

Statutory Issue Paper No. 46

Accounting for Investments in Subsidiary, Controlled and Affiliated Entities

STATUS

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SUMMARY OF ISSUE

1. Current statutory accounting guidance for investments in subsidiaries, controlled and affiliated entities (hereafter referred to as SCA entities) specifies various valuation bases. The basic guidance is set forth in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures) and the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. GAAP guidance requires consolidation of majority-owned and controlled subsidiaries and the equity method for all other significant investments in subsidiaries and other entities where the reporting entity has the ability to exercise significant influence over operating and financial policies of the investee. Consolidation of majority-owned subsidiaries was rejected in *Issue Paper No. 1—Consolidation of Majority-Owned Subsidiaries*.

2. The purpose of this issue paper is to establish statutory accounting principles for investments in SCA entities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Definitions

3. A parent and subsidiary shall be defined as:

- a. Parent - An entity that directly or indirectly owns and controls the reporting entity.
- b. Subsidiary - An entity that is, directly or indirectly, owned and controlled by the reporting entity.

4. An affiliate shall be defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and partnerships, joint ventures and limited liability companies as defined in *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies* (Issue Paper No. 48). Those entities are accounted for under the guidance provided in Issue Paper No. 48 which requires the equity method for all such investments.

5. Control means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of the investee, whether through the ownership of voting securities, by

contract other than a commercial contract for goods or nonmanagement services, by common management, or otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

6. Investments in SCA entities meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this paper.

Applying the Market Valuation, Statutory Equity and GAAP Equity Methods

7. The admitted investments in SCA entities shall be recorded using a market valuation approach (as described in paragraph 7.a.), or equity methods (as described in paragraph 7.b.).

- a. In order to use the market valuation approach for SCA entities, the following requirements apply:
 - i. Once the reporting entity elects to use the market valuation approach for a particular subsidiary, the reporting entity cannot change the valuation method to another method (e.g., equity) without the approval of the domiciliary commissioner;
 - ii. The subsidiary must be traded on one of the following three major exchanges: (1) the New York Stock Exchange, (2) the American Stock Exchange, or (3) the NASDAQ National exchange;
 - iii. The reporting entity must submit subsidiary information to the Securities Valuation Office (SVO) for their calculation of the subsidiary's market value. Such calculation could result in further discounts in market value above the established base discounts based on ownership percentages detailed below;
 - iv. Ownership percentages for determining the discount rate shall be measured at the holding company level;
 - v. If an investment in a SCA results in an ownership percentage between 10% and 50%, a base discount percentage between 0% and 20% on a sliding scale basis is required;
 - vi. If an investment in a SCA results in an ownership percentage greater than 50% up to and including 80%, a base discount percentage between 20% and 30% on a sliding scale basis is required;
 - vii. If an investment in a SCA results in an ownership percentage greater than 80% up to and including 85%, a minimum base discount percentage of 30% is required. Further, the SCA must have at least two million shares outstanding, with a total market value of at least \$50 million in the public's control; and

- viii. Any ownership percentages exceeding 85% will result in the SCA being recorded on an equity method.
- b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 7.a. or, if the requirements are met, but a reporting entity elects not to use that approach, investments in SCAs shall be recorded as follows:
 - i. Investments in insurance SCA entities shall be recorded based on the underlying statutory equity of the respective entity's financial statements, adjusted for unamortized goodwill as provided for in *Issue Paper No. 68—Business Combinations and Goodwill* (Issue Paper No. 68);
 - ii. Investments in noninsurance SCA entities that have no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded based on the underlying equity of the respective entity's financial statements adjusted to a statutory basis of accounting and the resultant proportionate share of the subsidiary's adjusted surplus, adjusted for unamortized goodwill as provided for in Issue Paper No. 68. Examples include but are not limited to: 1) an insurer and a SCA entity that leases autos, furniture, office equipment, or computer equipment to the insurer, 2) an insurer and a SCA entity that owns real estate property that is leased to the insurer for office space, and 3) an insurer and an SCA entity which holds investments which an insurer could acquire directly (i.e., "look through" investment subsidiary);
 - iii. Investments in noninsurance SCA entities that have significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded based on the audited GAAP equity of the investee. Examples include but are not limited to: 1) a property-casualty or life insurer and a SCA entity that is an oil and gas venture, and 2) a property-casualty or life insurer and a SCA manufacturer.

8. For investments in entities recorded on the underlying audited GAAP equity of the investee the amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in Issue Paper No. 68). The carrying amount of the investment shall be adjusted to recognize the reporting entity's share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. A reporting entity's share of adjustments that are recorded directly to the investee's stockholder's equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded directly to unrealized capital gains and losses on investments.

9. The statutory equity method of accounting, as described in subparagraph 7.b.i., shall be applied by recording an initial investment in an investee at cost, which is defined in Issue Paper No. 68 as the sum of a) any cash payment, b) the fair value of other assets distributed, c) the fair value of any liabilities assumed and d) any direct costs of the acquisition. After the date of acquisition, the initial investment amount shall be adjusted for the amortization of goodwill and to recognize the reporting entity's share of statutory basis earnings or losses and other changes in surplus (including changes in nonadmitted assets) of the investee. This represents the carrying amount of the investment. To apply the equity method of accounting to investees as described in subparagraphs 7.b.ii., certain adjustments shall be made to GAAP (or other basis) income to determine the reporting entity's share of the investee's statutory earnings and losses and other changes in surplus. Further guidance on recording the initial investment (including

goodwill and negative goodwill) and other aspects of applying the equity method are discussed in paragraph 11 below.

