Statutory Accounting Principles (E) Working Group

Hearing Agenda

August 10, 2022
10:00 a.m. – Noon (Pacific)

ROLL CALL

Dale Bruggeman, Chair
Ohio
Judy Weaver
Michigan
Kevin Clark/Carrie Mears, Co-Vice Chairs
Iowa
Doug Bartlett/ Pat Gosselin
New Hampshire
Sheila Travis
Alabama
Bob Kasinow
New York
Kim Hudson
California
Melissa Greiner/Matt Milford
Pennsylvania
William Arfanis/Michael Estabrook
Connecticut
Jamie Walker
Texas
Rylynn Brown
Delaware
Doug Stolte/David Smith
Virginia
Eric Moser
Illinois
Amy Malm/Elena Vetrina
Wisconsin
Stewart Guerin/Melissa Gibson
Louisiana

NAIC Support Staff: Julie Gann, Robin Marcotte, Jim Pinegar, Jake Stultz, Jason Farr

Note: This meeting will be recorded for subsequent use.

REVIEW AND ADOPTION OF MINUTES

1. Spring National Meeting (Attachment 1)
2. May 24, 2022 (Attachment 2)
3. July 18, 2022 (Attachment 3)

The Statutory Accounting Principles (E) Working Group met in regulator-to-regulator sessions on August 4, 2022. This regulator session was pursuant to the NAIC Open Meetings Policy paragraph 3 (discussion of specific companies, entities or individuals) and paragraph 6 (consultations with NAIC staff related to NAIC technical guidance of the Accounting Practices and Procedures Manual). No actions were taken during these meetings as the discussion previewed the Summer National Meeting agendas and discussed other items with NAIC staff pursuant to the NAIC open meeting policy.

REVIEW AND ADOPTION of NON-CONTESTED POSITIONS

The Working Group may individually discuss the following items, or may consider adoption in a single motion:

1. Ref #2022-04: ASU 2021-10, Government Assistance
2. Ref #2022-05: ASU 2021-09, Leases, Discount Rate for Lessees
3. Ref #2022-06: ASU 2021-07, Compensation – Stock Compensation
4. Ref #2022-07: ASU 2021-08, Business Combinations

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Summary:
On April 4, the Working Group exposed revisions to SSAP No. 24—Discontinued Operations and Unusual or Infrequent Items to incorporate certain disclosures from Accounting Standards Update (ASU) 2021-10, Government Assistance, Disclosures by Business Entities about Government Assistance, supplementing existing disclosures to require that if a reporting entity experiences unusual or infrequent item and those items is as a result of government assistance, the transaction will require identification as well as a description of the terms and provisions of the assistance received. The agenda item recommended the disclosures apply to all entity types, which was a minor modification from the ASU, which excludes not for profit entities or benefit plans. As a final note, existing disclosures for unusual/infrequent items (captured in financial statement note #21) already contains the requirement to identify the specific line items which have been affected by the events or transactions considered to be unusual and/or infrequent - thus that specific portion of ASU 2021-10 was not proposed for inclusion.

Interested Parties’ Comments:
Interested parties have no comment on this item.

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed SAP clarifications to SSAP No. 24—Discontinued Operations and Unusual or Infrequent Items to incorporate certain disclosures from ASU 2021-10. The proposed additions will supplement existing disclosures to require that if the unusual or infrequent item is as the result of government assistance, the transaction will require identification as well as a description of the terms and provisions of the assistance received.

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2022-05 SSAP No. 22R (Jake) | ASU 2021-09, Leases, Discount Rate for Lessees | 5 – Agenda Item | No Comment | IP-2 |

Summary:
On April 4, the Working Group exposed revisions to SSAP No. 22R—Leases to reject ASU 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities for statutory accounting. ASU 2021-09 was issued as part of FASB’s post-implementation review to address issues found during the implementation of the new lease guidance from ASU 2016-02, Leases (Topic 842). Topic 842 generally requires the capitalization of leases, which is calculated by discounting the lease payments utilizing the implicit rate in the lease, or if not determinable, the lessee’s incremental borrowing rate. However, the standard also provides nonpublic entities with a practical expedient, permitting the use of a risk-free rate (e.g., U.S. Treasury Rate) for the capitalization calculation. The amendments in ASU 2021-09 state that when the rate implicit in the lease is readily determinable for any individual lease, that the lessee should use that rate (rather than a risk-free rate or an incremental borrowing rate), regardless of whether it has made the risk-free rate election.

The guidance provided in this ASU is specific to the financing lease treatment under U.S. GAAP, and since SSAP No. 22R—Leases requires nearly all leases to be treated as operating leases for statutory accounting, adoption of this guidance would be unnecessary.

Interested Parties’ Comments:
Interested parties have no comment on this item.
Recommended Action:
NAIC staff recommends the Working Group adopt the exposed SAP clarifications which reject ASU 2021-09 in SSAP No. 22R—Leases. As statutory accounting requires most leases to be classified as operating leases, this U.S. GAAP guidance is not necessary.

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Summary:
On April 4, the Working Group exposed revisions to SSAP No. 104R—Share-Based Payments to incorporate a practical expedient in ASU 2021-07, Compensation – Stock Compensation (Topic 718), Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards. The amendments in ASU 2021-07 provides nonpublic companies with a practical expedient to determine fair value for share-based payments. When equity share options or similar instruments are granted in a share-based payment transaction, the fair value (which is used to determine expense recognition at inception and during any subsequent award modification) is estimated using an option-pricing model valuation technique.

In terms of option-priced models, the Black-Scholes-Merton model is considered to be one of the most widely used as it has less complexity than other pricing models. However, despite its reduced complexity, it (and various other pricing models) requires numerous inputs. For public entities, the determination of these values is generally readily available, however for nonpublic entities, many of these inputs are not easily determinable. The practical expedient in this ASU is the third such practical expedient permitted in Topic 718, of which the previous two have previously been adopted and are currently permissible for use in SSAP No. 104R—Share-Based Payments. Integration of this third practical expedient is consistent with previous decisions by the Working Group to adopt the prior two practical expedients regarding option-pricing modeling input permitted by FASB.

The language proposed by NAIC staff directs that the practical expedient is only available when a reporting entity is not able to reasonably estimate the current fair value. While this language is technically broader than what was adopted by FASB (as ASU 2021-07 directly references non-public companies), the proposed language is consistent with prior Working Group adoptions and by default, should not be utilized by public entities – as they would be able to reasonably estimate fair value, which is likely the publicly traded share price.

Interested Parties’ Comments:
Interested parties have no comment on this item.

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed SAP clarifications SSAP No. 104R—Share-Based Payments which incorporate the practical expedient for the current price input, a required component for the option-pricing models – models in which are utilized in the determination of fair value for share-based payments. Integration of this third practical expedient is consistent with previous decisions by the Working Group with its adoption of two prior practical expedients regarding option-pricing modeling input permitted by FASB. The language proposed directs that the practical expedient is only available when a reporting entity is not able to reasonably estimate the current fair value. While this language is technically broader than what was adopted by FASB (as ASU 2021-07 directly references non-public companies), the proposed language is
consistent with prior Working Group adoptions and by default, should not be utilized by public entities – as they would be able to reasonably estimate fair value.

Summary:
On April 4, the Working Group exposed revisions to SSAP No. 47—Uninsured Plans and SSAP No. 68—Business Combinations and Goodwill to reject ASU 2021-08, Business Combinations, Accounting for Contract Assets and Contract Liabilities from Contracts with Customers for statutory accounting. ASU 2021-08 requires that acquiring entities apply Topic 606 (the topic that specifies the accounting for revenue and liabilities resulting from contacts with customers), when valuing and recognizing contract related assets and liabilities in a business combination. Prior to the issuance of ASU 2021-08, acquirers would generally only recognize such items based on their fair values on the date of acquisition. When assessing liabilities at fair value, acquirers would generally only recognize an acquiree’s deferred revenue (i.e., a contract liability), to the extent the acquirer had a legal obligation to perform a service or remit a product. However, to only recognize a contract liability to the extent of a legal obligation is contrary to Topic 606 as it states that performance obligations may (and often) extend beyond legal obligations – with examples including implied promises and customer business practices within the contract with a customer, regardless of whether such promises were legally enforceable.

For statutory accounting, other than the reporting of statutory goodwill, the acquiree’s book value of all associated assets (and liabilities) are reported on the acquirer’s books. As ASU 2021-08 requires the acquirer to utilize the acquiree’s book value, measured via Topic 606, for contract liabilities, the practice (unless the acquiree has not previously or has incorrectly applied Topic 606) while conceptually consistent statutory accounting requirements, requires a measurement method previously rejected by statutory accounting.

Interested Parties’ Comments:
Interested parties have no comment on this item.

Recommended Action:
NAIC staff recommends the Working Group adopt the exposed SAP classifications which reject ASU 2021-08 in SSAP No. 47—Uninsured Plans and SSAP No. 68—Business Combinations and Goodwill. The exposed revisions in SSAP No. 68 also include notation that rejection of ASU 2021-08 does not impact the determination of U.S. GAAP book value in an acquired entity (i.e., U.S. GAAP net book value, which is utilized for the determination of statutory goodwill, should not be modified as a result of the rejection of ASU 2021-08).
The following items received comments during the exposure period that are open for discussion.

