced or confirmed in writing within the two months following the most previously filed financial statement, or the financial statement in which the related estimate was reported. For example, using the example in Q&A #1 above, the reporting entity could admit billed amounts for rebates attributable to prescription drugs filled in third quarter of 20X1, only if the rebates were invoiced or confirmed in writing no later than November 30, 20X1. Further, the billed amount must be collected by February 28, 20X2, or it will become a nonadmitted asset.
Secondly, reporting entities typically administer their pharmaceutical benefit programs in one of two fashions, either directly or through a pharmaceutical benefit manager (PBM). SSAP No. 84 makes a distinction for these two instances. Entities that contract directly with the pharmaceutical company will invoice the pharmaceutical company for its rebates. However, for those entities that use a PBM, the SSAP requires the entity to admit billed amounts for which the reporting entity receives reports from the PBM on a quarterly basis. The quarterly reports should provide detailed information as to the number of each prescription drug filled, the rebate for each individual drug, the total amount of rebates to be received, any rebates to be received that relate to prior periods, etc. The reporting entity must then accept or “confirm” the report, and then communicate formal acceptance of the report to the PBM. Only after this occurs is the amount considered confirmed as required by SSAP No. 84.

3. What is a reasonable method of confirming a report received from our PBM?

**Answer:** The reporting entity should perform whatever verification procedures it deems necessary to provide adequate assurance that the report is accurate. These procedures might include, but are not limited to, reviewing the information required from the PBM as discussed in item #2 above, verification of payments for prescription drug charges, trend testing, etc.

4. Rebates relating to uninsured plans have been included in the gross receivable for pharmaceutical rebates. However, much of the amount was nonadmitted because of the requirement to bill within two months was not met. Is it still necessary to record the payable to the uninsured plan, even though the liability is essentially a pass-through?

**Answer:** Yes. The liability must still be recorded, regardless of the fact that the related asset may be nonadmitted.

5. Should the disclosure in Exhibit A include rebates for both insured and uninsured business?

**Answer:** Yes. The disclosure to be included in the Notes to Financial Statements for pharmaceutical rebate receivables should include pharmaceutical rebates of insured and uninsured business. However, ultimately, the reporting entity must have the ability to separately identify rebates for insured and uninsured business, given the distinct difference in treatment on the Statement of Revenue and Expenses.

6. Should the disclosure include rebates invoiced or confirmed in writing that relate to prior periods?

**Answer:** Yes. The disclosure should include all rebates invoiced or confirmed in writing during the respective quarter, regardless of whether such rebates relate to the most recently invoiced quarter or any quarter preceding that.
Illustrative timeline of SSAP No. 84 requirements relative to pharmaceutical rebate receivables, assuming a financial statement date of December 31, 20X1:

<table>
<thead>
<tr>
<th>6/30/20X1</th>
<th>7/31/20X1</th>
<th>8/31/20X1</th>
<th>9/30/20X1</th>
<th>10/31/20X1</th>
<th>11/30/20X1*</th>
<th>12/31/20X1</th>
<th>1/31/20X2</th>
<th>2/28/20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Billed amounts may be admitted</td>
<td>Billing Period</td>
<td>Collection period for Billed amounts</td>
<td>Estimated amounts may be admitted</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Billed amounts are an admitted asset on the 12/31/20X1 financial statement if invoiced or confirmed in writing by 11/30/20X1.

Loans and Advances to Providers

7. Why was a distinction made between loans and advances to providers and loans and advances to hospitals?

**Answer:** This distinction was made to recognize the unique nature of certain arrangements between reporting entities and hospitals, whereby the participating hospitals are loaned and advanced amounts monthly or quarterly. Such arrangements oftentimes result in lower charges to the reporting entity and work to the benefit of the reporting entity.

8. With regard to the phrase “a loan or advance to a non-related party hospital shall be admitted up to the amount of claims incurred and payable to the hospital,” what does this mean? Does this require that the IBNR valuation be performed for each hospital in which funds are loaned or advanced?

**Answer:** In a situation in which amounts are loaned/advanced to a hospital, because the hospital provides services and reports such to the reporting entity, the costs of such services are applied against the outstanding loan. Also applied against the loan is the reporting entity’s estimate of the amount of services provided but not yet reported (i.e., IBNR). The remaining portion of the loan represents the receivable subject to the requirements of SSAP No. 84.

In determining the amount of claims incurred and payable to a particular hospital, the reporting entity should use the most accurate method available. In most instances, an IBNR calculation would be the most accurate method of determining this amount.
9. Please explain the reconciliation requirements in SSAP No. 84, paragraph 16.d. and 16.e., related to loans and advances to hospitals.

Answer: While loans and advances to hospitals are typically paid monthly, the SSAP requires that such balances be reconciled at least quarterly on a per-hospital basis. The SSAP further requires that each quarter’s account be reconciled within nine months of the end of that quarter; i.e., the reconciliation for the quarter ending March 31, 20X1, must be completed by December 31, 20X1.

Therefore, at December 31, 20X1, a reporting entity could have four quarters of loans and advances in its receivable: three quarters’ worth of unreconciled amounts and one quarter that has been reconciled but not settled.

10. If amounts are loaned or advanced to a hospital but the reconciliation requirements of SSAP No. 84, paragraph 16, are not met, must these amounts be nonadmitted?

Answer: Not necessarily. In this event, the guidance in paragraph 15 can be followed to determine admissibility, in that the loan or advance may be admitted up to the amount of the payable to the provider for reported claims.

Risk Sharing Receivables

11. SSAP No. 84 allows for the classification of certain estimates of risk sharing receivables as admitted assets. In what instances may estimates be admitted, and what is a reasonable method of determining receivables for estimated amounts?

Answer: At any reporting date, a reporting entity’s receivable for any one risk sharing arrangement can consist of two amounts: (1) an estimated amount; and (2) a billed amount (that can include adjustments to previously billed amounts). An estimate can be admitted only if at least six months have passed since the commencement of the annual experience period. The estimated amount represents the reporting entity’s best estimate of the receivable related to the contract period from inception to the reporting date.

When determining its estimate, the reporting entity should use the most accurate methods possible that utilize inception-to-date encounter data relative to outpatient surgery encounters, hospital days, etc. If the reporting entity cannot reasonably estimate its risk sharing receivables, then such amounts must be nonadmitted.
12. The SSAP requires that the determination of the risk share balance begin within six months from the end of the annual experience period, and further requires that the final amount must be invoiced no later than eight months following the close of such period. Must data accumulation stop with month six? Can the reporting entity utilize experience data from months seven and eight in its calculation?

**Answer:** The reporting entity should use as much experience data as possible within the eight-month invoicing requirement of SSAP No. 84, paragraph 20.a. This requirement was included to ensure that reporting entities are being proactive when determining risk share balances, but was in no way intended to limit the amount of experience data considered.

13. Describe a situation when a receivable and payable would exist with the same provider under a risk sharing arrangement.

**Answer:** This could happen: (1) if the risk share arrangement requires separate risk sharing for each line of business, for certain large groups, etc.; or (2) where two contract/evaluation periods under a risk sharing arrangement are involved.

14. The disclosure for risk sharing receivables seems confusing. Please explain what should be included in columns three through six that address estimated and billed/invoiced balances.

**Answer:** The third column from the left contains the heading “Risk Sharing Receivable as Estimated and Reported in the Prior Year.” This column should reflect the amount of risk sharing receivables as determined in the prior year and reported as admitted assets on the prior year’s financial statement. Therefore, there will never be information reported for the year subsequent to the year in question, as contracts with evaluation periods ending in the following year cannot have risk sharing receivables recorded in the previous year.

The fourth column, “Risk Sharing Receivable as Estimated and Reported in the Current Year,” should contain the admitted amounts of risk sharing receivables on the current year’s financial statement. These amounts should be segregated between those agreements with contract periods ending in the current year and those ending in the following year.

The fifth column from the left contains the heading “Risk Sharing Receivable Invoiced” and will contain the amount of risk sharing receivables invoiced during the designated year, regardless of whether such receivables are outstanding as of the financial statement date.

The sixth column, reflecting the heading “Risk Sharing Receivable Not Invoiced,” should contain the current year-end receivable balance for agreements that qualify for estimation under SSAP No. 84, paragraph 20.b. (i.e., the contract has been in effect for at least six months but no amounts have been invoiced). Note that a particular reporting entity might not have any estimated receivables, if that entity’s risk sharing contracts have not been in effect for at least six months.
Illustrative timeline of SSAP No. 84 requirements relative to risk sharing receivables, assuming the reporting entity has one risk sharing agreement in place with an effective date of January 1, 20X1:

**SSAP No. 85—Claim Adjustment Expenses, Amendments to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses**

This statement supersedes two paragraphs in SSAP No. 55, and insurers shall follow this guidance when accounting for claim adjustment expenses of accident and health contracts and managed care contracts.

Claim adjustment expenses for accident and health reporting entities are those costs that an insurer expects to incur in connection with the adjustment and recording of accident and health claims defined in SSAP No. 55. Claim adjustment expenses for managed care reporting entities are those costs the managed care entity expects to incur in connection with the adjustment and recording of managed care claims defined in SSAP No. 55. Certain claim adjustment expenses reduce the number or cost of health services, thereby resulting in lower premiums or lower premium increases. The reporting entity shall classify these claim adjustment expenses as cost containment expenses.

Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses as follows:

*Cost containment expenses:* Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered “cost containment expenses” only if they result in reduced levels of costs or services:

1. Case management activities.
2. Utilization review.
iii. Detection and prevention of payment for fraudulent requests for reimbursement.

iv. Network access fees to preferred provider organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting.

v. Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (including smoking cessation and disease-management programs, and other programs that involve hands-on medical education).

vi. Expenses for internal and external appeals processes.

Other claim adjustment expenses: Claim adjustment expenses as defined above, excluding those that are not defined as cost containment expenses. Examples of other claim adjustment expenses are:

i. Estimating the amounts of losses and disbursing loss payments.

ii. Maintaining records, general clerical and secretarial.

iii. Office maintenance, occupancy costs, utilities and computer maintenance.

iv. Supervisory and executive duties.

v. Supplies and postage.
Section 11 – Review Questions

Please read Section 11 and answer the following multiple-choice questions. Answers must be entered into the “Test Answer Form” in order to obtain credit. See instructions in the Program Overview for purposes of obtaining credit.

HINT: There might be review questions from previous sections.

83. Supplies, except for pharmaceuticals and surgical supplies used directly in the treatment of medical conditions, shall be nonadmitted assets.
   a. True
   b. False

84. Furniture, medical equipment and fixtures shall be depreciated over their estimated useful lives, but for a period not to exceed:
   a. Two years
   b. Three years
   c. Four years
   d. Five years

85. What type of arrangement is defined as a compensation plan used in connection with some managed care contracts in which a physician or other medical provider is paid a flat amount for each subscriber who has elected to use that physician or medical provider?
   a. Reinsurance
   b. Subscription
   c. Capitation
   d. None of the above

86. Pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers, capitation arrangement receivables, risk sharing receivables and amounts receivable under government insured plans meet the definition of assets as set forth in SSAP No. 4.
   a. True
   b. False

87. Estimated amounts of pharmaceutical rebate receivables shall be related solely to actual prescriptions filled during the _____ months immediately preceding the reporting date:
   a. Twelve
   b. Nine
   c. Six
   d. Three
88. Income from pharmaceutical rebates of insured plans shall be reported as a reduction to claims expense on which of the following statements:
   a. Balance Sheet
   b. Cash Flow
   c. Summary of Operations
   d. None of the above

89. A claim overpayment may be recorded as a receivable either before or after it has been invoiced.
   a. True
   b. False

90. A loan or advance to a non-related party hospital shall be admitted up to the amount of claims incurred and payable to the hospital if which of the following conditions are met:
   a. The loan or advance meets the setoff conditions in SSAP No. 84
   b. The contractual terms of the agreement provide for separate monthly reconciliations
   c. Each quarterly reconciliation shall be completed within 12 months of the end of such quarter
   d. A quarterly reconciled difference shall be settled within 90 days of the date the reconciliation is completed

91. Which of the following is not an example of cost containment expenses (i.e., expenses that actually serve to reduce the number of health services provided or the cost of such services)?
   a. Case management activities
   b. Network access fees to preferred provider organizations and other network-based health plans
   c. Expenses for internal and external appeals processes
   d. None of the above

92. Which of the following is not an example of other claim adjustment expenses (i.e., claim adjustment expenses as defined above that are not cost containment expenses)?
   a. Depreciation
   b. Maintaining records, general clerical and secretarial
   c. Office maintenance, occupancy costs, utilities and computer maintenance
   d. None of the above
Introduction

This case study is designed to provide a hands-on approach enabling participants to:


(2) Understand the organization of the NAIC Statements of Statutory Accounting Principles (SSAPs) and related guidance.