10. If the reporting entity is using an equity method, the reporting entity's share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity's share of other changes in the investee's surplus (e.g., the change in the investee's nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. If the reporting entity uses the market valuation approach outlined in paragraph 7.a., changes in that valuation shall be included in unrealized gains and losses. Dividends or distributions received from an investee shall be recognized in investment income when declared to the extent that they are not in excess of the undistributed accumulated earnings attributable to the investee. Dividends or distributions declared in excess of the undistributed accumulated earnings attributable to the investee shall reduce the carrying amount of the investment.

11. The procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting, as applicable, to investments in SCA entities:

- a. A difference between the cost of an investment and the underlying equity in the statutory book value (GAAP book value if a noninsurance SCA entity that has significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates) of the acquired company at the date of acquisition shall be accounted for in accordance with Issue Paper No. 68.
- b. A transaction of an investee of a capital nature that affects the reporting entity's share of stockholders' equity of the investee shall be reflected as an unrealized gain or loss (e.g., where the investee issues additional stock or a new class of stock that impacts the reporting entity's equity ownership in the investee, the reporting entity's recorded investment shall be adjusted to reflect the transaction).
- c. Realized gains or losses on the sale of an investment in an SCA entity shall be recorded in an amount equal to the difference at the time of sale between the selling price and carrying amount of the investment plus any previously recorded unrealized gain or loss.
- d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period.
- e. A reporting entity's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that the equity method was suspended.
- f. When an investee has outstanding cumulative preferred stock, the reporting entity shall compute its share of earnings (losses) after deducting the investee's preferred dividends, whether or not such dividends are declared.

- g. An investment in an SCA entity may fall below the level of ownership described in paragraph 5 from the sale of a portion of an investment by the reporting entity, the sale of additional interests by an investee, or other transactions. The reporting entity shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for an equity method. The earnings or losses that relate to the investment interests retained by the reporting entity and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this subparagraph. However, dividends received by the investor in subsequent periods which exceed the reporting entity's share of earnings for such periods shall be applied as a reduction of the carrying amount of the investment.
- h. An investment in a SCA entity that was previously accounted for under one method may become qualified for use of another method (as described in paragraph 7) because of a change in the level of ownership (i.e., acquisition of additional interests by the reporting entity, acquisition or retirement of interests by the investee, or other transactions, or a change in facts or circumstances (e.g., paragraphs 7.a.i., 7.a.viii.)). When an investment qualifies for use of another method of accounting, the reporting entity shall adopt the new method of accounting and the investment shall be adjusted to reflect the reporting entity's equity interest in the SCA entity under the new method. A corresponding amount shall be recorded as an unrealized gain or loss.
12. A reporting entity that owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent shall reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by a reporting entity, via a down-stream SCA entity, the directly held entity, which owns the parent's shares, shall have its value reduced for the reciprocal ownership.
13. Any parent reporting entity that owns an interest in itself via either direct or indirect ownership of a down-stream affiliate, which in turn owns shares of the parent reporting entity, shall eliminate its proportionate interest in these shares from the valuation of such affiliate.

Impairment

14. When there is a decline in the fair value of an asset owned by an SCA entity that is deemed to be other than temporary, the SCA entity shall write the asset down to fair value.
15. For any decline in the fair value of an investment in a SCA entity that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses. This is consistent with Issue Paper No. 5. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Disclosures

16. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results

of operations of an investee. Disclosures as follow shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:

- a. Financial statements of a reporting entity shall disclose (1) the name of each SCA entity and percentage of ownership of common stock, (2) the accounting policies of the reporting entity with respect to investments in SCA entities and (3) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., goodwill, other nonadmitted assets, market value or discounted market value adjustments) and the accounting treatment of the difference.
- b. For those SCA entities for which a quoted market price is available, the aggregate value of each SCA investment based on the quoted market price and the difference, if any, between the amount at which the investment is carried and the quoted market price shall be disclosed.
- c. Summarized information as to assets, liabilities, and results of operations shall be presented for SCA entities, either individually or in groups.
- d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances shall be disclosed in notes to the financial statements of the reporting entity.

17. Any commitment or contingent commitment to a subsidiary, controlled or affiliated entity shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

18. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment writedown:

- a. A description of the impaired assets and the facts and circumstances leading to the impairment.
- b. The amount of the impairment and how fair value was determined.

DISCUSSION

19. The statutory accounting principles described in the summary conclusion section are consistent with current statutory accounting guidance for investments in SCA entities except as follows:

- a. Current statutory guidance provides reporting entities with five alternatives for the valuation of common stock investments in subsidiary, controlled and affiliated companies: (1) statutory capital and surplus value, (2) net worth excluding nonadmitted assets, (3) net worth based on audited GAAP financial statements, (4) cost adjusted to reflect statutory basis operating results and (5) market value. Selection of the appropriate alternative depends on whether the investee is an insurance company, whether its stock is publicly traded and whether it is a noninsurance company with audited financial statements.
- b. Current statutory accounting guidance allows investments in noninsurance companies to be carried on the audited GAAP equity basis of accounting regardless of the nature of the investee's business operations and its relationship to the investor's business operations. However, in certain circumstances adjustments to reflect the equity in net assets on a statutory basis are required.