1. Ref #2021-20: Effective Derivatives – ASU 2017-12
2. Ref #2022-02: SSAP No. 48 – Alternative Valuation of Minority Ownership Interests

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**Summary:**
During the 2021 Fall National Meeting, the Working Group exposed an agenda item that summarized key changes detailed in *ASU 2017-12: Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities* to reduce complexity and align hedge accounting with risk management activities. In addition to summarizing key U.S. GAAP changes, the agenda item identified various elements to consider as a result of the different accounting approaches between U.S. GAAP and SAP. Despite these variations, the agenda item noted that the determination of an effective hedge should be consistent between U.S. GAAP and SAP. With the exposure of the agenda item, NAIC staff was directed to work with industry and regulators in assessing and developing revisions to facilitate effective hedge assessments between SAP and U.S. GAAP. This agenda item noted that the revisions will likely result in changes from the original intent of SSAP No. 86, therefore would be considered a change in SAP concepts and should be accompanied by the development of an issue paper.

During the 2022 Spring National meeting, the Working Group exposed two documents for public comment. The first document (labeled 21-20 SSAP No. 86 – Exhibit A 3-2-22), proposed revisions in the form of a new Exhibit A (which will replace both Exhibit A and Exhibit B of SSAP No. 86 that adopts with modification U.S. GAAP guidance in determining hedge effectiveness. The second document (labeled 21-20 SSAP No. 86 – Excluded Components - 3-17-22), proposed measurement methods for excluded components in hedging Ref # 2021-20.

**Interested Parties’ Comments:**
Interested parties support the changes and we look forward to working with the staff on the further updates.

**Recommended Action:**
NAIC staff recommends that the Working Group adopt the exposed revisions, reflecting new SAP concepts, to incorporate new guidance in SSAP No. 86 (as a new Appendix A) on assessing hedge effectiveness as well as the exposed revisions to incorporate new guidance on permitted excluded components and the appropriate measurement for those excluded items with an effective date of January 1, 2023, with early application permitted. The exposed revisions adopt, with modification, U.S. GAAP. The adoption reflects consistent guidance for initial and subsequent hedge effectiveness, with modifications to specify that the accounting and reporting of hedging instruments, including excluded components of the instruments, shall follow statutory specific guidance detailed in SSAP No. 86. In addition to the exposed revisions, NAIC staff has drafted edits to detail the proposed effective date / relevant literature language (detailed below) and shared these proposed edits with interested parties. However, staff recommends confirming with regulators and interested parties on whether this additional language should be exposed prior to adoption.

With adoption, NAIC staff recommends that the Working Group sponsor a blanks proposal to incorporate new Schedule DB reporting fields (electronic only) and templates to capture the new disclosures for excluded

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components detailed in paragraph 41g of the exposed revisions. These reporting revisions will be in effect Dec. 31, 2023. (Entities that early adopt shall provide the required disclosures in narrative form for year-end 2022 and detail the adoption as a change in accounting principle.)

NAIC staff recommends the Jan. 1, 2023, effective date with early application permitted as this effective date will permit the insurers to immediately proceed with changes to be consistent with U.S. GAAP for effective hedge assessments involving excluded components. It will also allow the insurers to proceed towards uniform measurement guidance for the excluded components and remove ambiguity and conflicting guidance within the SAPs. For insurers that have these derivative structures and need time to implement system changes, the Jan. 1, 2023, timeframe provides the ability to incorporate those changes. This could result with variations among insurers at year-end 2022 between those that have early adopted and those that will adopt in 2023. Although the impact of these variations could be significant, the number of insurers impacted is expected to be limited. Additionally, the revisions to SSAP No. 86 captures additional information on excluded components in Schedule DB as well as the notes to the financial statements. For the early adopters, the disclosure templates will not be in place for these disclosures. Entities that early adopt shall capture the disclosure information in a narrative as well as detail the adoption and impact as a change in accounting principle for year-end 2022.

In addition to the revisions detailed in the two attachments (revisions to SSAP No. 86 for excluded components and revisions to incorporate a new Appendix A (replacing both Appendix A and B) for assessing effectiveness), NAIC staff recommends incorporating the following guidance to detail the adoption action and effective date:

Relevant Literature

64. This statement adopts the framework established by FAS 133, FASB Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133, An amendment of FASB Statement No. 133 (FAS 137) and FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, An amendment of FASB Statement No. 133 (FAS 138), for fair value and cash flow hedges, including its technical guidance to the extent such guidance is consistent with the statutory accounting approach to derivatives utilized in this statement. This statement adopts the provisions of FAS 133 and 138 related to foreign currency hedges. With the exception of guidance specific to foreign currency hedges and amendments specific to refining the hedging of interest rate risk (under FAS 138, the risk of changes in the benchmark interest rate would be a hedged risk), this statement rejects FAS No. 137 and 138 as well as the various related Emerging Issues Task Force interpretations. This statement adopts paragraphs 4 and 25 of FASB Statement No. 149: Amendment of Statement 133 on Derivative Instruments and Hedging Activities (FAS 149) regarding the definition of an underlying and guidance for assessing hedge effectiveness. (The adoption from FAS 149 on the assessment of hedge effectiveness is impacted by the adoption with modification of guidance from ASU 2017-12 as detailed in paragraph 65b, with the guidance from ASU 2017-12 superseding the prior adoption to the extent applicable.) All other paragraphs in FAS 149 are rejected as not applicable for statutory accounting. This statement adopts FSP FAS 133-1 and FIN 45-5: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No.45 and Clarification of the Effective Date of FASB Statement No. 161 (FSP FAS 133-1 and FIN 45-4) and requires disclosures by sellers of credit derivatives. This statement rejects FSP FIN 39-1, Amendments of FASB Interpretation No. 39, and ASU 2014-03, Derivatives and Hedging – Accounting for Certain Receivable-Variable, Pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach.

65. This statement adopts, with modification, certain revisions to ASC 815-20 included in ASU 2017-12. Remaining provisions of ASU 2017-12 will be subsequently assessed for statutory accounting and shall not be considered adopted for statutory accounting until that assessment is complete.

a. Revisions effective January 1, 2019 with early adoption permitted. This adoption is limited to specific provisions, and related transition guidance, pertaining to the documentation and assessment of hedge effectiveness and only includes: 1) provisions allowing more time to perform the initial quantitative hedge effectiveness assessment; 2) provisions allowing subsequent assessments of hedge effectiveness to be performed qualitatively if certain conditions are met; and
3) revisions regarding use of the critical terms and short-cut methods for assessing hedge effectiveness.

b. Revisions effective January 1, 2023, with early adoption permitted, are limited to the criteria for initial and subsequent hedge effectiveness detailed in the FASB Accounting Standards Codification (ASC) paragraphs 815-20-25-72 through 815-20-35-20, as modified through the issuance of ASU 2017-12. This adoption reflects statutory modifications to specify that the accounting and reporting of hedging instruments, including excluded components of the instruments, shall follow statutory specific guidance detailed in the statement. The intent of this guidance is to clarify that the determination of whether a hedging instrument qualifies as an effective hedge shall converge with U.S. GAAP, but that the measurement method shall continue to follow statutory specific provisions. The adoption of the referenced ASC paragraphs only extends to revisions incorporated through ASU 2017-12; therefore, any subsequent U.S. GAAP edits would require statutory accounting consideration before considered adopted. The remaining provisions of ASU 2017-12 will be subsequently assessed for statutory accounting and shall not be considered adopted for statutory accounting until that assessment is complete.

Effective Date and Transition

This statement is effective for derivative transaction entered into or modified on or after January 1, 2003. A modification is any revision or change in contractual terms of the derivative. SSAP No. 31 applies to derivative transaction prior to January 1, 2003. Alternatively, an insurer may choose to apply this statement to all derivatives to which the insurer is a party as of January 1, 2003. In either case, the insurer is to disclose the transition approach that is being used.

a. Revisions adopted to paragraph 64 to reject FSP FIN 39-1 is effective January 1, 2013, for companies that have previously reported a position in the balance sheet that was net of counterparty agreements. (Companies that have previously reported derivative instruments and/or related collateral gross shall not be impacted by these revisions.)

b. Revisions adopted in paragraph 16 clarify the reporting for amounts received/paid to adjust variation margin until the derivative contract has ended and are effective January 1, 2018, on a prospective basis, for reporting entities that have previously considered these amounts to reflect settlement or realized gains/losses. (Companies that have previously reported variation margin changes in line with the revisions shall not be impacted by these revisions.)

c. Revisions to incorporate limited provisions from ASU 2017-12 pertaining to the documentation of hedge effectiveness (detailed in paragraph 65) are effective January 1, 2019, with early adoption permitted for year-end 2018. However, if the reporting entity is a U.S. GAAP filer, the reporting entity may only elect early adoption if the entity has also elected early adoption of ASU 2017-12 for year-end 2018.

d. Revisions adopted April 2019 to explicitly include structured notes in scope of this statement are effective December 31, 2019. Revisions adopted July 2020 to define “derivative premium,” require gross reporting of derivatives without the impact of financing premiums and require separate recognition of premiums payable and premiums receivable, are effective January 1, 2021.

e. Revisions adopted August 2022 that adopt with modification the criteria for initial and subsequent hedge effectiveness detailed in the FASB ASC paragraphs 815-20-25-72 through 815-20-35-20, as modified through the issuance of ASU 2017-12 and that incorporate statutory accounting revisions for the accounting and reporting of excluded components are effective January 1, 2023, with early adoption permitted. These revisions shall be applied prospectively for all new and existing hedges. Entities shall detail the adoption of this guidance as a change in accounting principle pursuant to SSAP No. 3—Accounting Changes and Corrections of Errors.