(3) How to perform research using these items.

Certain parts of the case study are applicable to all types of reporting entities, whereas some sections or questions are specific to certain types of entities. For the purposes of this case study, we will assume the general sections pertain to the ABC Company. Each part of the case study provides additional background facts on the ABC Company for use in completing the case study problems.

Instructions

Carefully read the Background Facts for each part of the case study. Then, based on the Background Facts presented, complete the case study problems.
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Section 5 – Premium and Reserves

Part A
Background Facts – Life

1. The following information is available regarding the company’s net reserves:

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>Policy Reserves 12/31/X0</th>
<th>Policy Reserves 12/31/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Deferred Life Annuity</td>
<td>7,000,000</td>
<td>12,000,000</td>
</tr>
<tr>
<td>Group Annuity Certain</td>
<td>9,000,000</td>
<td>18,150,000</td>
</tr>
<tr>
<td>Whole Life</td>
<td>23,000,000</td>
<td>30,000,000</td>
</tr>
<tr>
<td>Term Life</td>
<td>10,000,000</td>
<td>9,000,000</td>
</tr>
<tr>
<td>Universal Life</td>
<td>30,000,000</td>
<td>35,000,000</td>
</tr>
<tr>
<td>A&amp;H</td>
<td>1,000,000</td>
<td>850,000</td>
</tr>
<tr>
<td>Total</td>
<td>80,000,000</td>
<td>105,000,000</td>
</tr>
</tbody>
</table>

2. The company determined that the following premiums were earned during the year ended December 31, 20X1:

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>Premiums Earned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ind Def Life Annuity</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Group Annuity Certain</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Whole Life</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Term Life</td>
<td>35,000,000</td>
</tr>
<tr>
<td>Universal Life</td>
<td>13,000,000</td>
</tr>
<tr>
<td>A&amp;H</td>
<td>16,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>90,000,000</td>
</tr>
</tbody>
</table>

3. For the year ended December 31, 20X1, the company incurred the following in benefits net of reinsurance:

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>Benefits Incurred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ind Def Life Annuity</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Group Annuity Certain</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Whole Life</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Term Life</td>
<td>23,375,000</td>
</tr>
<tr>
<td>Universal Life</td>
<td>5,625,000</td>
</tr>
<tr>
<td>A&amp;H</td>
<td>15,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>51,000,000</td>
</tr>
</tbody>
</table>
4. On June 15, 20X1, ABC changed its method of recording whole life insurance reserves. The change in valuation basis was not recorded in the 20X0 financial statements, as the statements had already been issued. The change would have resulted in surplus being reduced by $1 million at the end of 20X0 had the change been recorded at that time. ABC is interested in grading the effect of the hit to surplus in over five years, but is currently not allowed by its state of domicile.

5. Policyholders were credited with interest of $400,000, $500,000 and $1.8 million on their deferred life annuity, annuity certain and universal life insurance accounts, respectively, for the year ended December 31, 20X1. ABC also paid surrenders (net of surrender charges) of $300,000, $500,000 and $4 million, respectively, on the same accounts for the year. Additionally, the company paid surrenders of $6 million on whole life accounts during the year.
Part A – Life Case Study Problems

Problem 1
Using the information provided in the Background Facts, complete the following schedule for use in preparing the ordinary life column of ABC’s Analysis of Operations by Lines of Business page. (Hint: Refer to SSAP No. 51—Life Contracts in determining the change in reserves.)

<table>
<thead>
<tr>
<th>Description</th>
<th>Life Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium and Annuity Considerations</td>
<td></td>
</tr>
<tr>
<td>Death Benefits</td>
<td></td>
</tr>
<tr>
<td>A&amp;H Benefits</td>
<td></td>
</tr>
<tr>
<td>Annuity Benefits</td>
<td></td>
</tr>
<tr>
<td>Surrender Benefits</td>
<td></td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td></td>
</tr>
</tbody>
</table>

Problem 2
Using the information provided in the Background Facts, complete the following schedule for use in preparing the individual annuity column of ABC’s Analysis of Operations by Lines of Business page. (Hint: Refer to SSAP No. 52—Deposit-Type Contracts to determine if the item should be recorded as a deposit-type contract.)

<table>
<thead>
<tr>
<th>Description</th>
<th>Individual Annuities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium and Annuity Considerations</td>
<td></td>
</tr>
<tr>
<td>Death Benefits</td>
<td></td>
</tr>
<tr>
<td>A&amp;H Benefits</td>
<td></td>
</tr>
<tr>
<td>Annuity Benefits</td>
<td></td>
</tr>
<tr>
<td>Surrender Benefits</td>
<td></td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td></td>
</tr>
</tbody>
</table>
Life Case Study Problems (Continued)

Problem 3
Using the information provided in the Background Facts, complete the following schedule for use in preparing the group annuity column of ABC’s Analysis of Operations by Lines of Business page. (Hint: Refer to SSAP No. 52—Deposit-Type Contracts to determine how the amounts given in the problem should be recorded.)

<table>
<thead>
<tr>
<th>Description</th>
<th>Group Annuities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium and Annuity Considerations</td>
<td></td>
</tr>
<tr>
<td>Death Benefits</td>
<td></td>
</tr>
<tr>
<td>A&amp;H Benefits</td>
<td></td>
</tr>
<tr>
<td>Annuity Benefits</td>
<td></td>
</tr>
<tr>
<td>Surrender Benefits</td>
<td></td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td></td>
</tr>
</tbody>
</table>

Problem 4
Using the information provided in the Background Facts, complete the following schedule for use in preparing the Group A&H column of ABC’s Analysis of Operations by Lines of Business page. (No Hints!)

<table>
<thead>
<tr>
<th>Description</th>
<th>Group A&amp;H</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium and Annuity Considerations</td>
<td></td>
</tr>
<tr>
<td>Death Benefits</td>
<td></td>
</tr>
<tr>
<td>A&amp;H Benefits</td>
<td></td>
</tr>
<tr>
<td>Annuity Benefits</td>
<td></td>
</tr>
<tr>
<td>Surrender Benefits</td>
<td></td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td></td>
</tr>
</tbody>
</table>

* * * * *
Part A – Life Case Study Answers

Problem 1
Using the information provided in the Background Facts, complete the following schedule for use in preparing the ordinary life column of ABC’s Analysis of Operations by Lines of Business page. (Hint: Refer to SSAP No. 51—Life Contracts in determining the change in reserves.)

<table>
<thead>
<tr>
<th>Description</th>
<th>Life Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium and Annuity</td>
<td></td>
</tr>
<tr>
<td>Considerations</td>
<td>$ 56,000,000</td>
</tr>
<tr>
<td>Death Benefits</td>
<td>34,000,000</td>
</tr>
<tr>
<td>A&amp;H Benefits</td>
<td>-</td>
</tr>
<tr>
<td>Annuity Benefits</td>
<td>-</td>
</tr>
<tr>
<td>Surrender Benefits</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td>10,000,000</td>
</tr>
</tbody>
</table>

Step 1: The premium to be recorded as revenue can be obtained by simply adding the various amounts given in Fact #2 as follows:

\[
\text{Life Insurance:} \\
\begin{align*}
\text{Whole Life} & \quad $8,000,000 \quad \text{Given in Fact #2} \\
\text{Term Life} & \quad 35,000,000 \quad \text{Given in Fact #2} \\
\text{Universal Life} & \quad 13,000,000 \quad \text{Given in Fact #2} \\
\text{Total} & \quad \$56,000,000
\end{align*}
\]

Step 2: The balance of death benefits to be recorded as expense can be obtained by simply adding the various amounts given in Fact #3 as follows:

\[
\text{Life Insurance:} \\
\begin{align*}
\text{Whole Life} & \quad $5,000,000 \quad \text{Given in Fact #3} \\
\text{Term Life} & \quad 23,375,000 \quad \text{Given in Fact #3} \\
\text{Universal Life} & \quad 5,625,000 \quad \text{Given in Fact #3} \\
\text{Total} & \quad \$34,000,000
\end{align*}
\]

Step 3: The balance of surrender benefits to be recorded as expense can be obtained by simply adding the applicable amounts given in Fact #5 as follows:

\[
\text{Life Insurance:} \\
\begin{align*}
\text{Universal Life} & \quad $4,000,000 \quad \text{Given in Fact #5} \\
\text{Whole Life} & \quad 6,000,000 \quad \text{Given in Fact #5} \\
\text{Total} & \quad \$10,000,000
\end{align*}
\]
**Life Case Study Answers (Continued)**

**Step 4:** The increase in reserves to be recorded as expense can be obtained by comparing the information given in Fact #1. The information given in Fact #4 should also be used. The computation is summarized below:

<table>
<thead>
<tr>
<th>Life Insurance</th>
<th>Whole Life</th>
<th>Term Life</th>
<th>Universal Life</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve Calculation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/X1 Reserve Balance</td>
<td>$ 30,000,000</td>
<td>$ 9,000,000</td>
<td>$35,000,000</td>
<td>$ 74,000,000</td>
</tr>
<tr>
<td>12/31/X0 Reserve Balance</td>
<td>23,000,000</td>
<td>10,000,000</td>
<td>30,000,000</td>
<td>63,000,000</td>
</tr>
<tr>
<td>Change in Valuation Basis</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td>$ 6,000,000</td>
<td>$(1,000,000)</td>
<td>$ 5,000,000</td>
<td>$10,000,000</td>
</tr>
</tbody>
</table>

**Note:** The change in valuation basis represents an increase in the reserves that should be recorded immediately to surplus. SSAP No. 51—Life Contracts states that a change in valuation basis shall be defined as a change in the interest rate assumption or other factor affecting the reserve computation of policies in-force and meets the definition of an accounting change as defined in SSAP No. 3—Accounting Changes and Corrections of Errors. Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus, rather than as a part of the reserve change recognized in the summary of operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. The following journal entry would be recorded for this change in valuation basis.

**Journal Entry**
June 15, 20X1 Change in Valuation Basis (Surplus) 1,000,000
Life Reserves 1,000,000

*Entry to record reserve strengthening as a change in valuation basis.*
Life Case Study Answers (Continued)

Problem 2
Using the information provided in the Background Facts, complete the following schedule for use in preparing the individual annuity column of ABC’s Analysis of Operations by Lines of Business page. (Hint: Refer to SSAP No. 52—Deposit-Type Contracts to determine if the item should be recorded as a deposit-type contract.)

<table>
<thead>
<tr>
<th>Description</th>
<th>Individual Annuities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium and Annuity Considerations</td>
<td>$8,000,000 Given in Fact #2</td>
</tr>
<tr>
<td>Death Benefits</td>
<td>N/A</td>
</tr>
<tr>
<td>A&amp;H Benefits</td>
<td>N/A</td>
</tr>
<tr>
<td>Annuity Benefits</td>
<td>1,000,000 Given in Fact #3</td>
</tr>
<tr>
<td>Surrender Benefits</td>
<td>300,000 Given in Fact #5</td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td>5,000,000 See Below</td>
</tr>
</tbody>
</table>

Note: Because the individual annuities contain mortality risk, the individual annuities should not be accounted for as deposit-type contracts under the provisions of SSAP No. 52. In accordance with SSAP No. 51, the contracts shall be accounted for as insurance in the summary of operations and reported consistent with current requirements.