- c. Current statutory accounting guidance permits, in certain situations, the recognition of equity in an SCA entity's earnings as income rather than unrealized gains and losses in the reporting entity's financial statements.

20. The statutory accounting principles described in the summary conclusion above reject *Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock* (APB 18), *AICPA Accounting Interpretations, The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretations of APB Opinion No. 18, FASB Technical Bulletin No. 79-19, Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee, FASB Emerging Issues Task Force No. 87-21, Change of Accounting Basis in Master Limited Partnership Transactions, and FASB Emerging Issues Task Force No. 96-16, Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The statutory accounting principles differ from GAAP promulgated as follows:

- a. APB 18 defines control as ownership of over 50% of the outstanding voting stock but states that it may exist with a lesser percentage of ownership. The statutory accounting principles above define control as ownership of 10% or more of the outstanding voting interests.
- b. APB 18 specifies the GAAP equity method of accounting for investments where the investor has the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less and specifies investments of 20% or more should lead to a presumption that an investor has such influence unless there is evidence to the contrary. The statutory accounting principles above specify the statutory equity method, if applicable, for investments of 10% or more of the voting interests unless predominant evidence to the contrary is presented.
- c. APB 18 paragraph 19.c. specifies that under the GAAP equity method, an investor recognizes its share of the earnings or losses of an investee in the income statement as a single amount except for extraordinary items, whereas the statutory accounting principles described in paragraph 10 of the conclusion above specify when amounts shall be included in unrealized gains and losses or investment income.

21. The statutory accounting principles described in paragraph 5 above state control shall be presumed to exist for investees for which 10 percent or more of the voting interest is owned and presumed not to exist for investees for which less than 10 percent of the voting interest is owned. These presumptions can be overcome if there is predominant evidence to the contrary. *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investment in Common Stock an Interpretation of APB Opinion No. 18* (FIN 35), provides guidance on determining when such evidence exists. This issue paper adopts FIN 35 which is included in its entirety in paragraph 29.

22. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

Conservatism

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.

Recognition

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.

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.

23. The statutory accounting principles outlined in the conclusion above require that the investment for noninsurance SCA entities that have no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, and that do not qualify for the market valuation approach outlined in paragraph 7.a. or for which the reporting entity does not elect that approach, shall be recorded based on their underlying equity adjusted to a statutory basis of accounting. In applying the provisions of this issue paper to noninsurance SCA entities, the focus is on the primary operations of the SCA for purposes of determining if it is ancillary to the insurance industry and thereby requiring the application of provisions under subparagraph 7.b.ii. Entities whose primary operations do not provide services to the insurance industry fall under provisions of subparagraph 7.b.iii. It is not the intent of subparagraph 7.b.ii. to apply to an affiliate which has insignificant transactions within the insurance industry. Although this is a subjective rule, a bright line test would not benefit insurers or regulators. This rule requires judgment by the reporting entity in making the determination and provides flexibility to the regulator in analyzing the determination. This is consistent with the objectives of statutory financial reporting which emphasize the measurement of solvency for the protection of policyholders. This is consistent with the concepts of conservatism and recognition described above.

Drafting Notes/Comments

- Business combinations and goodwill are addressed in *Issue Paper No. 68—Business Combinations and Goodwill*.
- CMO special purpose subsidiaries are addressed in *Issue Paper No. 86—Securitization*.
- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Accounting for related party transactions is addressed in *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

24. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides the following guidance:

CHAPTER 6

INVESTMENTS IN SUBSIDIARY, CONTROLLED OR AFFILIATED COMPANIES

Recent times have evidenced an increasing interest on the part of insurers in acquiring or organizing subsidiary companies for expanded corporate activities. Some insurers have done this through the vehicle of a separate holding company, whereas others have accommodated this aspect of their corporate operations and expansion directly within the framework of an existing insurance company.

Increasing interest has also developed within the regulatory agencies of various states, as well as the National Association of Insurance Commissioners (NAIC), with respect to regulation of investments in subsidiaries and the valuation of such investments. State insurance regulators are also concerned about transactions and commitments among parent, subsidiary, controlled, and affiliated companies because of the potential for detrimental impacts upon a particular insurance company.

Within this chapter the term SCA is intended to include parent, subsidiary, controlled, and affiliated companies.

Investments in SCA companies include debt security loans to and preferred and common stock. In general, the accounting for each type of investment is the same as it would be for any other bond, preferred stock, or common stock investment except that there are some special valuation considerations.

Loans to SCA companies are accounted for in the same manner as any other private placement bond. Preferred stock and common stock investments in SCA companies are subject to valuation procedures described below under Valuation.

A subsidiary, controlled, or affiliated company is generally defined in terms of controlling ownership in a company's voting capital stock. Ownership of more than 50% provides undisputed control and 80% or more is sufficient for inclusion in a consolidated U.S. federal income tax return. When 50% or less of the outstanding stock is owned, control is dependent upon the influence that the owner of that block of stock may have on the other holders of outstanding capital stock.

The NAIC instructions for the annual statement define a "person" as an individual, corporation, or any other legal entity. A parent is any person that, directly or indirectly, owns or controls the insurer. A "subsidiary" is any person that is, directly or indirectly, owned or controlled by the insurer. An "affiliate" is any person that is, directly or indirectly, owned or controlled by the same person or by the same group of persons that, directly or indirectly, own or control the insurer. The term affiliate includes parents and subsidiaries. Control and affiliated status shall be presumed to exist if a person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing 10% or more of the voting securities of any other person.