The revisions are considered new SAP concepts and will be detailed in an issue paper. NAIC staff recommends that the Working Group direct NAIC staff to proceed with drafting this issue paper, but that
the issue paper also be expanded to contain other statutory derivative revisions currently being considered from U.S. GAAP. (As detailed within the Meeting agenda, there is a new agenda item that reviews the U.S. GAAP guidance for portfolio and partial term hedges.) This would delay adopting the issue paper until all current derivative revisions are discussed and up for adoption. (NAIC staff anticipates that would occur in 2023.)

### Summary:

SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies specifies that if an insurer has less than 10% ownership, measured at the holding company level, or lacks control, the investment is generally required to have a U.S. GAAP financial statement audit. However, when audited U.S. GAAP financials statements are not available, SSAP No. 48 provides three U.S. GAAP audit alternatives, which includes: 1) audited foreign GAAP with an audited U.S. GAAP reconciliation footnote, 2) audited IFRS financial statements, or 3) audited U.S. tax equity financial statements.

Upon inquiries with industry representatives regarding the use of the audited U.S. tax equity alternative, NAIC staff received informal comments from a member of the NAIC’s AICPA Task Force which indicated that they were unaware of audit firms issuing audit opinions based on a U.S. tax basis, nor were they aware of any insurer having obtained an U.S. tax basis audit to utilize this U.S. GAAP audit exception. In response, on April 4, the Working Group exposed two alternatives of SAP clarifications to SSAP No. 48.

**Option #1** proposed to delete the audited U.S. tax basis equity as a permissible valuation method as this method does not appear to be utilized by insurers.

**Option #2** proposed to retain the audited U.S. tax basis equity valuation method but clarify that the audit must reside at the investee level. The clarification that the audit must reside at the investee level is consistent with other explicit requirements in SSAP No. 48 and SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities.

**Interested Parties’ Comments:**

Interested parties recommend that Option #2 be adopted as there are insurers who use this approach for investments in some partnerships.

**Recommended Action:**

NAIC staff recommends that the Working Group adopt the exposed SAP clarifications to SSAP No. 48—Joint Ventures, Partnerships and Limited Liability to include the Option #2 proposal, which details the audited U.S. tax basis equity as a permissible valuation method but clarifies that the audit must reside at the investee level. The exposed revisions, which are proposed for adoption adopted revisions, are shown below.

9. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16 may be recorded based on either of the valuation methodologies allowed under paragraphs 9.a. or 9.b. If either one of the valuation methodologies
allowed under paragraphs 9.a. or 9.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

a. Non U.S. joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10% and for which audited U.S. GAAP basis financial statements of the investee are not available, may be recorded based on:

i. the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee’s equity and income to U.S. GAAP within the investee’s audited foreign GAAP prepared financial statements or,

ii. the IFRS basis equity as set forth in the investee’s audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).

b. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity. The U.S. tax basis equity audit shall occur at the investee level. For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 18 and 19. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.
The following items received comments during the exposure period that are open for discussion.

1. Ref #2022-01: Conceptual Framework – Updates

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Summary:
In December 2021, the Financial Accounting Standards Board (FASB) issued two new chapters of its conceptual framework. The conceptual framework is a body of interrelated objectives and fundamentals that provides the FASB with a foundation for setting standards and concepts to consider when it resolves questions or develops/modifies accounting and reporting guidance. It is important to note that the Statements of Financial Accounting Concepts are not authoritative and do not establish new or change existing U.S. GAAP. This agenda item was drafted to review each of the newly issued concept chapters and proposed updates to the Accounting Practices and Procedures Manual as noted below.

Update 1:
FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements introduced updated definitions of certain key elements used in financial reporting – the definition of an asset and liability.

- FASB has updated the definition of an **ASSET** to be defined as a present right of an entity to an economic benefit. The asset definition possesses two essential characteristics in that 1) an asset is a present right and 2), the right is to an economic benefit.

- FASB has updated the definition of a **LIABILITY** to be defined as a present obligation of an entity to transfer an economic benefit. The liability definition possesses two essential characteristics in that 1) the liability is a present obligation, and 2) the obligation requires an entity to transfer or otherwise provide economic benefit to others. (For the purposes of this characteristic, transfer is typically used to describe obligations to pay cash or convey assets, while the term provide is used to describe obligations to provide services or stand by to do so.)

Update 2:
FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 7, Presentation identifies factors that the FASB will consider when deciding how items should be displayed on the financial statements. Chapter 7 describes the information to be included in the financial statements and how appropriate presentation can contribute to the objective of financial reporting – to communicate financial information about an entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources (goods and services) to the entity. Chapter 7 superseded sections of Statement of Financial Accounting Concept 5 (a superseded concept statement that is specifically referenced in the Preamble); however, it did not result in fundamental changes to the principal concepts of financial reporting.
Accordingly, on April 4, the Working Group exposed revisions to incorporate:

1) FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements*, which updates the definitions of an asset and a liability. In conjunction with this exposure, the Working Group exposed two draft issue papers for historical documentation of these SAP clarifications to SSAP No. 4—Assets and Nonadmitted Asset and SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.


**Interested Parties’ Comments:**
Interested parties appreciate the extension of the comment deadline and the opportunity to comment on Ref# 2022-01 that was released for comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working Group) during its meeting on April 4 in Kansas City.

We offer the following comments:

**Ref #2022-01:** Conceptual Framework – Updates

**Liability**

Interested parties are concerned with the change for the liability definition as the FASB notes it will change the definition of a liability, expanding the population of liabilities and it will need to be reviewed on a standard basis. On expanding the population of liabilities, paragraph 12 states that the FASB recognized “the revised definition potentially expands the population of liabilities to include certain obligations to issue or potentially issue an entity’s own shares rather than settle an obligation exclusively with assets. In essence, clarifying that instruments with characteristics of both liabilities and equity may in fact be classified as liabilities in certain situations.”

We noted that there is not an analysis by the SAPWG of the impact on the various SSAP’s of incorporating the guidance. The FASB states that needs to be done “Thus, the FASB concluded that the specific facts and circumstances at the standards level (or in the case of statutory accounting, at the SSAP level) must be utilized to determine whether the entity has created a constructive obligation and must recognize a liability.” Please see the shaded text from the FASB excerpts below.

From the Liability Paper:

9. The updated liability definition from Concept Statement No. 8 no longer includes the term probable or the phrase in the future and as a result of past transactions or events. The FASB concluded that the term probable has historically been misunderstood as implying that a future obligation must meet a probability to a certain threshold before the definition of a liability was met. Thus, if the probability of a future transfer of an asset (or the requirement to provide a service) was low, a liability would likely not be recognized. In removing the term probable (and replacing it with “present obligation”), FASB concluded that in almost all situations, the presence of an obligation will be apparent. It stated that most present obligations are legally enforceable, including obligations arising from binding contracts, agreements, statutes, or other legal or contractual means. Chapter 4 also discusses the prevalence of certain business risks and how to assess if they result in the recognition of a liability. The FASB concluded that while certain businesses have a risk that a future event will cause them to transfer an economic benefit (an asset), the risk itself does not represent a present obligation because exposure to a potential negative consequence does not constitute a present obligation.

10. However, the FASB also stated that situations lacking clear legal or contractual evidence of a present obligation may pose particular challenges that may make it difficult to discern whether a present obligation exists. In these settings, the FASB stated that constructive obligations or other noncontractual obligations are
created by circumstance rather than by explicit agreement. In the absence of an explicit agreement, sufficient information to distinguish a present obligation is likely only available at the specific standards level. Thus, the FASB concluded that the specific facts and circumstances at the standards level (or in the case of statutory accounting, at the SSAP level) must be utilized to determine whether the entity has created a constructive obligation and must recognize a liability.

12. When reviewing the substance of the revisions, the FASB concluded that the updated definition resulted in a clearer and more precise definition. Furthermore, while it did not fundamentally change the historical concept of a liability, the revised definition potentially expands the population of liabilities to include certain obligations to issue or potentially issue an entity’s own shares rather than settle an obligation exclusively with assets. In essence, clarifying that instruments with characteristics of both liabilities and equity may in fact be classified as liabilities in certain situations.

13. In general, the FASB did not anticipate that the liability definition revisions would result in any material changes in instrument reclassification (e.g., items now being classified as a liability when previously they were not considered liabilities). Again, FASB Concept Statements are not authoritative and thus the guidance in any specific standard will still be utilized for instrument measurement and classification. For statutory accounting purposes, the updated definition should be viewed similarly, that is it does not change fundamental concepts, change current practices, or introduce a new, original or a modified accounting principle. The revisions to the definition of a liability clarify the definitional language and do not modify the original intent of SSAP No. 5R and thus the changes are deemed to be a statutory accounting principle clarification.

Consistent with the FASB approach that an evaluation needs to be done at the standards level, interested parties recommend that for the case of statutory accounting the Working Group complete an SSAP-by-SSAP analysis to identify potential effects prior to amending the definition of liability to avoid unintended consequences.