Steps 1, 2 and 3: The balance of the annuity items to be recorded as revenue, benefits expense and surrenders can be obtained by simply accumulating the amounts from the information given in Fact #2, Fact #3 and Fact #5.

Step 4: The increase in reserves to be recorded as expense can be obtained by comparing the information given in Fact #1 as follows:

<table>
<thead>
<tr>
<th>Individual Annuity Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X1 Reserve Balance</td>
</tr>
<tr>
<td>12/31/X0 Reserve Balance</td>
</tr>
<tr>
<td>Change in Valuation Basis</td>
</tr>
<tr>
<td>Increase in Reserves</td>
</tr>
</tbody>
</table>

* * * * *
Problem 3
Using the information provided in the Background Facts, complete the following schedule for use in preparing the group annuity column of ABC’s Analysis of Operations by Lines of Business page. (Hint: Refer to SSAP No. 52—Deposit-Type Contracts to determine how the amounts given in the problem should be recorded.)

<table>
<thead>
<tr>
<th>Description</th>
<th>Group Annuities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium and Annuity</td>
<td>N/A Per SSAP No. 52</td>
</tr>
<tr>
<td>Considerations</td>
<td></td>
</tr>
<tr>
<td>Death Benefits</td>
<td>N/A by Definition</td>
</tr>
<tr>
<td>A&amp;H Benefits</td>
<td>N/A</td>
</tr>
<tr>
<td>Annuity Benefits</td>
<td>N/A Per SSAP No. 52</td>
</tr>
<tr>
<td>Surrender Benefits</td>
<td>N/A Per SSAP No. 52</td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td>$ 650,000 See Below</td>
</tr>
</tbody>
</table>

Note: Because an annuity certain contains no mortality risk, the group annuities should be accounted for as deposit-type contracts under the provisions of SSAP No. 52. Accordingly, revenues, benefits and surrenders should be recorded directly to the policy reserve account.

Steps 1, 2 and 3: Based on the above, the balance of the annuity items to be recorded as revenue; benefits expense and surrenders should be zero. The following was noted with respect to this:

Revenue: The premiums incurred on annuity certain contracts are not recorded as premium revenue in the December 31, 20X1, annual statement under SAP, because they are classified as deposit-type contracts. Paragraph 6 of SSAP No. 52 requires that amounts received on deposit-type contracts be recorded directly to policy reserves and not recorded as income. Deposit-type contracts are not as a result of providing insurance and, therefore, are not considered revenue.

Journal Entry

| Receivable | 10,000,000 |
| Reserves – Group Annuity | 10,000,000 |

Entry to record premium incurred.
Life Case Study Answers (Continued)

**Benefits:** The benefits incurred on annuity certain contracts are not recorded as benefit expense in the December 31, 20X1, annual statement under SAP, because they are classified as deposit-type contracts. As stated above, SSAP No. 52 accounts for deposit-type contracts, or contracts that do not provide for mortality risk but act exclusively as investment vehicles by recording directly to the policy reserve. SSAP No. 52 requires benefit payments to be recorded as a decrease in the related policy’s reserve balance. This reflects that payments to policyholders that represent a return of the policyholder balances are not considered expenses.

*Journal Entry*

<table>
<thead>
<tr>
<th>Reserves</th>
<th>1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

*Entry to record payment to policyholder(s) representing a return on policyholder balance(s).*

**Surrender Benefits:** The surrenders incurred on annuity certain contracts are not recorded as expense in the December 31, 20X1, annual statement. As with benefit payments (discussed in Step 2 above), under SSAP No. 52, surrenders are recorded as a decrease to the related policy’s reserves, rather than as an expense under current statutory guidance. Because the amount of surrender should never exceed the related policy’s reserve, no surrender should be recorded in the summary of operations as a surrender expense. This also reflects that payments to policyholders that represent a return of the policyholder balances are not considered expenses.

*Journal Entry*

<table>
<thead>
<tr>
<th>Reserves – Group Annuity</th>
<th>500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>500,000</td>
</tr>
</tbody>
</table>

*Entry to record surrender payment to contract holder.*
**Change in Reserves:** For deposit-type contracts, this line does not merely represent the difference between the beginning and ending reserves, because certain items are recorded directly to the reserve account under SSAP No. 52. The following illustrates how the change in reserve would be calculated for ABC:

<table>
<thead>
<tr>
<th>Group</th>
<th>Annuity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve Calculation</td>
<td>$ 18,150,000 <strong>Given in Fact #1</strong></td>
</tr>
<tr>
<td>12/31/X1 Reserve Balance</td>
<td>$ 18,150,000 <strong>Given in Fact #1</strong></td>
</tr>
<tr>
<td>12/31/X0 Reserve Balance</td>
<td>$ 9,000,000 <strong>Given in Fact #1</strong></td>
</tr>
<tr>
<td>Change in Valuation Basis</td>
<td>$ -0- <strong>Calculated</strong></td>
</tr>
<tr>
<td>Increase in Reserves Calculated</td>
<td>$ 9,150,000 <strong>Calculated</strong></td>
</tr>
</tbody>
</table>

**Fund Value:**

<table>
<thead>
<tr>
<th>Event</th>
<th>Amount</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Balance</td>
<td>$ 9,000,000</td>
<td><strong>Given in Fact #1</strong></td>
</tr>
<tr>
<td>Annuity Considerations</td>
<td>$ 10,000,000</td>
<td><strong>Given in Fact #2</strong></td>
</tr>
<tr>
<td>Annuity Benefits</td>
<td>$ (1,000,000)</td>
<td><strong>Given in Fact #3</strong></td>
</tr>
<tr>
<td>Surrender Benefits</td>
<td>$ (500,000)</td>
<td><strong>Given in Fact #4</strong></td>
</tr>
<tr>
<td>Interest Credited</td>
<td>$ 500,000</td>
<td><strong>Given in Fact #5</strong></td>
</tr>
<tr>
<td>Increase in Surrender Value (Other)</td>
<td>$ 150,000</td>
<td><strong>Derived Adjustments</strong></td>
</tr>
<tr>
<td>Ending Balance</td>
<td>$ 18,150,000</td>
<td><strong>Calculated</strong></td>
</tr>
</tbody>
</table>

**Change in Reserve Represents:**

<table>
<thead>
<tr>
<th>Event</th>
<th>Amount</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Credited</td>
<td>$ 500,000</td>
<td><strong>Given in Fact #5</strong></td>
</tr>
<tr>
<td>Increase in Surrender Value (Other)</td>
<td>$ 150,000</td>
<td><strong>Derived Adjustments</strong></td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td>$ 650,000</td>
<td><strong>Calculated (P&amp;L)</strong></td>
</tr>
</tbody>
</table>

* * * * *
Problem 4

Using the information provided in the Background Facts, complete the following schedule for use in preparing the Group A&H column of ABC’s Analysis of Operations by Lines of Business page. (No Hints!)

<table>
<thead>
<tr>
<th>Description</th>
<th>Group A&amp;H</th>
<th>Given in Fact #2</th>
<th>See Below</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium and Annuity</td>
<td>$16,000,000</td>
<td>Given in Fact #2</td>
<td></td>
</tr>
<tr>
<td>Considerations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Death Benefits</td>
<td>-</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>A&amp;H Benefits</td>
<td>15,000,000</td>
<td>Given in Fact #3</td>
<td></td>
</tr>
<tr>
<td>Annuity Benefits</td>
<td>-</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Surrender Benefits</td>
<td>-</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Increase in Reserves</td>
<td>(150,000)</td>
<td>See Below</td>
<td></td>
</tr>
</tbody>
</table>

Note: SSAP No. 54—Individual and Group Accident and Health Contracts requires policy reserves and claim reserves for A&H contracts. Unearned premium reserves are generally included in the policy reserve.

Steps 1 and 2: The balance of the items to be recorded as revenue and A&H benefits can be obtained by simply accumulating the amounts from the information given in Fact #2 and Fact #3.

Step 4: The increase in reserves to be recorded as expense can be obtained by comparing the information given in Fact #1 as follows:

<table>
<thead>
<tr>
<th>Group A&amp;H</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve Calculation</td>
</tr>
<tr>
<td>12/31/X1 Reserve Balance</td>
</tr>
<tr>
<td>12/31/X0 Reserve Balance</td>
</tr>
<tr>
<td>Change in Valuation Basis</td>
</tr>
<tr>
<td>Increase in Reserves</td>
</tr>
</tbody>
</table>
6. The following information has been calculated by ABC’s internal actuaries and staff accountants regarding the company’s net reserves as of December 31, 20X1. Note that ABC’s actuaries have no prior experience in errors and omissions (E&O) business and were unable to determine a best estimate. However, for the E&O business, ABC was able to determine a range bound by a low point and high point of $2 million and $8 million, respectively. Management has determined that this range represents a continuous range of possible values.

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>Best Estimate</th>
<th>Excess Stat Reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td>35,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td>6,000,000</td>
<td>0</td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td>8,000,000</td>
<td>0</td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td>50,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>E&amp;O</td>
<td>N/A</td>
<td>0</td>
</tr>
</tbody>
</table>

7. For the year ended December 31, 20X1, the following information was available for premiums:

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>Premium Billed In 20X1</th>
<th>Premium Effective In 20X1</th>
<th>Premium Collected In 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td>31,000,000</td>
<td>28,000,000</td>
<td>30,000,000</td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td>8,500,000</td>
<td>7,500,000</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td>12,750,000</td>
<td>10,000,000</td>
<td>12,000,000</td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td>40,000,000</td>
<td>40,000,000</td>
<td>41,000,000</td>
</tr>
<tr>
<td>E&amp;O</td>
<td>4,500,000</td>
<td>4,500,000</td>
<td>4,500,000</td>
</tr>
<tr>
<td>Total</td>
<td>96,750,000</td>
<td>90,000,000</td>
<td>95,500,000</td>
</tr>
</tbody>
</table>

8. Periodically, ABC prepares an analysis of future anticipated losses, loss adjustment expenses and maintenance costs of its existing contracts in order to determine if rate increases need to be filed. The policies are marketed on a state-by-state basis, except for the E&O, which is currently only being written in one state. Individually and in the aggregate, only the E&O policy revealed inadequacies in the current pricing of policies. The information at the top of the following page was available as of December 31, 20X1:
9. Included in the premiums written amount above is $100,000 and $150,000 in accrued additional retrospective premiums and accrued return retrospective premiums, respectively. The $100,000 in accrued additional retrospective premium pertains to one large policy that has not been billed as of December 31, 20X1. The policy was silent with respect to billing, but the amount was accrued November 30, 20X1. Although the policy is silent with respect to the due date of an adjustment, the company has received a calculation from the insured that indicates what the insured believes the amount should be and payment is expected soon as the companies have verbally agreed to the calculation.

10. Based on a review of the company’s reinsurers as of December 31, 20X1, it appears that one of ABC’s reinsurers is experiencing financial difficulties and might be unable to pay its balance of $325,000 to ABC for losses due. Other reinsurance recoverable balances amount to $2,500,000 as of December 31, 20X1.

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>Losses</th>
<th>LAE</th>
<th>Applicable Expenses</th>
<th>Unearned Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td>10,000,000</td>
<td>700,000</td>
<td>800,000</td>
<td>15,000,000</td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td>2,500,000</td>
<td>250,000</td>
<td>300,000</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td>500,000</td>
<td>75,000</td>
<td>40,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td>2,700,000</td>
<td>200,000</td>
<td>175,000</td>
<td>4,375,000</td>
</tr>
<tr>
<td>E&amp;O</td>
<td>3,000,000</td>
<td>225,000</td>
<td>350,000</td>
<td>3,200,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>18,700,000</strong></td>
<td><strong>1,450,000</strong></td>
<td><strong>1,665,000</strong></td>
<td><strong>27,575,000</strong></td>
</tr>
</tbody>
</table>
Part B – P/C Case Study Problems

Problem 1
Using the information provided in Fact #6, determine the amount of reserves that should be recorded by the company as of December 31, 20X1. (Hint: Refer to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses for guidance.) Additionally, explain how a company would establish a liability under SSAP No. 55 if it determines that several point estimates are equally probable.