Allowable Investments

The insurance codes and regulations of the various states contain provisions setting forth the existing restrictions on investments in SCA companies by insurance companies and insurance holding companies. In general, a company may not invest, either directly or indirectly, an amount equal to or more than a certain percentage of its assets or its capital and surplus in the common stock of any one corporation. In the case of an investment in an insurance subsidiary, an insurance company may be allowed to invest amounts different from (generally in excess of) the amount allowable for investment in a non-insurance SCA company.

Valuation

The ultimate authority for SCA company valuation basis and procedures, as with other regulatory aspects of insurance operations, resides with the various state insurance departments. In practice, however, most states have come to utilize the provisions of the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* for the valuation of SCA companies. The specific provisions in this manual represent the efforts and recommendations of the NAIC Valuation of Securities (EX4) Task Force, and have been approved by the NAIC.

As noted in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, the principal alternatives for the valuation of common stock investments in SCA companies include:

1. Statutory capital and surplus value for an insurer whose common capital stock is not publicly traded.
2. Net worth of a non-insurance company, adjusted to use only those assets that would constitute admitted assets if owned directly by an insurance company.
3. Net worth of a non-insurance company provided the financial statements have been audited by an independent certified public accountant in accordance with generally accepted auditing standards. Such value shall be adjusted to reflect the equity in net assets on a statutory basis for any down-stream insurance subsidiary. Also, the value is subject to the limitations on goodwill and other intangible assets described below.
4. Cost adjusted to reflect subsequent operating results of the SCA company. Operating results for an insurer should be in accordance with statutory accounting requirements. Operating results of a non-insurance company should be from an independent certified public accountant's audited financial statement prepared in accordance with generally accepted accounting principles. Such value shall be adjusted to reflect the equity in net assets on a statutory basis for any down-stream insurance subsidiary. Any goodwill and other intangible assets are subject to the limitations described below.
5. Market value for a partially owned company that is listed and publicly traded on a national securities exchange or entered in the NASDAQ National Market System.

A valuation basis used shall be used consistently thereafter unless a change is substantiated as reasonable and approved in writing by the NAIC Securities Valuation Office staff.

An insurer which owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent must reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by an insurer, via a down-stream subsidiary, controlled or affiliated company, the directly held company, which owns the parent's shares, will have its value reduced for the reciprocal ownership.

Any parent insurer which owns an interest in itself via either direct or indirect ownership of a down-stream affiliate, which in turn owns shares of the parent insurer, shall eliminate its proportionate interest in these shares from the valuation of such affiliate. The Securities Valuation Office provides a worksheet for both of these reciprocal ownership elimination computations.

Valuation of common stock investments in SCA companies should be computed after provision for the liquidation value for any preferred stock interest in the SCA company.

The alternatives for market valuation of preferred stock investments in SCA companies are generally similar to those for non-SCA preferred shares. However, preferred stocks of wholly owned subsidiaries of insurance companies are valued in the same manner as the common stock of subsidiaries. The current manual should be consulted for the specific valuation basis in effect and the restrictions applicable to each basis.

Valuation of a CMO special purpose subsidiary is discussed in Chapter 1.

The change in value of subsidiaries is reported as part of the unrealized capital gain due to the change in the difference between asset value and cost.

Goodwill and Other Intangible Assets

The following provisions with respect to goodwill and other intangible assets are applicable:

1. Goodwill is defined as the difference between the cost and the net asset value of the subsidiary acquired. If the acquired subsidiary is an insurance company, statutory basis net asset value is used.

2. The statutory admissible amount of goodwill and other intangible assets in aggregate is limited at all times to a maximum of 10% of an insurance company's statutory capital and surplus.
3. For valuation purposes, the period over which goodwill may be written off (amortized to zero) is limited to 10 years.
4. Some special transitional provisions are included for goodwill in connection with subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972.

Reporting on SCA Companies

The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* provisions for the valuation of common stock investments in SCA Companies include requirements for the submission of reports on each SCA company to the Securities Valuation Office.

An original filing is to be made within 30 days after the acquisition or formation of a SCA company.

Thereafter, an annual filing is due not later than April 1 of each year for each directly and indirectly owned SCA company.

Accounting for Subsidiaries

Under statutory insurance accounting principles, the equity method of accounting for a subsidiary is usually limited to asset valuation of the subsidiary. The prevailing practice is to recognize equity in the undistributed income as an unidentified part of the unrealized capital gain due to change in the difference between asset value and cost. The practice of including equity in the undistributed income of subsidiaries in net gain from operations of a life insurer is followed by a minority of life insurers.

Accounting for a subsidiary using the equity method of accounting means that the parent company may recognize, in its income statement, its equity in the income of the subsidiary when it is reported by the subsidiary.

Under prevailing statutory accounting principles and practices, the accounting for a common stock investment in a subsidiary is the same as the accounting for any other common stock. The only difference is in the manner of investment valuation. However, the asset value of the subsidiary is the same under either of the acceptable alternatives described above. Nevertheless, the inclusion of equity in undistributed income of subsidiaries in net gain from operations can lead to certain abuses and, therefore, companies opting for its use should adhere to the following guidelines.