**Recommended Action:**
Both SSAP No. 4 and SSAP No. 5R are regarded as foundational statements for statutory accounting and they are referenced by many other statements. NAIC staff recommends that the Working Group adopt the exposed SAP clarification revisions to 1) SSAP No. 4—*Assets and Nonadmitted Assets*, and the draft issue paper which document the changes in definition of an asset and rationale why the revisions are considered SAP clarifications in nature, and 2) the Preamble to update reference to a superseded FASB concept statement.

For the exposed revisions to SSAP No. 5R—*Liabilities, Contingencies and Impairment of Assets* and the related issue paper, NAIC staff notes it is important that SAP is as conservative or more conservative than FASB in defining liabilities (conservatism concept). NAIC staff does not recommend that staff be directed to perform a detailed SSAP by SSAP analysis requested by interested parties. However, NAIC staff defers to the Working Group preference if it would like to provide another exposure of the liabilities guidance to allow the opportunity for interested parties to identify if the adoption of the exposed liabilities guidance would create a specific concern regarding a particular situation that would be required to be reported as a liability. (Essentially, this would require the identification of a scenario that is not reported as a liability or loss contingency now that industry believes would be required to be reported as a liability or loss contingency under the new liability definition, and for which industry believes that liability or loss contingency reporting would be inappropriate.) NAIC staff is of the opinion that if an instrument meets the current SAP or the new FASB definition for a liability, it should be reflected as a liability for statutory accounting purposes.

- FASB treats these assets and liabilities definitions as nonauthoritative Concept statements and defers details to specific statement. By putting the definitions into SSAPs, the definitions have an authoritative status for SAP.
**Hearing Agenda**

- In terms of the exposed clarifications to the Preamble, the revisions update reference to a superseded FASB concept statement. (Interested parties did not provide any comments on this aspect of the exposure).

- In terms of the exposed clarifications to SSAP No. 4 and its related draft issue paper, as described in the agenda item (and issue paper), the revised definition should not result in reclassification of any assets as the objective of the updated definition was to simplify and clarify the historical definition. (Interested parties did not provide any comments on this aspect of the exposure.)

- In terms of the exposed clarifications to SSAP No. 5R and its related draft issue paper, as described in the agenda item (and issue paper), the revised definition should generally not result in reclassification of any liabilities. While both FASB and the draft issue paper did identify the possibility of rare circumstances of items now meeting the definition of a liability, both FASB and the agenda item refer financial statement preparers to reference the specific standard (or SSAP) for financial accounting and reporting. Interested parties have suggested the Working Group review “SSAP-by-SSAP” to determine if amending the definition of a liability could have any potential unintended consequences. However, while a specific example was not included, NAIC staff support the review of any specific circumstance when/if it arises. **NAIC staff is of the opinion that if an instrument meets the current SAP or the new FASB definition for a liability, it should be reflected as a liability for statutory accounting purposes.** Statutory accounting prescribes the recognition of liabilities that meet the technical definition of a liability and requires the recognition of loss contingencies. In addition, paragraph 37 of the preamble states that “liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probably loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).” This fact pattern, in combination with the preamble’s concept of conservatism, should not result in an item meeting the technical definition of a liability that is not reported as such for statutory accounting. A review by each SSAP to determine specific carveouts (i.e., items that meet the definition of a liability but that are considered by the Working Group for codification to not be reported as such) will likely require detailed specifics. As such, review of these circumstances is recommended to be outside the scope of this definition change. However, if preferred by the Working Group, the liabilities changes to SSAP No. 5R and the related issue paper could be re-exposed to allow for industry to provide specific circumstances or scenarios where an item would be reported as a liability under the new, proposed definition, but where it should not be reported as such for statutory accounting. Final consideration could then occur during the Fall National Meeting.

If the Working Group does not believe re-exposure of the liability definition is necessary, the Working Group could proceed with adoption of the SSAP No. 5R revisions as well as the corresponding issue paper.

The comment letters are included in Attachment 15 (6 pages).

Draft Pending Adoption

Accounting Practices and Procedures (E) Task Force
4/5/22

Draft: 4/11/22

Statutory Accounting Principles (E) Working Group
Kansas City, Missouri
April 4, 2022

The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force met in Kansas City, MO, April 4, 2022. The following Working Group members participated: Dale Bruggeman, Chair (OH); Carrie Mears, Vice Chair (IA); Sheila Travis (AL); Kim Hudson and Susan Bernard (CA); William Arfanis and Kenneth Cotrone (CT); Rylynn Brown (DE); Cindy Andersen (IL); Stewart Guerin (LA); Judy Weaver (MI); Pat Gosselin (NH); Bob Kasinow (NY); Melissa Greiner and Matt Milford (PA); Jamie Walker (TX); Doug Stolte and David Smith (VA); and Amy Malm (WI).

1. Adopted its March 2, 2022; Jan. 27, 2022; and 2021 Fall National Meeting Minutes

The Working Group met March 2, 2022; Jan. 27, 2022; and Dec. 11, 2021. During these meetings, the Working Group took the following action: 1) exposed a revised principles-based bond definition and related issue paper; and 2) received comments on items previously exposed for a public comment period ending Jan. 14, 2022.

The Working Group also met March 31, 2022, and Feb. 28, 2022, in regulator-to-regulator session, pursuant to paragraph 3 (specific companies, entities or individuals) and paragraph 6 (consultations with NAIC staff related to NAIC technical guidance) of the NAIC Policy Statement on Open Meetings, to: 1) discuss its Spring National Meeting agenda; and 2) receive information on the bond project development.

Ms. Walker made a motion, seconded by Ms. Bernard, to adopt the Working Group’s March 2, 2022 (Attachment One-A), Jan. 27, 2022 (Attachment One-B), and Dec. 11, 2021 (see NAIC Proceedings – Fall 2021, Accounting Practices and Procedures (E) Task Force, Attachment One) minutes. The motion passed unanimously.

2. Adopted Non-Contested Positions

The Working Group held a public hearing to review comments (Attachment One-C) on previously exposed items.

Ms. Malm made a motion, seconded by Mr. Hudson, to adopt the statutory accounting principle (SAP) clarifications, detailed below as non-contested statutory accounting revisions. The motion passed unanimously.

   a. Agenda Item 2021-24

Mr. Bruggeman directed the Working Group to agenda item 2021-24: Cryptocurrency General Interrogatory (Attachment One-D). Jake Stultz (NAIC) stated that this agenda item proposed a new general interrogatory within the annual reporting blanks specific to the use or acceptance of cryptocurrencies. The general interrogatory will capture whether cryptocurrencies are held, identification of which schedules cryptocurrencies held are reported, and whether cryptocurrencies are accepted for the payment of premiums. Mr. Stultz stated that while the agenda item did not propose statutory revisions, adoption will express support for the corresponding Blanks (E) Working Group’s proposal (2022-01BWG), which adds the new general interrogatory to the annual statement for year-end 2022 reporting.
b. Agenda Item 2021-28

Mr. Bruggeman directed the Working Group to agenda item 2021-28: ASU 2021-03, Intangibles – Goodwill and Other (Attachment One-E). Jim Pinegar (NAIC) stated that this agenda item reviews Accounting Standards Update (ASU) 2021-03, Intangibles – Goodwill and Other – Accounting Alternative for Evaluating Triggering Events. He stated that ASU 2021-03 provides private companies and not-for-profit entities with an optional accounting alternative for the performance of a goodwill impairment triggering evaluation. The amendments allow for the assessment of goodwill impairment at the end of a reporting period. Mr. Pinegar stated that the statutory accounting authoritative guidance regarding impairment is in Interpretation (INT) 06-07: Definition of Phrase “Other Than Temporary,” and this guidance does not permit the delay of an impairment assessment until a reporting period. He stated that since ASU 2021-03 provided guidance contrary to INT 06-07, this agenda item proposes SAP clarifications in Statement of Statutory Accounting Principles (SSAP) No. 68—Business Combinations and Goodwill to reject ASU 2021-03 for statutory accounting.

c. Agenda Item 2021-29

Mr. Bruggeman directed the Working Group to agenda item 2021-29: ASU 2021-05, Variable Lease Payments (Attachment One-F). Mr. Stultz stated that this agenda item reviews ASU 2021-05, Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments and applies to lessors with lease contracts that have variable lease payments that do not depend on a reference index or rate and/or would have resulted in the lessor being required to recognize a day one selling loss at lease commencement if those leases were classified as sales-type or direct financing lease. He stated that as SSAP No. 22R—Leases requires nearly all leases to be treated as operating leases, adoption of this guidance would be redundant and unnecessary. Accordingly, this agenda item proposes SAP clarifications in SSAP No. 22R to reject ASU 2021-05 for statutory accounting.

d. Agenda Item 2021-30

Mr. Bruggeman directed the Working Group to agenda item 2021-30: ASU 2021-06, Amendments to SEC Paragraphs (Attachment One-G). Mr. Stultz stated that this agenda item reviews ASU 2021-06, Presentation of Financial Statements (Topic 205), Financial Services—Depository and Lending (Topic 942), and Financial Services—Investment Companies (Topic 946), Amendments to SEC Paragraphs Pursuant to SEC Final Rule Releases No. 33-10786, Amendments to Financial Disclosures about Acquired and Disposed Businesses, and No. 33-10835, Update of Statistical Disclosures for Bank and Savings and Loan Registrants. He stated that ASU 2021-06 provides formatting and paragraph references applicable to U.S. Securities and Exchange Commission (SEC) registrants. This agenda item proposes SAP clarifications to Appendix D—Nonapplicable GAAP Pronouncements to reject ASU 2021-06 as not applicable to statutory accounting.

