

Statutory Issue Paper No. 128

Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

STATUS

Finalized June 12, 2006

Current Authoritative Guidance for Settlement Requirements for Intercompany Transactions: SSAP No. 25

This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 96

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Current statutory guidance relating to intercompany transactions is included in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25). SSAP No. 25 does not explicitly impose an aging threshold for admission of loans and advances to related parties outstanding as of the reporting date. In addition, no explicit aging threshold exists for admission of receivables associated with transactions for services provided to related parties outstanding as of the reporting date.
2. While SSAP No. 25 established statutory accounting principles and disclosure requirements for related party transactions, the purpose of this issue paper is to amend this guidance to include an explicit aging threshold for admissibility for these transactions. A threshold will further clarify the current requirement in paragraph 6 of SSAP No. 25 regarding the maintenance of accounts “on a current basis.” In addition, a threshold provides explicit parameters in which to apply the fair and reasonable standard established by Appendix A-440, which is referenced in paragraph 15, of SSAP No. 25.

SUMMARY CONCLUSION

3. This issue paper shall amend SSAP No. 25 to insert the following additional paragraph numbered six and to renumber the remaining paragraphs of the statement:

Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted. If the due date is not addressed by the written agreement any uncollected receivable is nonadmitted.

Disclosures

4. This issue paper requires no additional disclosures.

Effective Date and Transition

5. After adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The initial draft of the SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note

that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for reporting periods beginning on or after January 1, 2007.

DISCUSSION

6. This issue paper will help ensure transactions between the reporting entity and its parent, affiliates and related parties, are current. This inclusion of a 90-day rule is consistent with other statements of statutory accounting principles.

Drafting Notes/Comments

7. None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. The concept of an aging threshold for admissibility (i.e., 90-day rule) is contained in *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers* (SSAP No. 6) as follows:

9. Nonadmitted amounts are determined as follows:
 - a. Uncollected Premium—To the extent that there is no related unearned premium, any uncollected premium balances which 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;
 - b. Bills Receivable—Bills receivable shall be nonadmitted if either of the following conditions are present:
 - i. If any installment is past due, the entire bills receivable balance from that policy is nonadmitted; or
 - ii. 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.
 - c. Agents' Balances—The uncollected agent's receivable on a policy by policy basis which is over ninety days due shall be nonadmitted regardless of any unearned premium;
 - i. If amounts are both payable to and receivable from an agent on the same underlying policy, and the contractual agreements between the agent and the reporting entity permit offsetting, the nonadmitted portion of amounts due from that agent shall not be greater than the net balance due, by agent;

If reconciling items between a reporting entity's account and an agent's account are over ninety days due, the amounts shall be nonadmitted.

9. This aging concept is also include in *SSAP No. 10—Income Taxes* (SSAP No. 10) as follows:

13. Amounts owed to a reporting entity pursuant to a recognized transaction shall be treated as a loan or advance, and nonadmitted, pursuant to SSAP No. 25, to the extent that the

recoverable is not settled within 90 days of the filing of a consolidated income tax return, or where a refund is due the reporting entity's parent, within 90 days of the receipt of such refund.

Generally Accepted Accounting Principles

10. GAAP does not address the concept of admitted assets.

RELEVANT LITERATURE

Statutory Accounting

- *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*

Generally Accepted Accounting Principles

- None

State Regulations

- No additional guidance obtained from state statutes or regulations.

EXHIBIT A: Illustration of Marked Changes to Amended SSAP No. 25

The following depicts the amendment made by this issue paper as “marked changes”: (new text underlined):

SCOPE OF STATEMENT

1. 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. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny. This statement establishes statutory accounting principles and disclosure requirements for related party transactions.

SUMMARY CONCLUSION

2. Related parties are defined as entities that have common interests as a result of ownership, control, affiliation or by contract. Related parties shall include but are not limited to the following:

- a. Affiliates of the reporting entity, as defined in paragraph 3;
- b. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;
- c. The principal owners of the reporting entity;
- d. The management of the reporting entity, its parent or affiliates (including directors);
- e. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;
- f. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;
- g. A party which can, directly or indirectly, significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;
- h. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;
- i. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and
- j. A U.S. manager of a U.S. Branch or any affiliate of the U.S. manager of a U.S. Branch.

3. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48). Those entities are accounted for under the

guidance provided in SSAP No. 48, which requires an equity method for all such investments. 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 reporting entity.

4. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) 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.

5. Control as defined in paragraph 4 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. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

- 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 an entity and there is an unaffiliated individual or group of investors who own a controlling interest.
- c. An entity where the insurer has given up participation rights¹ as a shareholder to the investee.

6. Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted. If the due date is not addressed by the written agreement any uncollected receivable is nonadmitted.

Related Party Loans

~~6.7.~~ Loans or advances (including debt, public or private) 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. An affiliate's ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or

¹ The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in *EITF 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 term "participating rights" shall be used consistent with the discussion of substantive participating rights in the EITF.

advances shall be made periodically. If, in accordance with *SSAP No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (SSAP No. 5), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

~~7-8.~~ Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm's-length transactions as defined in paragraph 10. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 10 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

~~8-9.~~ Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month's payment shall be nonadmitted assets.

~~9-10.~~ Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 6. Indirect loans or advances made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans or advances to related parties as described in paragraphs 7 and 8.

Transactions Involving the Exchange of Assets or Liabilities

~~10-11.~~ An arm's-length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell, or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction is defined as an arm's-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., "permanence." The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed in the case of the original transaction. Subsequent events are addressed in *SSAP No. 9—Subsequent Events*. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

~~11-12.~~ In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

- a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

- b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;
- c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;
- d. Whether limitations or restrictions exist on the buyer's use of the financial interest transferred or on the profits arising from it;
- e. Whether there is retention of effective control of the financial interest by the seller.

~~12.~~13. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting, but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at fair value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting, and therefore, the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (fair value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

~~13.~~14. A non-economic transaction is defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 12, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

~~14.~~15. When accounting for a specific transaction, reporting entities shall use the following valuation methods:

- a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 12);
- b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;
- c. Non-economic transactions between a reporting entity and an entity that has 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 at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified;
- d. Transactions which are designed to avoid statutory accounting practices shall be reported as if the reporting entity continued to own the assets or to be obligated for a liability directly instead of through a subsidiary.

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.

Transactions Involving Services

~~15~~16. Transactions involving services between related parties can take a variety of different forms. One of the significant factors as to whether these transactions will be deemed to be arm's length is the amount charged for such services. In general, amounts charged for services are based either on current market rates or on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party's books and expense on the second party's books, and therefore, do not lend themselves to the mere inflation of surplus. These arrangements are generally subject to regulatory approval.

~~16~~17. 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, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See *SSAP No. 70—Allocation of Expenses* for additional discussion regarding the allocation of expenses.

Disclosures

~~17~~18. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm's-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

- a. The nature of the relationships involved;
- b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, any non-insurance transactions which involve less than 1/2 of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:
 - i. Date of transaction;
 - ii. Explanation of transaction;
 - iii. Name of reporting entity;
 - iv. Name of affiliate;
 - v. Description of assets received by reporting entity;
 - vi. Statement value of assets received by reporting entity;
 - vii. Description of assets transferred by reporting entity; and

- viii. Statement value of assets transferred by reporting entity.
- c. The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;
- d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;
- e. Any guarantees or undertakings, written or otherwise, for the benefit of an affiliate or related party which result in a material contingent exposure of the reporting entity's or any related party's assets or liabilities;
- f. A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements, and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity's financial statements;
- g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises; and
- h. The amount deducted from the value of an upstream intermediate entity or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated entity, in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, "Procedures for Valuing Common Stocks and Stock Warrants."

~~18-19.~~ Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

~~19-20.~~ This statement adopts *FASB Statement No. 57, Related Party Disclosures* with a modification to paragraph 2 to require disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business.

~~20-21.~~ This statement rejects *AICPA Accounting Interpretations, Business Combinations: Accounting Interpretations of APB Opinion No. 16, #39, "Transfers and Exchanges Between Companies Under Common Control"*.

Effective Date and Transition

~~21-22.~~ This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

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