1. An insurer shall not include equity in undistributed income of subsidiaries in net gain from operations for any subsidiary unless it has the ability to exercise significant influence over the operating and financial policies of the subsidiary. That ability is presumed to exist for subsidiaries for which 20 percent or more of voting control is owned and is presumed not to exist for subsidiaries for which less than 20 percent of voting control is owned (unless otherwise defined by the domiciliary state). Both presumptions may be overcome by predominant evidence to the contrary. The ability to exercise influence or control may be indicated in several ways, such as representation on the board of directors, participation in policy-making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency.
2. If an insurer includes in net gain from operations the equity in undistributed income of subsidiaries from any subsidiary, the insurer shall apply that practice to all subsidiaries that meet or exceed the significant influence test of the preceding paragraph.

3. Prior to changing the method for any subsidiary, the insurer shall first obtain approval from its domiciliary regulatory authority.
4. The filing of such separate supplemental information as may be required to disclose the equity in the undistributed income of the subsidiary.

25. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides similar guidance as above with the exception that it does not allow a reporting entity the option of including the equity in undistributed net income of subsidiaries in operations.

26. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* provides the following guidance in Section 5, Procedures for Valuing Common Stocks and Stock Warrants:

(B) Common Stocks of Subsidiary, Controlled or Affiliated Companies.

(a) Subject to the requirements of Section 5(B)(b), shares of common stock of an insurance or non-insurance company owned by an insurer, which insurer is either the parent of, or under direct or indirect common control, or affiliated with the issuer of such stock, shall have an Association Value determined on the basis of one of the following bases, provided, however, that such basis and the resultant value are reasonable and appropriate in the circumstances, and provided further that an insurer shall not be required to value the common stock of all its subsidiary, controlled and affiliated companies on the same basis. All of the following valuation bases shall be subject to an adjustment for any reciprocal share holdings as required by Section 5(B)(b)(x).

- (i) the value of only such of the assets of such company as would constitute lawful investments for the insurer if acquired or held directly by the insurer; or
- (ii) subject to the limitations imposed herein and under Section 5(B)(b)(ix), hereunder, the shares of a non-insurance company may be valued on the basis of the net worth of such company determined in accordance with generally accepted accounting principles, as of the end of its most recent fiscal year, provided, subject to (b) hereof, that the financial statements of the company for its most recent fiscal year have been audited by an independent certified public accountant in accordance with generally accepted auditing standards (the common stock of an insurance company may not be valued under this section); or

(If the common stock of a subsidiary, controlled or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section, such value shall be adjusted to reflect the equity in net assets on a statutory basis with respect to the shares of any underlying insurance company subsidiaries and to reflect the market value appropriately discounted for any underlying company valued using option 5(B)(a)(v)); or

- (iii) book value, defined as in Section 5(A)(c), provided, however, that the common stock of a non-insurance company may not be valued on the basis of this subsection (iii); or
- (iv) subject to the limitations imposed under Section 5(B)(b)(ix), hereunder, a value equal to the cost of the common stock of such company, provided such value is determined and adjusted to reflect subsequent operating results (1) in the case of insurance companies in accordance with statutory accounting requirements, and (2) for other than insurance companies from an independent certified public accountant audited financial statement prepared in accordance with generally accepted accounting principles; or

(If the common stock of a subsidiary, controlled, or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section the adjustment “to reflect subsequent operating results” shall include net changes in all the capital and surplus accounts on a statutory basis with respect to the shares of any underlying insurance company subsidiaries); or

- (v) the market value of the common stock of the company, if the stock is listed on a national securities exchange or entered in the NASDAQ System (other securities traded over-the-counter will not be considered under this section); The share price will be discounted for legal restrictions requiring a registration before any sale may be made and the size and depth of the trading activity in relation to the publicly traded shares outstanding; or
 - (vi) See Section 3(C)(2) for valuation of preferred stocks of wholly-owned subsidiaries of insurance companies.
 - (vii) In applying the provisions of this section to insurers organized in foreign countries, the provisions of Subsection (i) of this section will be applied (based on financial statements for the most recent fiscal year as prepared by an independent certified public accountant), except where special considerations indicate other treatment would be appropriate; or
 - (viii) Any other value which the insurer can substantiate to the satisfaction of the SVO staff as being a reasonable value.
- (b)
- (i) The provisions of Section 5(B) shall in all cases be subject to the procedures prescribed by state insurance department practices or laws concerning the use of acquisition cost or any other basis for the valuation of common stocks of subsidiary, controlled or affiliated companies.
 - (ii) Not later than April 1 of each year, every insurer shall file with the SVO staff, on the appropriate form prescribed by the Valuation of Securities Task Force, (Task Force), relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for each of its subsidiary, controlled or affiliated companies reported upon in the Annual Statement for the preceding year.
 - (iii) Within thirty (30) days after the acquisition or formation of a subsidiary, controlled or affiliated company, every insurer shall file with the SVO staff, on the appropriate form prescribed by the Task Force, relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for such company.
 - (iv) A valuation basis used for a subsidiary, controlled or affiliated company shall thereafter be consistently applied unless a change is substantiated as reasonable and on that basis is approved in writing by the SVO staff.
 - (v) If a subsidiary, controlled or affiliated company is valued on the basis of Section 5(B)(a)(ii) and its books are not audited at the time the valuation is included in the insurer’s annual statement, the insurer shall thereafter report to the SVO staff and explain the difference, if any, between the value of such company as reported in the annual statement and the value as determined by audit. Such report and explanation shall be made as soon as possible following such audit.
 - (vi) If the common stock of any subsidiary, controlled or affiliated company is valued other than on the basis of market value as defined in Section 5(B)(a)(v), there shall be deducted from the otherwise determined value a sum equal to the value claimed

for any of its assets which would not constitute admitted assets for the insurer if held directly by the insurer, if such assets