3. Reviewed Comments on Exposed Items – Minimal Discussion

a. Agenda Item 2021-23

Mr. Bruggeman directed the Working Group to agenda item 2021-23: SSAP No. 43R – Financial Modeling – Updated Guidance. Mr. Pinegar stated that this agenda item reflects SAP clarifications to be consistent with the revised NAIC designation financial modeling guidance adopted on Oct. 20, 2021, by the Valuation of Securities (E) Task Force to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) for residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS). He stated that while the P&P Manual provides the financial modeling process, when this guidance was first adopted, a
summarized narrative was reflected in the *Accounting Practices and Procedures Manual* (AP&P Manual). With revisions to the financial modeling guidance, and as designations are determined by the Valuation of Securities (E) Task Force, the Working Group exposed two alternatives for consideration, noting that both options refer to the P&P Manual for detailed financial modelling guidance. He stated that the first option retained summarized financial modeling guidance in SSAP No. 43R—*Loan-Backed and Structured Securities*, updated to reflect the revisions to the P&P Manual by the Task Force. The second option removed financial modeling guidance from SSAP No. 43R and referred users to the guidance in the P&P Manual. He stated that in response to feedback from interested parties, which recommended a minor edit and supported option one, NAIC staff recommended retaining the summarized financial modeling guidance in SSAP No. 43R updated for the recent Task Force revisions.

Mr. Bruggeman stated that this agenda item updates the summarized financial modeling guidance in SSAP No. 43R and that it is important to note that the P&P Manual provides the detailed financial modelling and the designation process, which is the responsibility of the Valuation of Securities (E) Task Force. He stated that the AP&P Manual takes precedence over the P&P Manual in the statutory hierarchy. However, he noted that the AP&P Manual defers to the detailed guidance in the P&P Manual for the financial modeling process and the resulting NAIC designation.

Ms. Weaver made a motion, seconded by Ms. Bernard, to adopt the exposed option one SAP clarification revisions, updating the financial modeling guidance summarized in SSAP No. 43R and incorporating a grammatical edit as proposed by interested parties. Along with the updated financial modeling summary, this guidance continues to refer users to the detailed financial modeling guidance in the P&P Manual (Attachment One-H). The motion passed unanimously.

b. Agenda Item 2021-26EP

Mr. Bruggeman directed the Working Group to agenda item 2021-26EP: Editorial Updates (Substantive vs. Nonsubstantive). Mr. Pinegar stated that this agenda item is in response to the Working Group’s adoption of agenda item 2021-14: Policy Statement Terminology Change – Substantive and Nonsubstantive, which modified the use of the terminology of “substantive” and “nonsubstantive” in the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles* (Policy Statement). He stated that this agenda item proposed editorial revisions to the preamble, table of contents, summary of changes, and the *NAIC Policy Statement on Statutory Accounting Principles Maintenance Agenda Process*. He stated that interested parties’ comments requested further clarification during the development process, specifically requesting effective dates for every adopted revision, regardless of if the revision was deemed to be an SAP clarification or a new SAP concept. He stated that this comment, similar to what was expressed during the 2021 Fall National Meeting, goes beyond the Financial Condition (E) Committee request to simply change the terminology references. This current agenda item only enacts editorial updates to reflect the previously adopted terminology changes, and if the editorial revisions were not adopted, there would be a disconnect between the Policy Statement and the terminology reflected in other sections of the AP&P Manual.

Ms. Walker made a motion, seconded by Mr. Kasinow to adopt the exposed SAP clarification editorial revisions to the preamble, table of contents, summary of changes, and the *NAIC Policy Statement on Statutory Accounting Principles Maintenance Agenda Process* (Attachment One-I). The motion passed unanimously.

c. Agenda Item 2021-27
Mr. Bruggeman directed the Working Group to agenda item 21-27: ASU 2021-04, Issuer’s Accounting for Certain Modifications. Mr. Stultz stated that this agenda item reviews ASU 2021-04, Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40): Issuer’s Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options. He stated that ASU 2021-04 directs that when a freestanding equity-classified written call option is modified or exchanged and the instrument remains classified as equity after the modification/exchange, the differences in fair value before and after the modification are accounted for as an adjustment to equity. However, conversely, ASU 2021-04 directs that if the modification/exchange is related to a debt instrument or line-of-credit, the differences in fair value before and after the modification may be capitalized in accordance with U.S. generally accepted accounting principles (GAAP) debt issuance guidance, a concept disallowed under SSAP No. 15—Debt and Holding Company Obligations. Mr. Stultz stated that while this agenda item proposes to reject ASU 2021-04 for statutory accounting, it also proposes SAP clarifications to SSAP No. 72—Surplus and Quasi-Reorganizations, incorporating minor updates related to the accounting for changes in fair value involving the exchange of free-standing equity-classified written call options. He stated that in response to interested parties’ comments, NAIC staff recommended additional clarifications in SSAP No. 72 to precisely identify what guidance from ASU 2021-04 was being adopted or rejected. Mr. Bruggeman stated that while the additional clarifications proposed by NAIC staff do reflect the request by interested parties, they do make the sentence regarding applicable rejections quite lengthy. However, the applicable guidance should be sufficiently clear. Rosemarie Albrizio (Equitable), representing interested parties, agreed with the additional clarifications as proposed by NAIC staff. She noted this is consistent with other such clarifications in the AP&P Manual.

Ms. Malm made a motion, seconded by Ms. Weaver, to adopt the exposed SAP clarifications to SSAP No. 72, while incorporating additional clarification edits to precisely identify what guidance from ASU 2021-04 was adopted or rejected. [Attachment One-d]. The motion passed unanimously.

4. Reviewed Comments on Exposed Items

   a. Agenda Item 2019-21

Mr. Bruggeman directed the Working Group to agenda item 2019-21: SSAP No. 43R – Proposed Bond Definition (Reporting Options). Julie Gann (NAIC) stated that this agenda item is a continuation of the bond definition project. She stated that during the 2021 Fall National Meeting, the Working Group exposed two additional elements regarding the bond project for public comment. The first item was a revised draft bond definition with limited edits focusing on changing the terminology of a “sufficient credit enhancement” to a “substantive credit enhancement” and a discussion document on potential reporting changes for initial comment. She stated that the comments on the bond definition were previously considered, and an updated bond definition and issue paper were exposed March 2 for a public comment period ending May 6. She stated that the exposed reporting changes discussion document is the focus for this meeting, with the intent to consider industry comments and receive Working Group direction. She stated that it is anticipated that the bond project will result in significant reporting changes to improve transparency and granularity of investments and that all reporting entities should be aware that these reporting changes are being discussed.

Ms. Gann stated that while there is not an exposure planned for this meeting, it was requested that the Working Group direct NAIC staff to work with state insurance regulators and industry in developing proposed reporting changes and SSAP edits for subsequent exposure. She stated that after considering interested parties’ comment
letters, NAIC staff are planning not to proceed with edits on the following industry requests. However, state insurance regulator feedback is requested if consideration of these changes should occur:

- Interested parties recommended moving items in scope of SSAP No. 41—Surplus Notes from Schedule BA: Other Long-Term Invested Assets to Schedule D-1: Long-Term Bonds. Ms. Gann stated that as these instruments have special characteristics and are not required to be reported with an NAIC designation, she does not believe state insurance regulators will support moving these items to Schedule D-1 and does not anticipate the proposed revisions to Schedule D-1 will include proposed reporting of surplus notes.

- Interested parties requested clarification on the use of a sub-schedule for Schedule D-1. She stated that the intent for a sub-schedule was to identify asset-backed securities (ABS) that qualify for bond reporting, but are financial asset-backed, but not self-liquidating (e.g., equity backed items), or that are not financial-asset backed and that do not meet the practical expedient for determining meaningful generation of cash flows. State insurance regulators wish to have the ability to identify these investments quickly and stated that a sub-schedule may be the preferred method for clear identification. Ms. Gann stated that when proposed reporting changes are drafted, that will likely assist in the understanding and use of the proposed sub-schedule.

- Interested parties requested that affiliate reporting be accomplished using an electronic column, rather than the current process of using an affiliate reporting line. Ms. Gann stated that NAIC staff believe regulators wish to continue the current process of utilizing separate reporting lines.

Ms. Gann stated that depending on the feedback from the Working Group, it is anticipated that a discussion document for possible reporting changes will be exposed by the Summer National Meeting. Mr. Bruggeman stated that NAIC staff will also draft revisions for SSAP No. 26R—Bonds and SSAP No. 43R to incorporate the principle-based bond definition into authoritative statutory guidance.

Tip Tipton (Thrivent), representing interested parties, stated that they appreciate the Working Group’s ongoing collaboration as they deem this will likely be one of the most significant reporting changes in recent years. He stated that interested parties look forward to continuing discussions so that they can get clarity on what is a sub-schedule, and what reporting columns and lines are required to meet the needs of state insurance regulators. Mr. Bruggeman stated that he believes the sub-schedule is required as the additional reporting elements (columns) do not fit within the existing reporting framework. He stated that the sub-schedule’s totals will still be reported as bonds, and state insurance regulators will be cognizant of reporting limitations of insurers. However, the use of the sub-schedule will be beneficial to the Risk-Based Capital (RBC) Investment Risk and Evaluation (E) Working Group as its review these items for additional risk-based capital granularity.