Step 1: Determine the amount of reserves (before excess statutory reserves) that should be recorded, based on information given in Fact #6. Additionally, explain how a company would establish a liability under SSAP No. 55 if it determines that several point estimates are equally probable.

P/C Case Study Problems (Continued)

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>12/31/X1 Reserves Before Excess Stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td></td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td></td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td></td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td></td>
</tr>
<tr>
<td>E&amp;O</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
</tr>
</tbody>
</table>

Step 2: Using the reserves determined in Step 1 and the information given in the problem, determine the amount of reserves that the company should record as of December 31, 20X1, and fill in the following table. (Hint: Refer to paragraph 44 of SSAP No. 65—Property and Casualty Contracts for guidance.)

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>Before Excess Stat Reserves</th>
<th>Excess Stat Reserves</th>
<th>Reserves @ 12/31/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E&amp;O</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* * * * *
**Problem 2**

*Using the information provided in Fact #7, determine the amount that should be recorded as premiums written for the year ended December 31, 20X1. (Hint: Refer to SSAP No. 53—Property Casualty Contracts – Premiums to determine the applicable revenue recognition rules for each type of business):*

**Step 1:** For each type of business listed in Fact #7, determine the basis on which premiums written should be recorded under SAP by placing an X in the appropriate column of the following table. (Hint: For one of the lines of business, two methods are available.)

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>As the premium is billed</th>
<th>On the effective Date of the policy</th>
<th>As the premium is collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E&amp;O</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Step 2:** Complete the following table based on the conclusions reached in Step 1:

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>Premiums Written</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td></td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td></td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td></td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td></td>
</tr>
<tr>
<td>E&amp;O</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
</tr>
</tbody>
</table>

* * * * *
**Problem 3**  
*Using the information provided in Fact #8, Fact #9 and Fact #10, complete the following table for all transactions that require a journal entry for the year ended December 31, 20X1. In addition, for the asset balances listed in the table, determine if any of the amounts should be nonadmitted.*

*Note: The table represents excerpts of certain lines from the Assets and Liabilities pages but does not include line items for accounts included in the statement of income (Hint: Refer to SSAP No. 53—Property Casualty Contracts – Premiums, SSAP No. 62R—Property and Casualty Reinsurance, and SSAP No. 66—Retrospectively Rated Contracts.)*

**Step 1:** Complete the table for the transactions identified in Fact #8, Fact #9 and Fact 10.

<table>
<thead>
<tr>
<th>Description</th>
<th>Beg Balance</th>
<th>Debits</th>
<th>Credits</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other Invested Assets</td>
<td>1,500,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued Retrospective</td>
<td></td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Premiums</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reinsurance Recoverable</td>
<td>2,825,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other than Invested Assets</td>
<td>607,500</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserves</td>
<td>104,000,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provision for Reinsurance</td>
<td></td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unearned Premiums</td>
<td>27,575,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Write in liability</td>
<td>48,750</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Step 2:** For the assets listed in the completed table, determine if any assets need to be nonadmitted.

* * * * *
**Problem 1**

Using the information provided in Fact #6, determine the amount of reserves that should be recorded by the company as of December 31, 20X1. (Hint: Refer to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses for guidance.) Additionally, explain how a company would establish a liability under SSAP No. 55 if it determines that several point estimates are equally probable.

**Step 1:** Determine the amount of reserves (before excess statutory reserves) that should be recorded based on information given in Fact #6. Additionally, explain how a company would establish a liability under SSAP No. 55 if it determines that several point estimates are equally probable.

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>12/31/X1 Reserves Before Excess Stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td>35,000,000</td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td>50,000,000</td>
</tr>
<tr>
<td>E&amp;O</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>104,000,000</td>
</tr>
</tbody>
</table>

As noted in SSAP No. 55, for each line of business and for all lines of business in the aggregate, management should record its best estimate of its liabilities for unpaid claims. Management’s analysis in determining the best estimate shall include an analysis of the variability in the estimate. If management develops its estimate bound by a high and low estimate, the best estimate within that range should be recorded. The range should be realistic and should not be based on outcomes that are not reasonable.

As noted in SSAP No. 55, in the rare cases that for a particular line of business, no point within management’s estimated range is a better point than another, the mid-point of the range within management’s estimated range should be accrued. This guidance is not applicable when there are several point estimates that have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine its best estimate of the liability. Therefore, for the E&O business noted in Fact #6, the mid-point of the range should be accrued.
**SECTION 5 – PREMIUM AND RESERVES**

*P/C Case Study Answers (Continued)*

**Step 2:** Using the reserves determined in Step 1 and the information given in the problem, determine the amount of reserves that the company should record as of December 31, 20X1, and fill in the following table. (Hint: Refer to SSAP No. 65—*Property and Casualty Contracts* for guidance.)

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>Before Excess Stat Reserves</th>
<th>Excess Stat Reserves</th>
<th>Reserves @ 12/31/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td>35,000,000</td>
<td>0</td>
<td>35,000,000</td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td>6,000,000</td>
<td>0</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td>8,000,000</td>
<td>0</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td>50,000,000</td>
<td>0</td>
<td>50,000,000</td>
</tr>
<tr>
<td>E&amp;O</td>
<td>5,000,000</td>
<td>0</td>
<td>5,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>104,000,000</strong></td>
<td><strong>0</strong></td>
<td><strong>104,000,000</strong></td>
</tr>
</tbody>
</table>

SSAP No. 65 eliminates the requirement to record excess statutory reserves. Excess statutory reserves do not meet the definition of a liability as established in SSAP No. 5R. Because of this, the entire amount of reserves calculated above of $104,000,000 should be used as the total amount of reserves recorded as of December 31, 20X1.

* * * * *
Problem 2  
Using the information provided in Fact #7, determine the amount that should be recorded as premiums written for the year ended December 31, 20X1. (Hint: Refer to SSAP No. 53—Property Casualty Contracts – Premiums to determine the applicable revenue recognition rules for each type of business.)

Step 1: For each type of business listed in Fact #7, determine the basis on which premiums written should be recorded under SAP by placing an X in the appropriate column of the following table. (Hint: For one of the lines of business, two methods are available):

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>As the premium is billed</th>
<th>On the effective Date of the policy</th>
<th>As the premium is collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>E&amp;O</td>
<td></td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

As noted in SSAP No. 53, for workers’ compensation contracts that have a premium that may periodically vary based on changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Written premiums for all other contracts should be recorded based upon the effective date of the contract, as noted in paragraph 5.

Step 2: Complete the following table based on the conclusions reached in Step 1.

<table>
<thead>
<tr>
<th>Line of Business</th>
<th>Premiums Written</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Liability</td>
<td>28,000,000</td>
</tr>
<tr>
<td>H/O Multiple Peril</td>
<td>7,500,000</td>
</tr>
<tr>
<td>Auto Physical Damage</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Workers’ Comp</td>
<td>40,000,000</td>
</tr>
<tr>
<td>E&amp;O</td>
<td>4,500,000</td>
</tr>
<tr>
<td>Total</td>
<td>90,000,000</td>
</tr>
</tbody>
</table>
Based on the information given in Fact #7 and the conclusions reached in Step 1, the premiums written for this problem amount to $90 million. The amount is obtained by using the amounts in the column labeled “Premiums effective in 20X1” for all amounts except workers’ compensation. As noted above, workers’ compensation premiums can also be recorded as premiums written when billed. In this case, the two amounts do not differ and, therefore, result in the same answer. In theory, the difference in the two methods should not result in a large difference, but could if the timing of the billing was unusually seasonal.
### Problem 3

Using the information provided in Fact #8, Fact #9 and Fact #10, complete the following table for all transactions that require a journal entry for the year ended December 31, 20X1. In addition, for the asset balances listed in the table, determine if any of the amounts should be nonadmitted.

**Note:** The table represents excerpts of certain lines from the Assets and Liabilities pages but does not include line items for accounts included in the statement of income. (Hint: Refer to SSAP No. 53—Property Casualty Contracts – Premiums, SSAP No. 62R—Property and Casualty Reinsurance, and SSAP No. 66—Retrospectively Rated Contracts.)

**Step 1:** Complete the table for the transactions identified in Fact #8, Fact #9 and Fact #10.

<table>
<thead>
<tr>
<th>Description</th>
<th>Beg Balance</th>
<th>Debits</th>
<th>Credits</th>
<th>Adj Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other Invested Assets</td>
<td>1,500,000</td>
<td></td>
<td></td>
<td>1,500,000</td>
</tr>
<tr>
<td>Accrued Retrospective Premium</td>
<td>0</td>
<td>100,000 (4)</td>
<td></td>
<td>100,000</td>
</tr>
<tr>
<td>Reinsurance Recoverable</td>
<td>2,825,000</td>
<td></td>
<td>325,000 (10)</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Other than Invested Assets</td>
<td>607,500</td>
<td></td>
<td></td>
<td>607,500</td>
</tr>
<tr>
<td>Reserves</td>
<td>104,000,000</td>
<td></td>
<td>375,000 (8)</td>
<td>104,375,000</td>
</tr>
<tr>
<td>Provision for Reinsurance</td>
<td>0</td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Unearned Premiums</td>
<td>27,575,000</td>
<td></td>
<td></td>
<td>27,575,000</td>
</tr>
<tr>
<td>Write-in liability</td>
<td>48,750</td>
<td>0</td>
<td>150,000 (9)</td>
<td>198,750</td>
</tr>
</tbody>
</table>

**Note:** The numbers in parentheses to the right of each amount represent the Background Fact from where the amount was obtained.

**Fact #8:** Based on the requirements of SSAP No. 53, a premium deficiency reserve shall be recorded when anticipated losses, loss adjustment expenses, and commissions and other maintenance costs exceed the recorded unearned premium and future installment premiums on existing policies.

Using the information given in the problem, only the E&O contracts appear to be in a position that would require deficiency reserves to be recorded. The amount is calculated at the top of the following page.
Unearned Premiums $3,200,000
Less: Losses 3,000,000
Less: LAE 225,000
Less: Other Expenses 350,000
Deficiency Reserves $375,000

Entry to record premium deficiency reserves as required by SSAP No. 53.

Fact #9: SSAP No. 66 requires that accrued additional retrospective premiums and accrued return retrospective premiums be recorded as a receivable and write-in liability, respectively. The corresponding side to both of these entries is to either written premium or an adjustment to earned premium.

Accrued Retro Premium Receivable 100,000
Premiums Written 50,000
Write-In Liability 150,000

To record accrued additional retrospective premiums and accrued return retrospective premiums.

Fact #10: SSAP No. 62R requires that all uncollectible reinsurance balances be written off through the accounts, exhibits and schedules in which they were originally recorded.

Ceded Losses 325,000
Reinsurance Recoverables 325,000

To record write-off of uncollectible reinsurance recoverables.

Step 2: For the assets listed in the completed table, determine if any assets need to be nonadmitted.

Per SSAP No. 66, if accrued additional retrospective premiums are not billed in accordance with the policy provisions or the policy provisions do not address the due date of the retrospective premiums, the accrual shall be nonadmitted.

Based on this, the entire $100,000 that has been accrued should be nonadmitted.

*   *   *   *   *

*   *   *   *   *
**Background Facts**

This part of the case study encompasses Section 6 and Section 7.

1. As of December 31, 20X0, the book value of the company’s bonds, as presented in its annual statement was $75 million. During 20X1, besides the transactions listed in the remainder of this problem, the company bought and had mature $15 million and $10 million, respectively, in corporate bonds. Premium and discount amortization netted to zero for the year on these bonds, as well as all other bonds owned, as of December 31, 20X0.

2. On October 1, 20X1, the company purchased a $3 million par value D&U Airways corporate bond at par. On December 15, 20X1, substantial press coverage described events that occurred at D&U Airways that appeared to be damaging to the organization’s reputation, as well the organization’s continued service to its customers. D&U Airway’s bond rating was downgraded immediately and it was determined that the fair value of the bond was only $2 million at year-end. The company had previously submitted a filing to the NAIC Securities Valuation Office (SVO), but the bond was not rated by the NAIC as of December 31, 20X1.