- (1) are held by the company but used, under a lease arrangement or otherwise, significantly in the conduct of the insurer's business; or
 - (2) were acquired from or purchased for the benefit or use of the insurer by the company under circumstances that, in the opinion of the SVO staff, support a finding that the primary purpose of such acquisition was the evasion or avoidance of state laws or regulations pertaining to non-admitted assets.
- (vii) The SVO staff may require filings to be by the use of such forms as it prescribes and may request such supplemental information as it deems desirable. The SVO staff shall utilize the information in such filings and supplemental information to make its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value and shall notify the insurer and its state of domicile of such determination.
- (viii) In making its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value for each subsidiary, controlled or affiliated company, the SVO staff shall, among other relevant factors, take into account the following:
- (1) the effect of subsidiary valuation on the solvency of the insurer (it being the intent hereof that doubt as to reasonableness shall be resolved by selection of a conservative valuation standard in those circumstances where the higher valuation would make an otherwise insolvent insurer appear solvent);
 - (2) if the valuation involves acquisition cost, the degree of affiliation between the insurer and the party from whom such company was acquired, the form of the consideration (cash, property, or the exchange of stock), evidence of ability to recover cost, and whether the acquisition price represented the result of arms-length dealing between economic equals; and,
 - (3) whether revaluation of assets is involved, and the reasonableness thereof.
- (ix) With respect to values determined under Sections 5(B)(a)(ii) and 5(B)(a)(iv), amounts attributable to goodwill, as defined in (a) hereunder, and other intangibles shall not, except as provided in (b), hereunder, in the aggregate (of all direct and indirect subsidiaries), exceed, (either initially upon the acquisition of a subsidiary, or thereafter), 10% of the capital and surplus of an insurer, as reported in its next preceding Annual Statement. Such amounts shall, except as provided in (c) and (d), hereunder, be written off over a period not in excess of 10 years, commencing in all cases with the accounting period ending December 31, 1972. (For instructions as to the manner of write-off in certain cases, see (e) and (f), hereunder.)
- (a) For the purposes of this section, "goodwill" shall be defined as the amount arising at a given point in time, resulting from an arms-length transaction involving the transfer of a business, representing the difference between the value of the consideration given and the net asset value of the properties acquired on the books of the predecessor company. With respect to insurance company subsidiaries "net asset value" shall mean statutory or annual statement book value. In addition any asset account representing the present value of future contractual or estimated revenue streams will also be deemed goodwill and subject to the limitations of this section.
 - (b) The limitation with respect to the permissible amount of goodwill shall not apply in the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972.

- (c) The write-off period for goodwill in the cases of subsidiaries described in (b), above, may, upon application to and approval by the Securities Valuation Office, be extended to not in excess of 20 years.
- (d) Where warranted in exceptional cases, the Securities Valuation Office may require a more rapid write-off of goodwill than is otherwise provided in this section.
- (e) In the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972, an insurer may charge the write-off of goodwill to the common stock component of the Asset Valuation Reserve, where such a reserve exists.
- (f) In the cases of subsidiaries acquired after June 14, 1972, amounts of goodwill in excess of 10% of an insurer's capital and surplus shall be written off immediately by a direct charge to surplus.
- (x) An insurer which owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent must reduce the value of such shares for the reciprocal ownership. When such shares are owned directly their value, as determined under any option of Section 5(B)(a), will be reduced by a percentage amount calculated by dividing the common stockholders equity of the owning insurer by the common stockholders equity of the parent whose shares are owned. A filing with the Securities Valuation Office under the provisions of Section 5(B)(b)(ii) is required. If the shares of the parent are owned indirectly by an insurer, via a downstream subsidiary, controlled, or affiliated (SCA) company, the value of the directly held SCA company which statutorily consolidates the SCA company, which owns the parent shares, into its annual statement will have its value reduced by an amount equal to the common stockholders equity of the SCA owner divided by the common stockholders equity of the parent company whose shares are owned, multiplied times the statement value of the parents shares on the books of the SCA company owning such shares.

Any parent insurer, which owns an interest in itself, i.e., treasury stock, via either direct or indirect ownership of a downstream insurance or non-insurance subsidiary controlled or affiliated (SCA) company which in turn owns shares of the parent insurer, shall eliminate its proportionate interest in these shares from the statutory value of such SCA company as determined under the provision of Section 5(B)(a) if owned directly or from the statutory value of the direct SCA company which consolidates on either a GAAP or Statutory accounting basis the results of the SCA company owning the parent insurer's shares.

- (xi) The SVO staff may question the reasonableness and appropriateness of the valuation basis or the resultant value for any subsidiary, controlled or affiliated company, and if, after giving notice and opportunity to be heard, the staff determines that such basis or value is not, under the specific circumstances of the case, reasonable and appropriate, the staff shall report such determination to the insurer and to the insurance department of the state in which the insurer is domiciled and may recommend to such department either an adjustment in valuation or the use of one of the other specified bases of valuation. The SVO staff shall notify the insurance departments of all states of any such determinations or redetermination of value. The SVO staff shall also report such findings of value to the Task Force.