Mr. Bruggeman, on behalf of the Working Group, directed NAIC staff to continue working with state insurance regulators and interested parties in developing potential reporting changes for bond investments. This discussion will include the development of illustrations and reporting instructions.

b. Agenda Item 2021-20

Mr. Bruggeman directed the Working Group to agenda item 2021-20: Effective Derivatives – ASU 2017-12. Ms. Gann stated that this agenda item was drafted to consider revising SSAP No. 86—Derivatives to mirror effective hedging determinations permitted in ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. While ASU 2017-12 was previously reviewed, the review was
limited in scope and only adopted updates for hedging documentation, noting that a broader review would occur at a later date. Ms. Gann stated that both state insurance regulators and industry representatives requested further consideration of ASU 2017-12, particularly with regards to derivative arrangements that U.S. GAAP allow to qualify as an effective hedge. She stated that in general, NAIC staff believe that if a hedging relationship is considered to be effective under U.S. GAAP, it should also be considered effective for statutory accounting. However, differences in the valuation between U.S. GAAP and statutory accounting need to be reviewed before those new effective hedging relationships are permitted to ensure the financial statement reporting and derivative impact is defined and understood. Ms. Gann stated since this item’s original exposure, NAIC staff have continued discussion with industry representatives. She stated that although industry has proposed revisions to SSAP No. 86 as part of their comment letter, NAIC staff are recommending exposure of two documents, which are more detailed than the industry proposed edits. She summarized the proposed revisions as follows:

- A new SSAP No. 86, Exhibit A, which is proposed to replace both of the existing SSAP No. 86, Exhibits A and B. This updated exhibit proposes adoption with modification of the overall U.S. GAAP guidance for determining hedge effectiveness even though not all paragraphs are proposed to be captured within the exhibit. The proposed modification would exclude U.S. GAAP guidance for the measurement of the hedging instruments, including excluded components of those instruments. This exclusion is required as statutory accounting has specific accounting and reporting guidance that differs from U.S. GAAP.

- Proposed SSAP revisions to incorporate new measurement guidance for different types of excluded components. As identified by industry, there are current inconsistencies in SSAP No. 86 for excluded components. While the proposed measurement methods vary by excluded component, the proposed accounting and reporting is consistent with the overall recommendations from industry. The proposed edits are more robust than what industry proposed to ensure that the measurement methods are clearly defined and with more detailed disclosures to allow state insurance regulators the ability to identify and assess the impact of any excluded component in the financial statements.

Mr. Bruggeman stated that review of this ASU is welcome as insurers have historically had differences in the assessment of hedge effectiveness for U.S. GAAP versus statutory accounting. He stated he was aware of instances where insurers would purchase supplemental derivative instruments to eliminate statutory surplus volatility of their original hedging instruments. This practice causes an insurer to incur excess costs that is likely not necessary.

Ms. Albrizio, representing interested parties, stated that they appreciate the collaborative efforts on this topic and support exposure of the proposed documents.

Ms. Walker made a motion, seconded by Ms. Bernard, to expose revisions to SSAP No. 86, which include: 1) a revised Exhibit A, which will replace Exhibit A and Exhibit B; and 2) proposed measurement guidance for excluded components. The motion passed unanimously.

c. Agenda Item 2021-21

Mr. Bruggeman directed the Working Group to agenda item 2021-21: Related Party Reporting. Mr. Stultz stated that this agenda item was drafted in response to recent discussions on the reporting and disclosure requirements for investments that involve related parties. He stated that the agenda item revised SSAP No. 25—Affiliates and Other Related Parties and SSAP No. 43R to clarify related party and affiliate guidance, as well as to require new reporting information for investments that are acquired from a related party, regardless of whether the investment is captured on the affiliate reporting line. He stated that interested parties’ comments recommended
additional clarifying language on the presumption of control, as well as modifications to the proposed annual statement instructions, and NAIC staff have incorporated limited changes in the proposal for exposure consideration.

Mr. Stultz stated that in response to interested parties’ comments, this agenda item does not intend to make any changes to items currently reported as affiliated transactions. He stated that the clarification is intended to be consistent with the definition of an affiliate pursuant to the *Insurance Holding Company System Regulatory Act* (#440), SSAP No. 25, and SSAP No. 97—*Investments in Subsidiary, Controlled and Affiliated Entities*. He stated that although the definition is consistently referenced, there is inconsistency in practice regarding the interpretation of what is required to be reflected on the affiliate reporting line. Pursuant to comments from interested parties, actual credit exposure should be present to report an investment on the affiliate reporting line. However, this interpretation is contrary to the preferences of some state insurance regulators who are expecting investment transactions with affiliates to be reported as affiliated transactions. Although there are no revisions proposed to change existing guidance for how affiliated investments are reported, it was noted that the expansion of the use of affiliates in structuring and procuring investment products has resulted with an increase in affiliated investment transactions in which there is no credit exposure to the actual affiliated entity, and state insurance regulators want to ensure that affiliated transactions are properly being disclosed to the domiciliary state. Mr. Stultz stated that interested parties also requested an effective date for 2023 year-end reporting. However, NAIC staff recommend a 2022 year-end effective date, as the reporting changes are in line with other state insurance regulators’ initiatives, including the Macroprudential (E) Working Group. In response to other interested parties’ comments, NAIC staff are recommending to also include additional clarifications that investments in exchange traded funds (ETFs) or mutual funds (as defined by the SEC) do not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity holds, unless the mutual fund or ETF has the power to direct or cause direction of management of the underlying company. This additional revision is consistent with existing guidance in SSAP No. 97.

Angelica Tamayo-Sanchez (New York Life), representing interested parties, stated that it is important for the investment schedules to differentiate between investments that have true affiliated credit risk exposure from those that are simply managed/serviced by affiliates where the underlying assets of the investment structure do not have any credit risk exposure to affiliates and related parties. She stated that the investment codes being proposed would be beneficial to state insurance regulators for this identification and are supported by interested parties. Citing investments on Schedule D as an example, she stated that interested parties determine affiliated reporting based on the cash flows to service the underlying debt. In the case of debt service cash flow from an affiliate, those items would be reported as an affiliated transaction as the reporting entity is exposed to affiliated credit risk. However, this circumstance is very different from cases where an investment is managed by an affiliate, regardless of if the investment was originated by the affiliate. In these cases, interested parties do not believe these would be reported on the affiliated line as the cash flows do not originate from an affiliate, nor do they represent credit risk to an affiliated entity. She stated concern remains regarding state insurance regulator comments that affiliated transactions are reported as affiliated, regardless of any underlying credit exposure to an affiliate. However, the additional clarifications regarding the look through of ETFs and mutual funds are supported by interested parties. In terms of the look-through requirements, she stated that the requirement should be limited to private equity funds reported on Schedule BA. Additionally, while interested parties understand that there is a presumption of indirect control if an affiliated fund owns more than 10% of the voting shares of a corporation, they believe it would be rare for an investor that owns less than 50% of the voting stock of a corporation to have the ability to exercise control over the management and operations of such investee. Ms. Tamayo-Sanchez stated that while they understand that there is no desire by state insurance regulators to
Mr. Bruggeman directed the Working Group to agenda item 2021-22: Schedule D-6-1, Supplemental Reporting. Mr. Pinegar stated that this agenda item proposed four additional data capture elements for Schedule D-6-1: Valuation of Shares of Subsidiary, Controlled or Affiliated Entities. He stated that the additional electronic-only columns will assist state insurance regulators in their review of subsidiary, controlled, and affiliated (SCA) filings, with a primary goal of helping identify filers who have repeated, identical adjustments year-after-year. He stated that in response to interested parties’ comments, the agenda details the current valuation communication process with the states and the respective filers, which includes details on the standard reporting templates and ongoing communication with the states of domicile. He noted that while this agenda item did not result in statutory revisions, adoption would express support for the corresponding Blanks (E) Working Group exposure (2022-02BWG). Mr. Bruggeman stated he believes this agenda item will further increase the efficiency of the SCA review process.

Ms. Walker made a motion, seconded by Ms. Gosselin, to adopt agenda item 2021-22, noting the agenda item did not result in statutory revisions. The motion passed unanimously.

e. Agenda Item 2021-25

Mr. Bruggeman directed the Working Group to agenda item 2021-25: Leasehold Improvements After Lease Termination. Mr. Stultz stated that this agenda item clarifies that when a lease terminates early, all remaining leasehold improvements shall be expensed, even if the leased asset is purchased. He stated that in response to interested parties’ comments, NAIC staff believe that if leasehold improvements are not expensed, items currently nonadmitted under SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements or SSAP No. 73—Health Care Delivery Assets and Leasehold Improvements in Health Care Facilities could ultimately be admitted under SSAP No. 40R—Real Estate Investments. Additionally, not all lease agreements include provisions for a purchase option at the time that the lease is signed, and in these situations, leasehold improvement assets should be expensed at the time the leased asset is purchased as almost all professional real estate companies would factor those leasehold improvements into the purchase price of the building. However, for lease agreements that include purchase options that discuss leasehold improvements, NAIC staff agree that these must be considered
as part of the purchase of an asset that was part of a prior lease. He stated that NAIC staff recommended that the Working Group direct NAIC staff to work further with the interested parties in refining guidance for consideration. Ms. Albrizio stated that interested parties stand ready to assist with revised guidance for future consideration. Mr. Bruggeman agreed with the staff recommendation and directed NAIC staff to proceed accordingly.