3. On December 29, 20X1, the company purchased $10 million of 7.5%, 10-year U.S. Treasury bonds. On January 4, 20X2, the transaction was settled with the company’s broker for $10 million and was put on deposit with the company’s state of domicile.

4. On December 15, 20X1, the company subscribed to purchase 500,000 shares of New Inc. common stock at $10 a share. As of December 31, 20X1, the stock had not been issued.

5. The company held various shares of common stock. The cost of the company’s investment in unaffiliated common stocks was originally $9,375 million on October 30, 20X1, with a fair value of $12.5 million, on December 31, 20X1.

6. The company maintains a wide portfolio of residential mortgage loans. For the year ended December 31, 20X1, the company received prepayment penalties of $25,000, nonrefundable loan origination fees of $50,000 and income on points paid by customers of $25,000 on the loans. Based on a system-generated constant effective yield amortization table, the points pertaining to the current year amount to $1,250.
Background Facts (Continued)

7. The company performs its daily operations in two facilities. The largest facility, which is wholly owned by the company, was purchased approximately five years ago and houses all of the company’s employees except for data processing. The larger facility, which is 100% owned and occupied by the company, was purchased for $1.1 million, carries accumulated depreciation of $200,000 (for a depreciated cost of $900,000), and carries an unpaid principal balance to The Bank of $750,000 on a 7% mortgage.

8. The data-processing staff operates out of the second facility, purchased three years ago, which is shared by three other organizations and is 25% occupied by the company. The depreciated cost of the data processing building is $135,000. The company’s original basis in the data processing building was $150,000 and there appears to be no decline in the value of the building given the current market prices in the area.

9. The company’s board of directors recently resolved a motion to sell its main facility (discussed in Fact #7) because the boilers (an adverse change in its physical condition) were going to need to be replaced within the next two years at a cost of $100,000. However, on December 1, 20X1, the company obtained an appraisal of $850,000 (based on updating the HVAC system) and estimated selling costs on the building at $75,000, resulting in estimated sales proceeds of $775,000. After obtaining this information, the company’s board of directors resolved that it would retrofit the office and not attempt to sell the building.

10. The company owns a property that it foreclosed on as a lienholder. The property is being leased to an unrelated party as of January 1, 20X2, but has been held for sale by the company for six years. The property was originally appraised for $350,000 at the time of foreclosure and, based on a 20-year life, has a depreciated cost of $245,000 as of December 31, 20X1. Based on recent changes in the area, the current tenants do not intend to renew their lease or take advantage of a bargain purchase option on their lease. The company has not obtained an appraisal since its foreclosure but, based on an analysis of sale of similar properties in the area as of December 31, 20X1, the value of the property has been estimated by the company to be $200,000, net of selling costs. Assume the analysis performed by the company does not meet the requirements of a proper internal appraisal.

* * * * *

STATUTORY ACCOUNTING PRINCIPLES SELF-STUDY PROGRAM
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Case Study Problems

Problem 1
Using the facts provided above, calculate ABC’s realized gain/loss before interest maintenance reserve (IMR) for the year ended 20X1, by following the steps below.

Step 1: Determine which transactions contain a write-down, which would result in a gain or loss and record a “yes” or “no” answer in the following table:

<table>
<thead>
<tr>
<th>Fact</th>
<th>Writedown?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

Step 2: For all write-down transactions noted in Step 1, calculate the realized gain/loss on the transaction. (Hint: There are three impairments (i.e., write-downs) that should be recorded, one pursuant to the provisions of SSAP No. 26 and two pursuant to the provisions of SSAP No. 40 and SSAP No. 90).

* * * * *
Case Study Problems (Continued)

Problem 2
Determine the balance of each of the following balance sheet items as of December 31, 20X1, by reviewing the Background Facts and following the steps below.

<table>
<thead>
<tr>
<th>Description</th>
<th>Total Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common Stock</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Properties Occupied by the Company (less $750,000 encumbrances)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Properties Held for Production of Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Properties Held for Sale</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Step 1: Determine the total asset balance (prior to nonadmitted assets) for each balance sheet item as of December 31, 20X1.

Hints:
1. For bonds, prepare a rollforward of bond investments from December 31, 20X0, to December 31, 20X1, using the following schedule:

   **Beginning Balance**
   - Given in Fact #1

   **Purchases:**
   - D&U Airways Corporate Bond
   - U.S. Treasury Bonds
   - Corporate Bonds
   - Given in Fact #2
   - Given in Fact #3
   - Given in Fact #1

   **Sales:**
   - **Maturities:**
   - Corporate Bonds
   - Given in Fact #1

   **Writedowns:**
   - D&U Airways Corporate Bond
   - Given in Fact #2

   **Ending Balance**
   - Calculated

2. For unaffiliated common stocks referred to in Fact #4 and Fact #5, review the provisions of SSAP No. 30.
3. For real estate, review the provisions of SSAP No. 40, SSAP No. 77 and SSAP No. 90. Do not forget to account for the realized loss from impairment calculated in Problem 1.

Step 2: Determine the nonadmitted asset balance for each balance sheet item as of December 31, 20X1. (Hint: Review the provisions of SSAP No. 40 and SSAP No. 90.)
Case Study Problems (Continued)

Problem 3
Using the facts provided above, determine the amount of net investment income and other income to be recorded by ABC for the year ended 20X1, by following the steps below.

Step 1: Determine which transactions result in the recording of investment income or other income and record a yes or no answer in the following table:

<table>
<thead>
<tr>
<th>Fact</th>
<th>Investment Income and/or Other Income?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

Step 2: Calculate the appropriate investment income and other income to be recorded in 20X1. (Hint: Review the provisions of SSAP No. 37).

* * * * *
Case Study Answers

Problem 1
Using the facts provided above, calculate ABC’s realized gain/loss before interest maintenance reserve (IMR) for the year ended 20X1, by following the steps below.

Step 1: Determine which transactions contain a write-down, which would result in a gain or loss and record a “yes” or “no” answer in the following table:

<table>
<thead>
<tr>
<th>Fact</th>
<th>Writedown?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>No</td>
</tr>
<tr>
<td>2</td>
<td>Yes</td>
</tr>
<tr>
<td>3</td>
<td>No</td>
</tr>
<tr>
<td>4</td>
<td>No</td>
</tr>
<tr>
<td>5</td>
<td>No</td>
</tr>
<tr>
<td>6</td>
<td>No</td>
</tr>
<tr>
<td>7</td>
<td>No</td>
</tr>
<tr>
<td>8</td>
<td>No</td>
</tr>
<tr>
<td>9</td>
<td>Yes</td>
</tr>
<tr>
<td>10</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Step 2: For all write-down transactions noted in Step 1, calculate the realized gain/loss on the transaction. (Hint: There are three impairments (i.e., write-downs) that should be recorded, one pursuant to the provisions of SSAP No. 26 and two pursuant to the provisions of SSAP No. 40).

Fact #2: Under SSAP No. 26, if it is determined that a decline in the fair value of a bond is other than temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bond’s carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include recoveries of fair value subsequent to the balance sheet date. Using the information in Fact #2, the following realized loss is calculated for bond investments:

**D&U Airways:**
Cost (October 1, 20X1) $3,000,000 Given in Fact #2
Fair Value @ 12/31/X1 2,000,000 Given in Fact #2
Realized Loss $1,000,000 Calculated

**Journal Entry**
December 15, 20X1  Realized Loss 1,000,000
Corporate Bonds 1,000,000

Entry to record the realized loss on other than temporary declines in fair value.
Case Study Answers (Continued)

**Fact #9:** Using the information in Fact #7, the depreciated cost of the larger facility can be calculated as follows:

<table>
<thead>
<tr>
<th>Cost</th>
<th>$1,100,000</th>
<th>Given in Fact #7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated Depreciation</td>
<td>(200,000)</td>
<td></td>
</tr>
<tr>
<td>Realized Loss</td>
<td>$900,000</td>
<td></td>
</tr>
</tbody>
</table>

Then, using the depreciated cost calculated above and the information in Fact #9, we must perform a recoverability test in conjunction with SSAP No. 90. SSAP No. 40 indicates that properties occupied by the company are subject to recoverability testing if any of the following conditions are present.

a. The financial condition of the reporting entity is in question, as described in paragraph 7 of this statement.

b. The property occupied by the company is held for sale, as defined in paragraph 21 of this statement.

c. A significant adverse change in the physical condition of the property occupied by the company has occurred.

d. The management of the reporting entity has voluntarily determined a need for recoverability testing.

Because the necessary repairs identified in Fact #9 qualify as “a significant adverse change in the physical condition of the property,” the occupied facility will need to be tested.

For testing a property occupied by the company, entities shall use the criteria in SSAP No. 40 to determine the fair value of the property; i.e., market quotes or appraisals. The fair value is based on the appraisal of $850,000; therefore, the realized loss (before IMR) can be calculated as follows:

**Journal Entry**

December 1, 20X1  
Realized Loss 50,000  
Property Occupied by Company 50,000  

*Entry to record realized loss on other than temporary declines in fair value.*
Case Study Answers (Continued)

Fact #10: Using the information in Fact #10 and the provisions of SSAP No. 90 regarding impairment, the depreciated cost of the foreclosed real estate property and the related realized loss (before IMR) can be calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$350,000</td>
<td>Given in Fact #10</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>(105,000)</td>
<td>Derived</td>
</tr>
<tr>
<td>Depreciated Cost</td>
<td>$245,000</td>
<td>Given in Fact #10</td>
</tr>
<tr>
<td>Market Value</td>
<td>$200,000</td>
<td>Given in Fact #10</td>
</tr>
<tr>
<td>Depreciated Cost</td>
<td>(245,000)</td>
<td>Given in Fact #10</td>
</tr>
<tr>
<td>Realized Loss (Before IMR)</td>
<td>$(45,000)</td>
<td>Calculated</td>
</tr>
</tbody>
</table>

**Journal Entry**

December 31, 20X1
Realized Loss  45,000
Property Held for Sale  45,000

Entry to record realized loss on other than temporary declines in fair value.

* * * * *
Case Study Answers (Continued)

Problem 2
Determine the balance of each of the following balance sheet items as of December 31, 20X1, by reviewing the Background Facts and following the steps below.

<table>
<thead>
<tr>
<th>Description</th>
<th>Total Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>$ 92,000,000</td>
<td>$ 92,000,000</td>
<td></td>
</tr>
<tr>
<td>Common Stock</td>
<td>12,500,000</td>
<td>12,500,000</td>
<td></td>
</tr>
<tr>
<td>Real Estate:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Properties Occupied by the Company</td>
<td>100,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>(less $750,000 encumbrances)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Properties Held for Production of Income</td>
<td>135,000</td>
<td>135,000</td>
<td></td>
</tr>
<tr>
<td>Properties Held for Sale</td>
<td>200,000</td>
<td>200,000</td>
<td>-0-</td>
</tr>
</tbody>
</table>

Step 1: Determine the total asset balance (prior to nonadmitted assets) for each balance sheet item as of December 31, 20X1.