27. The NAIC Annual Statement Instructions (Annual Statement Instructions) provide the following guidance:

SCHEDULE D PART 6 - SECTION 1
 VALUATION OF SHARES OF
 SUBSIDIARY, CONTROLLED OR AFFILIATED COMPANIES

If an insurer has any common stock or preferred stock reported for any of the following required groups, categories, or subcategories it shall report the subtotal amount of the corresponding group, category or subcategory, with the specified subtotal line number appearing in the same manner and location as the pre-printed total or grand total line and number.

Group or Category	Line Number
Preferred Stock:	
Parent	0199999
U.S. Property & Casualty Insurer	0299999
U.S. Life Insurer	0399999
Alien Insurer	0499999
Non-Insurer Which Controls Insurer	0599999
*Investment Subsidiary	0699999
Other Affiliates	0799999
Subtotal - Preferred Stock	0899999
Common Stock:	
Parent	0999999
U.S. Property & Casualty Insurer	1099999
U.S. Life Insurer	1199999
Alien Insurer	1299999
Non-Insurer Which Controls Insurer	1399999
Investment Subsidiary	1499999
Other Affiliates	1599999
Subtotal - Common Stock	1699999
Total - Preferred and Common Stock	1799999

*NOTE: Investment Subsidiary shall mean any subsidiary, other than a holding company, engaged or organized primarily in the ownership and management of investments for the insurer. An investment subsidiary shall not include any broker dealer or a money management fund managing funds other than those of the parent company. The following criteria is applicable:

1. 95% or more of the investment subsidiary’s assets would qualify as admitted assets;
2. The investment subsidiary’s total liabilities are 5% or less of total assets;
3. Combining the pro-rata ownership shares of the assets of all the investment subsidiaries with the owning insurer’s assets does not violate any state requirements concerning diversification of investments or limitations on investments in a single entity; and
4. The investment subsidiary’s statement value does not exceed the imputed value on a statutory accounting basis. If the statement value does exceed the imputed statutory value, the insurer may either non-admit the excess or categorize such subsidiary in the “All Other Affiliates” category.

Column 1 - Description

List the preferred and common stock for each subsidiary, controlled, or affiliated (SCA) company, as defined in the General Section of the Annual Statement Instructions.

Description of preferred and common stock payable in a foreign currency should include the purchase price in that foreign currency.

All CUSIP numbers must conform to those published by the Securities Valuation Office (SVO). CUSIP numbers for all purchased publicly issued securities are available from the broker’s confirmation or the certificate and will be identical to those used by the SVO. For

private placement securities NAIC has created a special number called a PPN to be assigned by the Standard and Poor's CUSP Bureau.

NAIC numbers for privately placed (unregistered) securities (PPNs) owned prior to December 31, 1988, were made available to all insurers by the SVO in a special publication in early 1989 and are published in the December 31, 1989, and all subsequent versions of the Valuations of Securities manual. Number assignments for privately issued securities purchased subsequent to December 31, 1988, will be made by a special NAIC facility at the Standard and Poor's CUSP Bureau. Call the SVO (212 285-0010) for details. Such a number must be obtained and provided to the SVO before any privately issued security in can be listed in the Valuations of Securities manual.

Column 3 - NAIC Valuation Method

Include the NAIC valuation method as detailed in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*.

Any NAIC Valuation Method which has not been approved by the filing of a SUB 1 form with the NAIC Securities Valuation Office and which is entered by the insurer under its own judgment shall have the letter "Z" appended to the method designation.

Column 4 - Do Insurer's Admitted Assets Include Intangible Assets Connected with Holding of Such Company's Stock?

State whether the admitted assets shown by the insurer in this statement include, through the carrying value of stock of the SCA Company valued under the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, include intangible assets arising out of the purchase of such stock by the insurer or the purchase by the SCA Company of the stock of a lower-tier company controlled by the SCA Company. For purposes of this question, intangible assets at purchase shall be defined as the excess of the purchase price over the tangible net worth (total assets less intangible assets and total liabilities) represented by such shares as recorded, immediately prior to the date of purchase, on the books of the company whose stock was purchased.

Column 5 - If Yes, Amount of Stock Intangible Assets

If the answer in Column 4 is "Yes", give the amount of intangible assets involved. The intangible assets shown for the SCA Company should include any intangible assets which are included in the SCA Company's carrying value of the stock of one or more lower-tier companies controlled by the SCA Company. In all cases, the current intangible assets equal the intangible assets at purchase, as defined above, minus any write-off thereof between the date of purchase and the statement date. If the answer in Column 4 is "No", state "N/A" in Column 5.

Columns 7 and 8 - Stock of Such Company Owned by Insurer on Statement Date

State the number of shares of stock of the SCA Company owned by the insurer on the statement date, and the percent owned of the outstanding shares of the same class.

SCHEDULE D - PART 6 - SECTION 2

If an insurer has any common or preferred stock reported for any of the following required groups, categories, or subcategories, it shall report the subtotal amount of the corresponding group, category or subcategory, with the specified subtotal line number appearing in the same manner and location as the pre-printed total or grand total line and number.

Group or Category	Line Number
Preferred Stock	0199999
Common Stock	0299999
Total - Preferred and Common Stock	0399999

Column 1 - Name of Lower-Tier Company

List each company which is controlled by an SCA Company by means of a holding of a controlling block of the outstanding stock, either directly or through one or more intervening companies which are also so controlled. Do not include companies which are themselves SCA Companies listed in Section 1.

Column 2 - Name of Company Listed in Section 1 Which Controls Lower-Tier Company

If more than one SCA Company controls the lower-tier company, list each SCA Company and complete Columns 3 through 5 separately for each.