5. **Considered Maintenance Agenda – Pending Listing – Exposures**

Ms. Mears made a motion, seconded by Ms. Travis, to move agenda items 202-01 through 202-08 to the active listing and expose all items for a public comment period. The motion passed unanimously.

Mr. Bruggeman stated that the public comment period for agenda items 2021-21, 2022-03 and 2022-08, is May 6. The comment deadline for all other exposure items is June 3.

a. **Agenda Item 2022-01**

Mr. Bruggeman directed the Working Group to agenda item 2022-01: Conceptual Framework – Updates. Mr. Pinegar stated that this agenda item reviews Financial Accounting Standards Board (FASB) Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements* (Chapter 4) and Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 7, Presentation* (Chapter 7) for their impact on statutory accounting. He stated Chapter 4 introduce revised definitions for the terms “asset” and “liability,” simplifying their definitional descriptions and redefining their essential characteristics. He stated that the historical definitions no longer include the term “probable” or the phrase “as the result of past transactions or events” citing rationale for their removal. He stated that as statutory accounting references these definitions, this agenda item proposed SAP clarifications to SSAP No. 4—*Assets and Nonadmitted Assets* and SSAP No. 5R—*Liabilities, Contingencies and Impairment of Assets* to reflect the FASB’s updated definitions. He stated that in addition, NAIC staff recommended exposing two issue papers, each articulating the changes for SSAP No. 4 and SSAP No. 5R, FASB’s rationale for the changes, and discussion as to why the updates are proposed to be SAP clarifications in nature.

Mr. Pinegar stated the final topic reviewed Chapter 7 and proposed a minor SAP clarification to the Preamble, updating a paragraph reference to *Statement of Financial Accounting Concept 5*, which was superseded by Chapter 7. He stated that Chapter 7 describes what information should be included in the financial statements and how appropriate presentation can contribute to the objective of financial reporting. However, Chapter 7 concepts were not expected to modify current guidance, other than to update references to superseded accounting concepts.

b. **Agenda Item 2022-02**

Mr. Bruggeman directed the Working Group to agenda item 2022-02: SSAP No. 48 – Alternative Valuation of Minority Ownership Interests. Mr. Pinegar stated this agenda item reviews the audited U.S. tax equity financial statements U.S. GAAP audit exception provided in SSAP No. 48—*Joint Ventures, Partnerships and Limited Liability Companies*. He stated that this agenda item arose trying to address questions regarding at which level the audited U.S. tax basis should apply as there was ambiguity regarding if the insurer’s audit would suffice, or if the audit should reside at the investee level. He stated that informal comments from a member of the NAIC/American Institute of Certified Public Accountants’ (AICPA) (E) Working Group indicated they were not aware of anyone using the audited U.S. tax basis method, which is permitted as an exception if audited U.S. GAAP basis financial statements were not available. They further indicated that they were not aware of anyone issuing U.S. tax basis
equity audits. This agenda item proposes two options for consideration. The first option seeks input as to whether the audited U.S. tax basis exception is being used and if not, whether it should be removed as a permissible exception to audited U.S. GAAP basis in SSAP No. 48. The second option proposes an SAP clarification that if the audited U.S. tax basis exception is retained, the audit is required at the investee (investment) level.

c. **Agenda Item 202-03**

Mr. Bruggeman directed the Working Group to agenda item 202-03: Premium Adjustment Allocated to Jurisdictions. Robin Marcotte (NAIC) stated that while this agenda item does not propose statutory revisions, it does propose blanks instructional changes to Schedule T, the State Page and Accident and Health Policy Experience Exhibit (AHPEE) to clarify guidance for premium adjustments. She stated that NAIC staff received inquiries regarding a minor number of entities that primarily wrote health business related to the federal Affordable Care Act (ACA), which are believed to have not properly allocated premium adjustments by jurisdiction on the statutory financial statement. The proposed instruction changes clarify that all premium adjustments (both increases and decreases), including but not limited to ACA premium adjustments related to the risk adjustment program, shall be allocated as premium in the respective jurisdiction. This agenda item has a shortened comment period ending May 6.

d. **Agenda Item 202-04**

Mr. Bruggeman directed the Working Group to agenda item 202-04: ASU 2021-10, Government Assistance. Mr. Pinegar stated that this agenda item reviews *ASU 2021-10, Government Assistance, Disclosures by Business Entities about Government Assistance*, which increases transparency regarding certain types of government assistance by increasing the disclosure of such information in the financial statements. He stated that while ASU 2021-10 broadly defines government assistance, the disclosures are significantly reduced in scope as they would not apply to government transactions that are accounted for in accordance with other codification topics (e.g., accounted for as debt). He stated that due to the relative rarity of such disclosure, this agenda item proposed SAP clarifications to SSAP No. 24—*Discontinued Operations and Unusual or Infrequent Items*, incorporating certain disclosures from ASU 2021-10. The proposed additions will supplement existing disclosures to require that if the unusual or infrequent item is as the result of government assistance, the transaction will require identification, as well as a description of the terms and provisions of the assistance received.

e. **Agenda Item 202-05**

Mr. Bruggeman directed the Working Group to agenda item 202-05: ASU 2021-09, Leases, Discount Rate for Lessees. Mr. Stultz stated that this agenda item reviews *ASU 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities*, which states that when the rate implicit in the lease is readily determinable for any individual lease, that the lessee should use that rate (rather than a risk-free rate or an incremental borrowing rate), regardless of whether it has made the risk-free rate election. However, as statutory accounting generally requires all leases be classified as operating leases, this agenda item proposes SAP clarifications to reject ASU 2021-05 in SSAP No. 22R for statutory accounting.

f. **Agenda Item 202-06**

Mr. Bruggeman directed the Working Group to agenda item 202-06: ASU 2021-07, Compensation – Stock Compensation. Mr. Pinegar stated that this agenda item reviews *ASU 2021-07, Compensation – Stock Compensation (Topic 718), Determining the Current Price of an Underlying Share for Equity-Classified Share-Based
Draft Pending Adoption

Awards which offers nonpublic companies a practical expedient to one of the several inputs necessary for option-priced modeling. He stated that when equity share options or similar instruments are granted in a share-based payment transaction, the fair value (which is used to determine expense recognition at inception and during any subsequent award modification) is estimated using an option-pricing model valuation technique. ASU 2021-07 provides a third practical expedient for nonpublic companies and is the third such practical expedient permitted, of which the two other practical expedients have previously been adopted and are currently permissible for use in SSAP No. 104R—Share-Based Payments. He stated that this agenda item proposes SAP clarifications to SSAP No. 104R to incorporate the new practical expedient for the current price input.

g. Agenda Item 2022-07

Mr. Bruggeman directed the Working Group to agenda item 2022-07: ASU 2021-08, Business Combinations. Mr. Pinegar stated that this agenda item reviews ASU 2021-08, Business Combinations, Accounting for Contract Assets and Contract Liabilities from Contracts with Customers, which requires acquiring entities to apply the revenue from contracts with customer standard (Topic 606), when valuing and recognizing contract related assets and liabilities in a business combination. Prior to the issuance of ASU 2021-08, acquirers would generally only recognize such items based on their fair values on the date of acquisition. He stated that in keeping with historical precedent, this agenda item proposes SAP clarifications to reject ASU 2021-08 in SSAP No. 47—Uninsured Plans. However, as ASU 2021-08 is related to business combinations, the agenda item also proposes SAP clarifications to SSAP No. 68 to reject ASU 2021-08 for statutory accounting, while noting that rejection does not impact the determination of U.S. GAAP book value in an acquired entity.

h. Agenda Item 2022-08

Mr. Bruggeman directed the Working Group to agenda item 2022-08: INT 22-01T: Freddie Mac When-Issued K-Deal (WI Trust) Certificates. Ms. Gann stated that State Farm Mutual Automobile Insurance Company has sponsored this agenda item in collaboration with Freddie Mac requesting accounting and reporting clarification for Freddie Mac “When-Issued K-Deal (WI Trust) Certificates.” She stated that these certificates are akin to to-be-accounted (TBA) investments, in which certificate holders ultimately receive Freddie Mac guaranteed mortgage-backed securities. She stated that this program, in essence, creates an additional trust where the investor buys certificates in the “WI” trust, where then the WI trust uses the cash to purchase the mortgage securities from the real-estate mortgage investment conduit trust, who in turn purchases the mortgage securities directly from Freddie Mac. Upon conversion, the investor can take possession of the underlying mortgage securities or hold the trust certificates and receive the underlying mortgage security cashflows in a pass-through manner. In either event, the performance of the investment is guaranteed by Freddie Mac. The tentative statutory accounting interpretation clarifies that investments in the Freddie Mac WI Program shall be captured in scope of SSAP No. 43R from initial acquisition. This agenda item has a shortened comment period ending May 6.