Hints:
1. For bonds, prepare a rollforward of bond investments from December 31, 20X1, to December 31, 20X1, using the following schedule:

   **Beginning Balance**  
   **Purchases:**  
   - D&U Airways Corporate Bond  
   - U.S. Treasury Bonds  
   - Corporate Bonds  
   **Sales:**  
   - Maturities:  
   - Corporate Bonds  
   **Writedowns:**  
   - D&U Airways Corporate Bond  

   *Given in Fact #1*  
   *Given in Fact #2*  
   *Given in Fact #3*  
   *Given in Fact #1*  
   *Given in Fact #1*  
   *Calculated*

2. For unaffiliated common stocks referred to in Fact #4 and Fact #5, review the provisions of SSAP No. 30.
3. For real estate, review the provisions of SSAP No. 40, SSAP No. 77 and SSAP No. 90. Do not forget to account for the realized loss from impairment calculated in Problem 1.
Case Study Answers (Continued)

**Bonds:** Using the information in Fact #1, Fact #2 and Fact #3, as well as the guidance of SSAP No. 26, the following rollforward is prepared for bond investments:

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning Balance</strong></td>
<td>$75,000,000</td>
<td>Given in Fact #1</td>
</tr>
<tr>
<td><strong>Purchases:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D&amp;U Airways Corporate Bond</td>
<td>$3,000,000</td>
<td>Given in Fact #2</td>
</tr>
<tr>
<td>U.S. Treasury Bonds</td>
<td>$10,000,000</td>
<td>Given in Fact #3</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>$15,000,000</td>
<td>Given in Fact #1</td>
</tr>
<tr>
<td><strong>Sales:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>$(10,000,000)</td>
<td>Given in Fact #1</td>
</tr>
<tr>
<td><strong>Writedowns:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D&amp;U Airways Corporate Bond</td>
<td>$(1,000,000)</td>
<td>Given in Fact #2</td>
</tr>
<tr>
<td><strong>Ending Balance</strong></td>
<td><strong>$92,000,000</strong></td>
<td>Calculated</td>
</tr>
</tbody>
</table>

**Notes:**
(1) Under SSAP No. 26, an other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. A decline in fair value that is other-than-temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value. If it is determined that a decline in fair value of a bond is other than temporary, the cost of the bond shall be written down to fair value as a new cost basis and the write-down shall be accounted for as a realized loss.

(2) SSAP No. 26 provides that these transactions are to be recorded on the trade date, not the settlement date. The following illustrates the related transactions:

**Journal Entry**

December 29, 20X1
U.S. Treasury Bonds 10,000,000
Due to Broker 10,000,000

*Entry to record purchase of U.S. Treasury Bonds on the trade date.*

January 4, 20X2
Due to Broker 10,000,000
Cash 10,000,000

*Entry to record the settlement of the purchase.*
Case Study Answers (Continued)

(3) Other purchases and maturities represent cash transactions that would be recorded (if recorded simultaneously) as follows:

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Date</td>
<td>U.S. Treasury Bonds</td>
<td>15,000,000</td>
</tr>
<tr>
<td></td>
<td>Corporate Bonds</td>
<td>10,000,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>5,000,000</td>
</tr>
</tbody>
</table>

Entry to record purchases and maturities on trade date.

Common Stock: Using the information in Fact #4 and Fact #5, as well as the guidance of SSAP No. 30, the value of the company’s common stock is $12.5 million, which is calculated as follows.

Fact #4: Although SSAP No. 30 requires investments in common stock to be recorded on the trade date instead of the settlement date, exceptions are made for certain transactions. One of the exceptions is a stock subscription transaction. Because stock subscriptions are recorded on the settlement date, no entry is made in 20X1.

Fact #5 (Unaffiliated Common Stock): Consistent with current statutory accounting guidance, SSAP No. 30 requires unaffiliated common stock to be recorded at cost at acquisition and, subsequently, at fair value. Using the information given in Fact #5, the following book value and unrealized gain can be determined as follows.

<table>
<thead>
<tr>
<th>SVO Value</th>
<th>$12,500,000</th>
<th>Given in Fact #5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book Value</td>
<td>9,375,000</td>
<td>Given in Fact #5</td>
</tr>
<tr>
<td>Unrealized Gain</td>
<td>$3,125,000</td>
<td>Calculated</td>
</tr>
</tbody>
</table>

The following journal entries would be posted to record the purchase and value the stock at October 30, 20X1, and December 31, 20X1.

<table>
<thead>
<tr>
<th>Journal Entries</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>October 30, 20X1</td>
<td>Common Stock</td>
<td>9,375,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>9,375,000</td>
</tr>
</tbody>
</table>

Entry to record purchase of common stock.

| December 31, 20X1| Common Stock       | 3,125,000       |
|                 | Unrealized Gain    | 3,125,000       |

Entry to record year-end valuation of common stock.
Case Study Answers (Continued)

Note: This example does not illustrate the current market volatility that is occurring, whereby most company’s investment portfolios are fluctuating significantly resulting in, many cases, notable unrealized losses.

Real Estate: Using the information in Fact #7, Fact #8, Fact #9 and Fact #10, as well as the guidance of SSAP No. 40, the value of the company’s real estate can be calculated as follows:

Based on the classifications defined in SSAP No. 40, the company’s real estate investments are classified into the following categories:

Main Facility
Property Occupied by the Company
Data Processing
Property Held for the Production of Income
Foreclosed Property
Property Held for Sale

SSAP No. 40 requires that Properties Occupied by the Company and Property Held for the Production of Income be recorded at depreciated cost less encumbrances. This statement also requires that Property Held for Sale should be valued at the lesser of depreciated cost or fair value less encumbrances and estimated sales costs.

Fact #7 and Fact #9: The Main Facility is classified as Property Occupied by the Company as it is more than 50% owned and occupied by the company and should be recorded normally at depreciated cost. However, because circumstances indicate that the carrying amount may not be recoverable (as noted in Problem 1), a realized loss should be recorded on the asset and recorded at fair value less encumbrances which is calculated as follows:

\[
\begin{align*}
\text{Appraisal Value} & \quad \$ 850,000 \quad \text{Given in Fact #9} \\
\text{Encumbrances} & \quad \$ 750,000 \quad \text{Given in Fact #7} \\
\text{Total} & \quad \$ 100,000 \quad \text{Calculated}
\end{align*}
\]

Based on the calculations performed above, the facility is recorded at its fair value, less encumbrances of $750,000 payable to The Bank.

Fact #8: The data-processing building is classified as Property Held for the Production of Income, as it is only 25% occupied by the company and should be recorded at depreciated cost, which is given in Fact #8 and calculated as follows:

\[
\begin{align*}
\text{Cost} & \quad \$ 150,000 \quad \text{Given in Fact #8} \\
\text{Accumulated Depreciation} & \quad 15,000 \quad \text{Calculated} \\
\text{Depreciated Cost} & \quad \$ 135,000 \quad \text{Given in Fact #8}
\end{align*}
\]
Case Study Answers (Continued)

Fact #10: The foreclosed property is classified as Property Held for Sale pursuant to SSAP No. 40. Because the company is pursuing the sale of this property, it should be recorded at the lesser of depreciated cost or fair value less encumbrances, which is calculated as follows:

<table>
<thead>
<tr>
<th>Depreciated Cost</th>
<th>Fair Market Value</th>
<th>Age of Appraisal</th>
<th>Disposition</th>
</tr>
</thead>
<tbody>
<tr>
<td>245,000</td>
<td>200,000</td>
<td>&gt; 5 years</td>
<td>Non-admit</td>
</tr>
</tbody>
</table>

Step 2: Determine the nonadmitted asset balance for each balance sheet item as of December 31, 20X1. (Hint: Review the provisions of SSAP No. 40).

Fact #10: The property was foreclosed upon six years ago and no appraisal has been obtained since that time. SSAP No. 40 states that all appraisals obtained to determine fair market value of real estate investments shall be no more than five years old. When the appraisal is more than five years old, the related property shall be considered a nonadmitted asset until the required appraisals are obtained. Therefore, the entire recorded amount ($200,000) of the foreclosed property should be nonadmitted.

* * * * *
Problem 3
Using the facts provided above, determine the amount of net investment income and other income to be recorded by ABC for the year ended 20X1, by following the steps below.

Step 1: Determine which transactions result in the recording of investment income or other income and record a “yes” or “no” answer in the following table:

<table>
<thead>
<tr>
<th>Fact</th>
<th>Investment Income and/or Other Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>No</td>
</tr>
<tr>
<td>2</td>
<td>No</td>
</tr>
<tr>
<td>3</td>
<td>No</td>
</tr>
<tr>
<td>4</td>
<td>No</td>
</tr>
<tr>
<td>5</td>
<td>No</td>
</tr>
<tr>
<td>6</td>
<td>Yes</td>
</tr>
<tr>
<td>7</td>
<td>No</td>
</tr>
<tr>
<td>8</td>
<td>No</td>
</tr>
<tr>
<td>9</td>
<td>No</td>
</tr>
<tr>
<td>10</td>
<td>No</td>
</tr>
</tbody>
</table>

Step 2: Calculate the appropriate investment income and other income to be recorded in 20X1. (Hint: Review the provisions of SSAP No. 37.)

Fact #6: Using the information in Fact #6 and the guidance of SSAP No. 37, the income to be recorded for the year ended 20X1 is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepayment Penalties</td>
<td>$25,000</td>
</tr>
<tr>
<td>Non Refundable Loan Origination Fees</td>
<td>$50,000</td>
</tr>
<tr>
<td>Points Earned in Current Year</td>
<td>$1,250</td>
</tr>
<tr>
<td>Total</td>
<td>$76,250</td>
</tr>
</tbody>
</table>

Note: Per SSAP No. 37, prepayment penalties and nonrefundable loan-origination fees, except for points, should be recorded as income as received. Points shall be deferred as part of the loan balance and amortized over the life of the loan.
Case Study Answers (Continued)

Additionally, the company would record a contra-asset for the portion of the points collected but not yet earned as calculated and recorded below:

<table>
<thead>
<tr>
<th>Total Points Received</th>
<th>$ 25,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Points Earned</td>
<td>1,250</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 23,750</strong></td>
</tr>
</tbody>
</table>

*Journal Entry*

December 31, 20X1  
Cash 25,000  
Investment Income 1,250  
Mortgage Loan Points (Contra-asset) 23,750

*Entry to record contra-asset for points received and unearned.*

* * * * *
Background Facts

1. The company is a 5% limited partner in an agreement to buy, hold and sell real estate for investment purposes. The partnership, REP, prepares GAAP basis financial statements as of December 31, 20X0, and December 31, 20X1. As of December 31, 20X1, REP had total GAAP basis equity of $30 million. As of December 31, 20X0, the company recorded its interest in REP based on its audited GAAP financial statements.

2. As of September 30, 20X1, the company had capital and surplus amounting to $32,650,000; EDP equipment of $650,000; operating system software of $100,500; goodwill of $2,500,000; and net deferred tax assets of $0.

* * * * *
Case Study Problems

Problem 1
Determine the nonadmitted asset balance, if any, for each investment as of December 31, 20X1. (Hint: Calculate the admitted goodwill limit pursuant to SSAP No. 68 and nonadmit any recorded goodwill in excess of the maximum limit.)

Capital and Surplus at 9/30/X1:
Less:
  EDP Equipment
  Operating System Software
  Goodwill
  Net Deferred Tax Assets
  Subtotal
  Net

  10% SSAP No. 68 Limit

Goodwill at 12/31/X1:
  REP Partnership
  Maximum
  Nonadmitted Goodwill

* * * * *
Case Study Answers

Problem 1
Determine the nonadmitted asset balance, if any, for each investment as of December 31, 20X1. (Hint: Calculate the admitted goodwill limit pursuant to SSAP No. 68 and nonadmit any recorded goodwill in excess of the maximum limit.)

Determine the nonadmitted asset balance, if any, for each investment as of December 31, 20X1. The above investments were recorded based on acceptable methods under SAP; however, there are limits within SSAP No. 68 on the amount of goodwill that can be carried by an insurer. (Hint: Calculate the admitted goodwill limit pursuant to SSAP No. 68 and nonadmit any recorded goodwill in excess of the maximum limit.)

SSAP No. 68 requires that positive goodwill from all sources (including life, accident and health, as well as deposit-type assumption reinsurance) is limited in the aggregate to 10% of the parent entity’s capital and surplus. This is required to be shown on the statutory balance sheet of the entity for its most recently filed statement with the domiciliary state insurance commissioner, adjusted to exclude any positive goodwill, EDP equipment and operating system software, and net deferred tax assets.