Column 3 - Amount of Intangible Assets Included in Amount Shown in Column 5, Section 1

As explained in the instructions for Section 1, this amount is based on the intangible assets at purchase of the stock of the lower-tier company, reduced by any subsequent write-off. The amount shown is also based on the proportionate ownership of the lower-tier company by the reporting insurer.

Columns 4 and 5 - Stock in Lower-Tier Company Owned Indirectly by Insurer on Statement Date

These figures represent the proportionate ownership by the reporting insurer through the particular SCA Company.

Generally Accepted Accounting Principles

28. APB 18 requires the equity method of accounting when the investors' voting stock gives it the ability to exercise significant influence over operating and financial policies even though the investor holds 50% or less of the voting stock. Otherwise the cost method is required. APB 18 also requires disclosure of subsidiary information if significant in relation to investor's financial position or results of operations. Rather than repeat APB 18 in the Relevant GAAP Literature Section of this paper a summary from The Current Text - Section I82 - Investments: Equity Method is provided.

INVESTMENTS: EQUITY METHOD

SECTION I82

Sources: APB Opinion 18; AICPA Interpretations of APB Opinion 18; FASB Statement 58; FASB Statement 94; FASB Statement 109; FASB Statement 115; FASB Interpretation 35; FASB Technical Bulletin 79-19

Summary

The equity method is a method of accounting for investments. An investor using the equity method initially records an investment at cost. Subsequently, the carrying amount of the investment is increased to reflect the investor's share of income of the investee and is reduced to reflect the investor's share of losses of the investee or dividends received from the investee. The investor's share of the income or losses of the investee is included in the investor's net income as the investee reports them. Adjustments similar to those made in preparing consolidated financial statements, such as elimination of intercompany gains and losses and amortization of the difference between cost and underlying equity in net assets, also are applicable to the equity method. Under the equity method, an investment in common stock is generally shown in the balance sheet of an investor as a single amount. Likewise, an investor's share of earnings or losses from its investment is ordinarily shown in its income statement as a single amount.

This section requires that an investor use the equity method to account for investments in corporate joint ventures. This section also requires use of the equity method to account for other investments in common stock if the investor has the ability to exercise significant influence over operating and financial policies of the investee enterprise. That ability is presumed to exist for investments of 20 percent or more and is presumed not to exist for investments of less than 20 percent; both presumptions may be overcome by predominant evidence to the contrary.

29. *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock* and *Interpretation of APB Opinion No. 18*, provides the following guidance:

INTRODUCTION

1. The Board has been asked to clarify the provisions of *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock*, regarding application of that method to investments of 50 percent or less of the voting stock of an investee enterprise (other than a corporate joint venture).

INTERPRETATION

2. Opinion 18 requires that the equity method of accounting be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee. The presumptions in paragraph 17 of Opinion 18 are intended to provide a reasonable degree of uniformity in applying the equity method. The presumptions can be overcome by predominant evidence to the contrary.

3. Evidence that an investor owning 20 percent or more of the voting stock of an investee may be unable to exercise significant influence over the investee's operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies stands until overcome by predominant evidence to the contrary.¹

¹ Subject to the limitations on the use of the equity method identified in footnote 4 of Opinion 18. That footnote states that conditions that represent limitations on consolidation shall be applied as limitations to the use of the equity method.

4. Examples of indications that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include:

- a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence.
- b. The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder.²

² See paragraph 9 of this Interpretation for a discussion of such agreements.

- c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.
- d. The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.³

³ The subject of inability to obtain financial information also is addressed in the American Institute of Certified Public Accountants' Codification of Statements on Auditing Standards, AU Section 332, "Evidential Matter for Long-Term Investments," paragraph 9.

- e. The investor tries and fails to obtain representation on the investee's board of directors.

This list is illustrative and is not all-inclusive. None of the individual circumstances is necessarily conclusive that the investor is unable to exercise significant influence over the investee's operating and financial policies. However, if any of these or similar circumstances exists, an investor with ownership of 20 percent or more shall evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

EFFECTIVE DATE AND TRANSITION

5. The provisions of this Interpretation shall be effective for fiscal years beginning after June 15, 1981, with earlier application encouraged. Changes in the method of accounting for investments required by this Interpretation shall be recorded in accordance with paragraphs 19 (1) and (m) of Opinion 18, which provide that:

- a. If the investor discontinues application of the equity method, the earnings and losses of the investee that were previously accrued shall remain as part of the carrying amount of the investment. The carrying amount of the investment shall not be adjusted retroactively.
- b. If the investor begins applying the equity method, the investment, results of operations (current and prior periods presented), and retained earnings of the investor shall be adjusted retroactively.

This Interpretation was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board following submission to the Financial Accounting Standards Advisory Council.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 6, *Investments in Subsidiary, Controlled and Affiliated Companies*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 6, *Investments in Subsidiary, Controlled and Affiliated Companies*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 5, *Procedures for Valuing Common Stocks and Stock Warrants*
- *Issue Paper No. 1—Consolidation of Majority-Owned Subsidiaries*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*
- *Issue Paper No. 68—Business Combinations and Goodwill*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock*
- *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock an Interpretation of APB Opinion No. 18*
- *FASB Technical Bulletin 79-19, Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee*
- *FASB Emerging Issues Task Force No. 87-21, Change of Accounting Basis in Master Limited Partnership Transactions*
- *FASB Emerging Issues Task Force No. 96-16, Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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