### Capital and Surplus at 9/30/X1

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital and Surplus at 9/30/X1</td>
<td>$32,650,000</td>
</tr>
<tr>
<td>Given in Fact #2</td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>EDP Equipment</td>
<td>650,000</td>
</tr>
<tr>
<td>Operating System Software</td>
<td>100,500</td>
</tr>
<tr>
<td>Goodwill</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Net Deferred Tax Assets</td>
<td>-0-</td>
</tr>
<tr>
<td>Subtotal</td>
<td>3,250,500</td>
</tr>
<tr>
<td>Net</td>
<td>29,399,500</td>
</tr>
<tr>
<td>Given in Fact #2</td>
<td></td>
</tr>
<tr>
<td>SSAP No. 68 Limit</td>
<td>$2,939,950</td>
</tr>
<tr>
<td>Calculated</td>
<td></td>
</tr>
</tbody>
</table>

Goodwill at 12/31/X1

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>REP Partnership</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Maximum</td>
<td>2,939,950</td>
</tr>
<tr>
<td>Nonadmitted Goodwill</td>
<td>$-0-</td>
</tr>
</tbody>
</table>

Based on the limitation calculated above, the entire goodwill balance can be admitted at December 31, 20X1.

* * * * *
Background Facts

1. Over the years, ABC has utilized one major broker, Who’s Liable, in distributing its auto liability products. ABC maintains an account current with this broker and, as of December 31, 20X1, ABC had a net receivable from Who’s Liable of $3.75 million. The company has a system that allows for aging of its original and deposit premiums using the effective date of the contract, as opposed to the contractual due date with the agent. The following information is available on the amount due from Who’s Liable:

New System

<table>
<thead>
<tr>
<th>Aging-Policy Effective Date</th>
<th>Current</th>
<th>30–60 Days</th>
<th>61–90 Days</th>
<th>&gt; 90 Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Receivable</td>
<td>$2,880,000</td>
<td>$818,000</td>
<td>$275,500</td>
<td>$136,500</td>
</tr>
<tr>
<td>Commissions</td>
<td>255,000</td>
<td>68,000</td>
<td>25,500</td>
<td>11,500</td>
</tr>
<tr>
<td>Net Receivable</td>
<td>$2,625,000</td>
<td>$750,000</td>
<td>$250,000</td>
<td>$125,000</td>
</tr>
</tbody>
</table>

2. On January 10, 20X2, the company receives its November account current check from Who’s Liable. Attached to the check is a detail of the items paid, which include, among other things, $50,000 (net) for one large auto liability policy that is currently more than 90 days past due under the aging details noted above.

3. ABC also utilizes one major broker, Home Owner, in distributing all of its homeowners insurance products. ABC maintains an account current (on a net-of-commissions basis) with this broker and, as of December 31, 20X1, ABC had a net receivable from Home Owner of $1,350,000. This receivable pertains to the company’s November and December account currents only, as the October net account current of $625,000 was settled December 10, 20X1. However, on January 2, 20X2, ABC remitted the $625,000 back to Home Owner for unspecified reasons. In reviewing the aging of the October, November and December account currents, no items exist that are greater than 90 days past due as of December 31, 20X1.

4. ABC utilizes direct marketing in selling its auto physical damage insurance. The coverage is generally written on an annual basis but is collected monthly in some cases for policyholder's convenience. The company has $895,000 in receivables on this business and has extracted the following information on policies that have installment premiums greater than 90 days past due:

<table>
<thead>
<tr>
<th>Policy Type</th>
<th>Current</th>
<th>30-60 Days</th>
<th>61-90 Days</th>
<th>&gt; 90 Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Physical Damage</td>
<td>$7,000</td>
<td>$6,500</td>
<td>$5,750</td>
<td>$5,500</td>
</tr>
</tbody>
</table>
5. Additionally, some of ABC’s auto customers finance their premiums through what the company refers to as bills receivable. As of December 31, 20X1, ABC had $200,000 in receivables on these bills receivable. The following represents information on the company’s bills receivable that have installments that are past due:

<table>
<thead>
<tr>
<th>Policy Type</th>
<th>Not Yet Due But Recorded</th>
<th>Past Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bills Receivable</td>
<td>$40,500</td>
<td>$21,500</td>
</tr>
</tbody>
</table>

6. A substantial amount of ABC’s business relates to workers compensation insurance. The company completes and bills its annual audits on policies within 30 days of the expiration of the policy. The policy requires payment to be made to/from the company within 45 days of the expiration of the policy. The following is a listing of workers compensation audit receivables the company maintains on its books as of Dec. 31, 20X1:

<table>
<thead>
<tr>
<th>Policy Expiration Date</th>
<th>Billing Date</th>
<th>Due Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 31</td>
<td>August 30</td>
<td>September 14</td>
<td>$165,000</td>
</tr>
<tr>
<td>August 31</td>
<td>September 28</td>
<td>October 15</td>
<td>112,000</td>
</tr>
<tr>
<td>September 30</td>
<td>October 30</td>
<td>November 14</td>
<td>100,000</td>
</tr>
<tr>
<td>October 31</td>
<td>November 27</td>
<td>December 15</td>
<td>154,000</td>
</tr>
<tr>
<td>November 30</td>
<td>December 29</td>
<td>January 14</td>
<td>100,000</td>
</tr>
<tr>
<td>December 31</td>
<td>January 30</td>
<td>February 14</td>
<td>75,000</td>
</tr>
<tr>
<td>Total Balance</td>
<td></td>
<td></td>
<td>$706,000</td>
</tr>
</tbody>
</table>

7. The following represents the remaining receivables on this line of business:

<table>
<thead>
<tr>
<th>Type</th>
<th>Current</th>
<th>30-60 days</th>
<th>61-90 days</th>
<th>&gt; 90 days</th>
</tr>
</thead>
<tbody>
<tr>
<td>W/C Installments</td>
<td>$3,250,000</td>
<td>$900,000</td>
<td>$135,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

* * * * *
Case Study Problems

Problem 1
Using the information in Fact #1 and Fact #2, determine the balance of the amount due from Who’s Liable and any related nonadmitted amount by completing the following table. (Hint: Refer to SSAP No. 6 for guidance):

<table>
<thead>
<tr>
<th>Premiums and Agents Balances in Course of Collection</th>
<th>Total Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who’s Liable</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Problem 2
Using the information in Fact #3, determine the balance of the amount due from Home Owner and any related nonadmitted amount by completing the following table. (Hint: Refer to SSAP No. 6 for guidance.)

<table>
<thead>
<tr>
<th>Premiums and Agents Balances in Course of Collection</th>
<th>Total Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home Owner</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Problem 3
Using the information in Fact #4 and Fact #5, determine the balance of the amount due on auto physical damage policies and any related nonadmitted amount by completing the following table. (Hint: Refer to SSAP No. 6 for guidance.)

<table>
<thead>
<tr>
<th>Premiums and Agents Balances in Course of Collection</th>
<th>Total Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Physical Damage</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Problem 4
Using the information in Fact #6 and Fact #7, determine the balance of the amount due on workers’ compensation policies and any related nonadmitted amount by completing the following table. (Hint: Refer to SSAP No. 6 for guidance.)

<table>
<thead>
<tr>
<th>Premiums and Agents Balances in Course of Collection</th>
<th>Total Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workers’ Compensation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* * * * *
Case Study Answers

Problem 1
Using the information in Fact #1 and Fact #2, determine the balance of the amount due from Who's Liable and any related nonadmitted amount by completing the following table. (Hint: Refer to SSAP No. 6 for guidance):

<table>
<thead>
<tr>
<th>Premiums and Agents Balances in Course of Collection</th>
<th>Total Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who's Liable</td>
<td>$ 3,750,000</td>
<td>$ 125,000</td>
<td>$ 3,625,000</td>
</tr>
</tbody>
</table>

**Step 1:** Determine the amount that should be recorded prior to any nonadmission.

**Fact #1:** The balance can be accumulated as follows:

Total Receivable:
- Current: $2,625,000 *Given in Fact #1*
- 30–60 Days: $750,000 *Given in Fact #1*
- 61–90 Days: $250,000 *Given in Fact #1*
- > 90 Days: $125,000 *Given in Fact #1*
- Total: $3,750,000 *Calculated*

**Fact #2:** The balance is already included in the total asset above.

**Step 2:** Determine if any of the amount that is recorded should be nonadmitted.

**Fact #1:** The entire amount of $125,000 that is over 90 days should be nonadmitted.

**Fact #2:** The collection of $50,000 on January 10, 20X2, for an item that is nonadmitted cannot be used to adjust the nonadmitted asset otherwise calculated in Fact #1 above. SSAP No. 6, paragraph 11, states that amounts classified as nonadmitted assets collected subsequent to the date of the statutory financial statements shall not be used to adjust the nonadmitted asset otherwise calculated.

* * * * *
Case Study Answers (Continued)

Problem 2
Using the information in Fact #3, determine the balance of the amount due from Home Owner and any related nonadmitted amount by completing the following table. (Hint: Refer to SSAP No. 6 for guidance.)

<table>
<thead>
<tr>
<th>Premiums and Agents Balances in Course of Collection</th>
<th>Total Assets</th>
<th>Assets Not Net Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home Owner</td>
<td>$ 1,975,000</td>
<td></td>
<td>$ 1,975,000</td>
</tr>
</tbody>
</table>

Step 1: Determine the amount that should be recorded prior to any nonadmission.

Fact #3: The balance can be accumulated as follows.

Total Receivable:
Receivable from Home Owner at December 31, 20X1 $ 1,350,000 Given in Fact #3
Add: Premiums remitted to Home Owner January 2, 20X2 625,000 Given in Fact #3
Adjusted Premiums Receivable $ 1,975,000 Calculated

The following adjusting journal entry would be made to increase the receivable balance for the premiums remitted to Home Owner on January 2, 20X2.

Journal Entry
December 31, 20X1 Receivable from Home Owner 625,000
Payable to Home Owner 625,000

Entry to adjust for the wash transaction with Home Owner as of December 31, 20X1.

Once the receivable is placed back on the books of the company, it should be evaluated for collectibility and the nonadmitted asset calculation. Based on the information given, the asset is less than 90 days old and there is no obvious reason to believe the asset would be written off as of December 31, 20X1.

Step 2: Determine if any of the amount that is recorded should be nonadmitted.

Fact #3: Using the information provided in the fact, no amounts require nonadmission as of December 31, 20X1.

* * * * *
Case Study Answers (Continued)

Problem 3
Using the information in Fact #4 and Fact #5, determine the balance of the amount due on auto physical damage policies and any related nonadmitted amount by completing the following table. (Hint: Refer to SSAP No. 6 for guidance.)

<table>
<thead>
<tr>
<th>Premiums and Agents Balances in Course of Collection</th>
<th>Total Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Physical Damage</td>
<td>$ 1,095,000</td>
<td>$ 86,750</td>
<td>$ 1,008,250</td>
</tr>
</tbody>
</table>

Step 1: Determine the amount that should be recorded prior to any nonadmission.

Fact #4 and Fact #5: The balance can be accumulated as follows.

Total Receivable:
- Direct Marketing Receivable: $895,000 (Given in Fact #4)
- Bills Receivable: 200,000 (Given in Fact #5)
- Total Premiums Receivable: $1,095,000 (Calculated)

Step 2: Determine if any of the amount that is recorded should be nonadmitted.

Fact #4 and Fact #5: SSAP No. 6, paragraph 9, requires that all uncollected premium balances that are over 90 days past due and all bills receivable installments that are past due be nonadmitted. Paragraph 9 of SSAP No. 6 also requires that all future installments that have been recorded on these policies should be nonadmitted, as well. Therefore, the entire $24,750 (direct marketing) and $62,000 (bills receivable) should be nonadmitted at December 31, 20X1.

Nonadmitted Receivables:

<table>
<thead>
<tr>
<th>Fact #4</th>
<th>Fact #5</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Marketing</td>
<td>Bills Receivable</td>
<td>Total</td>
</tr>
<tr>
<td>Current</td>
<td>$ 7,000</td>
<td>$ 40,500</td>
</tr>
<tr>
<td>30–60 days</td>
<td>6,500</td>
<td></td>
</tr>
<tr>
<td>61–90 days</td>
<td>5,750</td>
<td></td>
</tr>
<tr>
<td>&gt;90 days</td>
<td>5,500</td>
<td>21,500</td>
</tr>
<tr>
<td>Nonadmitted Amount</td>
<td>$ 24,750</td>
<td>$ 62,000</td>
</tr>
</tbody>
</table>

* * * * *
Case Study Answers (Continued)

Problem 4
Using the information in Fact #6 and Fact #7, determine the balance of the amount due on workers’ compensation policies and any related nonadmitted amount by completing the following table. (Hint: Refer to SSAP No. 6 for guidance.)

<table>
<thead>
<tr>
<th>Premiums and Agents Balances in Course of Collection</th>
<th>Total Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workers’ Compensation</td>
<td>$ 5,091,000</td>
<td>$ 265,000</td>
<td>$ 4,826,000</td>
</tr>
</tbody>
</table>

The following information can be obtained from Fact #6 and Fact #7.

Workers’ Compensation Audits

<table>
<thead>
<tr>
<th>Due Date</th>
<th>Asset</th>
<th>Nonadmitted</th>
<th>Admitted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sep 14</td>
<td>$ 165,000</td>
<td>$ 165,000</td>
<td>$ -0-</td>
</tr>
<tr>
<td>Oct 15</td>
<td>112,000</td>
<td></td>
<td>112,000</td>
</tr>
<tr>
<td>Nov 14</td>
<td>100,000</td>
<td></td>
<td>100,000</td>
</tr>
<tr>
<td>Dec 15</td>
<td>154,000</td>
<td></td>
<td>154,000</td>
</tr>
<tr>
<td>Jan 14</td>
<td>100,000</td>
<td></td>
<td>100,000</td>
</tr>
<tr>
<td>Feb 14</td>
<td>75,000</td>
<td></td>
<td>75,000</td>
</tr>
<tr>
<td>Total</td>
<td>$ 706,000</td>
<td>$ 165,000</td>
<td>$ 541,000</td>
</tr>
</tbody>
</table>

Other Workers’ Compensation

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>30–60 days</td>
<td>900,000</td>
<td>900,000</td>
</tr>
<tr>
<td>61–90 days</td>
<td>135,000</td>
<td>135,000</td>
</tr>
<tr>
<td>&gt;90 days</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Total Other Workers’ Comp</td>
<td>4,385,000</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Total Workers’ Compensation  

<table>
<thead>
<tr>
<th></th>
<th>Total Assets</th>
<th>Assets Not Admitted</th>
<th>Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ 5,091,000</td>
<td>$ 265,000</td>
<td>$ 4,826,000</td>
</tr>
</tbody>
</table>

Paragraph 7 of SSAP No. 6, states that the provisions of the policy should govern all audit premium receivables. If the due date of the receivables is not addressed in the policy, the entire amount should be nonadmitted. Based on the information given, the company’s policy provides for a due date of 45 days after the expiration of the policy. Additionally, paragraph 9 of SSAP No. 6 states that uncollected premiums greater than 90 days past due shall be nonadmitted. Therefore, only items that are more than 90 days past due from the due date listed should be nonadmitted.

* * * * *
Background Facts

1. On October 1, 20X1, a news release was issued by the State Department of Insurance stating that Red Insurance Company was in liquidation and that the company was in the process of determining the amount that would be funded by the state guaranty fund. Shortly thereafter, the company received a formal notice from the state guaranty fund association that included specifics regarding the insolvency. However, the notice did not include the exact amount of the insolvency, but rather an estimate based on what had been reviewed by the state team in determining the insolvency. It was noted that the assessments would not be mailed until the following March.

2. The insolvency was estimated at $14.5 million and was to be assessed based on year 20X0 premium volume retrospectively. Using data obtained from an independent organization, ABC estimated that the state guaranty association would ultimately assess the company approximately $155,000. However, based on correspondence with the state, it believes that the assessment can result in premium tax credits of approximately $5,000.

3. The company also sponsors for all of its employees, a defined contribution plan that provides for a 100% match on all contributions made by employees up to 6% (made each pay period by the company), as well as a 25% match on all contributions made by employees in excess of 6% up to 10%. At December 31, 20X1, the vested employer contributions equaled 82.8325% of gross employer contributions. The following information is available for the plan year ending December 31, 20X1.

<table>
<thead>
<tr>
<th>Gross Employee Contributions</th>
<th>Employee Contributions (Equal to 6%)</th>
<th>Employee Contributions (&gt;6% and &lt;10%)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Employee Contributions</td>
<td>220,000</td>
<td>52,000</td>
<td>272,000</td>
</tr>
</tbody>
</table>

* * * * *
Case Study Problems

Problem 1
Should ABC accrue a liability for expected guaranty fund assessments as of December 31, 20X1, under the requirement of SSAP No. 35R? If so, should the premium tax credits be netted against the accrued assessment or recorded as an asset?

Problem 2
Using the information provided in the Background Facts, complete the following table for use in preparing ABC’s annual statement for the year ended December 31, 20X1. (It is recommended that you follow the steps below in completing this problem.)

<table>
<thead>
<tr>
<th>Description</th>
<th>Pension/Postretirement Expense</th>
<th>Liability at 12/31/X1</th>
<th>Prepaid Asset at 12/31/X1</th>
<th>Change in Accounting Principle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defined Contribution Plan</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Defined Contribution Plan

Step 1: Determine the pension expense and prepaid asset to be recorded in year 20X1 based on the employee contributions for the year 20X1. Assume the company makes all contributions immediately so that no contributions payable exist at December 31, 20X1. (Hint: It is necessary to calculate the amount of vested contributions for the year.)

Step 2: Record the appropriate journal entries to record the pension expense and the accrual of the prepaid asset that is necessary at December 31, 20X1.

* * * * *
Case Study Answers

Problem 1
Should ABC accrue a liability for expected guaranty fund assessments as of December 31, 20X1, under the requirement of SSAP No. 35R? If so, should the premium tax credits be netted against the accrued assessment or recorded as an asset?

Yes, SSAP No. 35R requires all companies to record a liability for guaranty fund assessments when the following conditions of SSAP No. 35R are met:

a. Information available prior to issuance of the statutory financial statements indicates that it is probable that an assessment will be imposed.

b. The event obligating an entity to pay has occurred on or before the date of the financial statements.

c. The amount of the assessment can be reasonably estimated.

For ABC Company, all three conditions are met:

1. Formal notice was received,
2. Premiums obligating ABC to the assessment have been written.
3. The assessment can be reasonably estimated.

1. The premium tax credits that the company expects to obtain from the assessment should be recorded as an asset and admitted to the extent the company believes the amount is recoverable. Pursuant to SSAP No. 35R, the liability for accrued assessments shall be established gross of any probable and estimable recoveries from premium tax credits and premium surcharges. When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset shall be recognized for that recovery in an amount that is determined based on current laws, projections of future premium collections or policy surcharges from in-force policies, and as permitted in accordance with subparagraphs 10a, 10b and 10c. Any recognized asset from premium tax credits or policy surcharges shall be re-evaluated regularly to ensure recoverability. Upon expiration, tax credits no longer meet the definition of an asset and shall be written off.

a. For assessments paid before premium tax credits are realized or policy surcharges are collected, an asset results, which represents a receivable for premium tax credits that will be taken and policy surcharges which will be collected in the future. These receivables, to the extent it is probable they will be realized, meet the definition of assets, as specified in SSAP No. 4— Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement. The asset shall be established and reported independent from the liability (not reported net).
b. Assets recognized from accrued liability assessments shall be determined in accordance with the type of guaranty fund assessment as detailed in the following subparagraphs. Assets recognized from accrued liability assessments meet the definition of an asset under SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement.

i. For retrospective-premium-based and loss-based assessments, to the extent that it is probable that accrued liability assessments will result in a recoverable amount in a future period from business currently in-force considering appropriate persistency rates for long-duration contracts, an asset shall be recognized at the time the liability is recorded. (In-force policies do not include expected renewals of short-term contracts.

ii. For prospective-premium-based assessments, the recognition of assets from accrued liability assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. This SSAP requires reporting entities to recognize prospective-based-premium assessments as the premium is written or obligated to be written by the reporting entity. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments shall be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

c. An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.

These amounts, to the extent it is probable they will be realized, meet the definition of assets specified in SSAP No. 4. The following journal entry should be made.

Journal Entry
December 31, 20X1 Taxes, Licenses and Fees 150,000
Premium Tax Credits 5,000
Taxes, Lic. & Fees Due & Accrued 155,000

* Entry to record the assessment resulting from the insolvency of Red Insurance Company.

* * * * *
Case Study Answers (Continued)

Problem 2
Using the information provided in the Background Facts, complete the following table for use in preparing ABC’s Annual Statement for the year ended December 31, 20X1. (It is recommended that you follow the steps below in completing this problem.)

<table>
<thead>
<tr>
<th>Description</th>
<th>Pension/ Postretirement Expense</th>
<th>Liability at 12/31/X1</th>
<th>Prepaid Asset at 12/31/X1</th>
<th>Change in Accounting Principle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defined Contribution Plan</td>
<td>$193,000</td>
<td>-0-</td>
<td>$40,000</td>
<td>-0-</td>
</tr>
</tbody>
</table>

**Defined Contribution Plan**

**Step 1:** Determine the pension expense and prepaid asset to be recorded in year 20X1 based on the employee contributions for the year 20X1. Assume the company makes all contributions immediately so that no contributions payable exist at December 31, 20X1. *(Hint: It is necessary to calculate the amount of vested contributions for the year.)*

According to the provisions of SSAP No. 89 for defined contribution plans, the insurance company shall expense contributions required by the plan over the period in which the employee vests in those contributions. Contributions to plan participants’ accounts made prior to vesting shall be treated as prepaid expenses, and shall be nonadmitted. Therefore, the prepaid asset represents the cash that is paid to the plan that has not been earned yet. For example, to the extent that an employee is 60% vested on the date of payment, 40% of the cash contributed is recorded as a prepaid asset. Mechanically, this process might work much different than this. The trustee of the plan might prepare periodic reports for the plan sponsor that detail the total contributions by type (i.e., vested and non-vested) and adjustments will be made between the expense and prepaid asset on a periodic (e.g., quarterly, monthly, etc.) basis.

Based on the above, the pension expense and prepaid asset to be recorded in year 20X1, based on the employee contributions for the year 20X1, can be calculated as follows.
Case Study Answers (Continued)

<table>
<thead>
<tr>
<th></th>
<th>Employee Contributions (Equal to 6%)</th>
<th>Employee Contributions (&gt;6% and &lt;10%)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Employee Contributions</td>
<td>$220,000</td>
<td>$ 52,000</td>
<td>$272,000</td>
</tr>
<tr>
<td>Employer Match</td>
<td>100%</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>Gross Employer Contribution</td>
<td>$220,000</td>
<td>$ 13,000</td>
<td>$233,000</td>
</tr>
<tr>
<td>Vested Employer Contribution</td>
<td>82.8325%</td>
<td>82.8325%</td>
<td></td>
</tr>
<tr>
<td>Vested Contributions (Pension Expense)</td>
<td>$182,232</td>
<td>$ 10,768</td>
<td>$193,000</td>
</tr>
</tbody>
</table>

Step 2: Record the appropriate journal entries to record the pension expense and the accrual of the prepaid asset that is necessary as of December 31, 20X1.

The accounting for a defined contribution plan follows the same requirements as the defined benefit plan; however, due to the structure of the plan, the accounting is sometimes different. Contributions required to be made by an employer under a defined contribution plan are to be deposited into the plan and the participants’ accounts within a specified time period. Because ABC makes all contributions immediately, no liability exists as of year-end and the following journal entry would be made each pay period.

Journal Entry
Weekly   Pension Expense   XX
Prepaid Asset   XX
Cash   XX

Entry to record employer’s contribution to defined contribution plan.

The following journal entry would be recorded for the company in year 20X1.

Journal Entry
December 31, 20X1   Pension Expense   193,000
Prepaid Asset   40,000
Cash   233,000

Entry to record employer’s contribution to defined contribution plan.

Again, the contributions in the amount of $40,000 that are made by the company and that are not vested are considered prepaid expenses and should be reported as nonadmitted assets.
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