6. Discussed Other Matters

a. Review of U.S. GAAP Exposure

Jason Farr (NAIC) stated that although there was one FASB exposure at the time the materials were published, its comment deadline of March 31 has passed. The proposed ASU would increase the disclosure regarding supplier finance programs. These programs allow a third-party financier to enter into the traditional buyer/supplier relationship, which effectively creates a structured payable agreement. NAIC staff recommend reviewing the final ASU under the SAP Maintenance Process as detailed in Appendix F—Policy Statements.
b. **Referral to the Casualty Actuarial and Statistical (C) Task Force – Update**

Ms. Marcotte stated that the Casualty Actuarial and Statistical (C) Task Force met March 8 to discuss a recommendation regarding the Working Group referral on agenda item 2019-49: Retroactive Reinsurance Exception regarding diversity in reporting for retroactive intercompany reinsurance contracts that meet the exception and allow for prospective reporting. She stated that the primary issue to address is whether to allocate premium back to prior years on annual statement Schedule P when multiple years of premium are ceded to a reinsurer. She stated that the Task Force plans to continue to work on this topic using a small group to draft proposed revisions to Schedule P instructions and other related guidance in **SSAP No. 62R—Property and Casualty Reinsurance**, specifically guidance in paragraph 36 and paragraph 37. NAIC staff were directed to continue working with the small group.

c. **Comment Letter Received from the ACLI**

Ms. Marcotte stated that the Working Group and the Valuation of Securities (E) Task Force received a comment letter from the American Council of Life Insurers (ACLI) regarding a proposed Task Force amendment to the P&P Manual to permit unguaranteed and unrated subsidiary obligors in working capital finance investment (WCFI) transactions. As the Working Group does not have an exposure on this topic, it noted receipt of the comments, including the mention of the FASB exposure of proposed disclosures regarding supply chain finance programs. The Working Group does not plan to address the ACLI comments at this time (See – **NAIC Proceedings – Spring 22 Valuation of Securities (E) Task Force – Attachments Six-B and Six-C**).

d. **ASU 2016-13**

Ms. Gann stated that NAIC staff have received an inquiry regarding anticipated work related to **ASU 2016-13, Financial Instruments – Credit Losses (CECL)**. She stated that since its private company implementation is scheduled for enactment on Jan. 1, 2023, NAIC staff request input from industry representative on how CECL has affected their U.S. GAAP financial statements. Information on the U.S. GAAP impact may provide insight on how to approach the CECL standard for statutory accounting.

Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.

https://naiconline.sharepoint.com/teams/frsstatutoryaccounting/national meetings/a. national meeting materials/2022/7-summer nm/hearing/1 - sapwg minutes 4.4.22 tpr.docx
Statsid Accounting Principles (E) Working Group
Virtual Meeting
May 24, 2022

The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force met May 24, 2022. The following Working Group members participated: Dale Bruggeman, Chair (OH); Kevin Clark and Carrie Mears, Co-Vice Chairs (IA); Sheila Travis (AL); Kim Hudson (CA); Michael Estabrook (CT); Rylynn Brown and Tom Hudson (DE); Eric Moser (IL); Judy Weaver (MI); Doug Bartlett and Pat Gosselin (NH); Bob Kasinow (NY); Melissa Greiner (PA); Jamie Walker and Shawn Frederick (TX); David Smith (VA); and Amy Malm (WI).

1. Reviewed Comments on Exposed Items

The Working Group held a public hearing to review comments (Attachment 1) on previously exposed items.

a. Agenda Item 2022-03

Mr. Bruggeman directed the Working Group to agenda item 2022-03: Premium Adjustment Allocated to Jurisdictions. Robin Marcotte (NAIC) stated that while this agenda item does not propose statutory revisions, it proposes blanks instructional changes to Schedule T, the State Page, and the Accident and Health Policy Experience Exhibit (AHPEE) to clarify guidance for premium adjustments. She stated that NAIC staff received inquiries regarding a minor number of entities that primarily wrote health business related to the federal Affordable Care Act (ACA), who did not properly allocate premium adjustments by jurisdiction but instead reported the adjustments on the “aggregate other alien line” in the statutory financial statements. The proposed instruction changes clarify that all premium adjustments, both increases and decreases, including but not limited to, ACA premium adjustments related to the risk adjustment program, shall be allocated as premium in the respective jurisdiction and are effective for year-end 2022 reporting.

Ms. Malm made a motion, seconded by Mr. Hudson, to adopt agenda item 2022-03 (Attachment 2), noting that the agenda item did not result in statutory revisions; however, it expressed support for the sponsored Blanks (E) Working Group proposal 2022-10BWG. The motion passed unanimously.

b. Agenda Item 2022-08

Mr. Bruggeman directed the Statutory Accounting Principles (E) Working Group to agenda item 2022-08: Treatment of Freddie Mac WI Certificates and the related Interpretation (INT) 22-01T: Freddie Mac When-Issued K-Deal (WI Trust) Certificates. Julie Gann (NAIC) stated that this sponsored agenda item is to address the accounting and reporting for Freddie Mac When-Issued K-Deal (WI Trust) Certificates. This program, in essence, creates an additional trust where the investor buys certificates in the WI trust, which is initially backed by cash; and within 90 days, the WI trust uses the cash to purchase the mortgage securities from the real estate mortgage investment conduit trust. Ms. Gann stated that although there is a short delay in acquiring the mortgage-backed securities, the performance of the investment is guaranteed by Freddie Mac. The tentative statutory accounting interpretation clarifies that investments in the Freddie Mac WI Program shall be captured in scope of Statement of Statutory Accounting Principles (SSAP) No. 43R—Loan-Backed and Structured Securities from initial acquisition.

Mr. Hudson made a motion, seconded by Ms. Greiner, to adopt the exposed INT 22-01 to clarify that Freddie Mac When-Issued K-Deal (WI Trust) Certificates are in scope of SSAP No. 43R from acquisition (Attachments 3 and 4). The motion passed unanimously.
c. **Agenda Item 2021-21**

Mr. Bruggeman directed the Working Group to agenda item 2021-21: Related Party Reporting. Jake Stultz (NAIC) stated that this agenda item was drafted in response to recent discussions on the reporting and disclosure requirements for investments that involve related parties. He stated that the agenda item proposes revisions to SSAP No. 25—*Affiliates and Other Related Parties* and SSAP No. 43R, clarifying related party and affiliate guidance, as well as requiring new reporting information for investments that are acquired from a related party, regardless of whether the investment is captured on the affiliate reporting line. He stated that the main goals are to: 1) clarify the reporting of affiliate transactions within existing reporting lines in the investment schedules; and 2) incorporate new reporting requirements for investment transactions with related parties using new reporting codes. He stated that interested parties requested the deletion of a proposed addition to SSAP No. 43R; i.e., an addition that seeks to clarify that investments with arrangements that result in a direct or indirect control shall be reported as affiliated. He stated that in response to these comments, pursuant to existing guidance in the *Insurance Holding Company System Regulatory Act* (#440) and SSAP No. 25, affiliation is determined through direct or indirect control, and that control can be based on voting rights, management and policies, contract, or otherwise. He also stated that the addition to SSAP No. 43R does not modify the current affiliation designation process. He stated that NAIC support staff recommended retaining the sentence requested for deletion; however, they modified it slightly to clarify that these scenarios are examples and not limitations in the determination of control. He stated that NAIC staff recommended that the Working Group adopt this agenda item and confirm that:

1. The new disclosures are effective for year-end 2022 reporting, as this date is in line with other state insurance regulators’ initiatives, including the Macroprudential (E) Working Group.
2. The related party new electronic code column is effective for all noted investment schedules: B–Mortgage Loans, D–Long-Term Bonds, DB–Derivatives, BA–Other Long-Term Invested Assets, DA–Short-Term Investments, E2–Cash Equivalents, and DL–Securities Lending Collateral Assets.
3. The related party new electronic code column shall be completed for all investments on any reporting line.
4. The Statutory Accounting Principles (E) Working Group supports the inclusion of Code 6 (no related party relationship), as exposed by the Blanks (E) Working Group (2021-22 BWG), to eliminate potential confusion on whether the absence of a code represents incomplete reporting or a non-related party relationship.

Mr. Stultz stated that information contained in the interested parties’ comment letter regarding the determination of affiliation under Model #440, and that it is solely based on voting rights of an equity holder, is incorrect. He stated that although ownership of 10% of voting securities results in a presumption of control, voting securities are not the sole basis for determining control. Determination of the affiliation of an investment is based on an evaluation of control of the investee, whether through voting interests or other means; accordingly, this agenda item does not propose to change the affiliate determination or definition. Mr. Stultz stated that interested parties also recommended other revisions to SSAP No. 25 and SSAP No. 97—*Investments in Subsidiary, Controlled and Affiliated Entities* to include open-ended foreign regulated investments that are currently captured in SSAP No. 3OR—*Unaffiliated Common Stock*; however, it was recommended that any other changes to the exposed language be considered in a separate agenda item.

Angelica Tamayo-Sanchez (New York Life), representing interested parties, stated that there remain interpretation questions regarding the objectives of the agenda item versus what reporting will result upon adoption. She stated that while interested parties agree that guidance states that control can be achieved through means other than ownership, specific questions remain regarding collateral loan obligations (CLOs). She stated that language being proposed for adoption implies that CLOs managed by an affiliated party would be deemed to be an affiliated transaction; i.e., an interpretation that differs from industry’s interpretation of current reporting requirements.
She stated that most insurance companies would not have reported CLOs as affiliated investments if the underlying investments do not have affiliated credit exposure, despite it being managed or originated by a related party. She stated that while the agenda item states that it is not intended to change current affiliated reporting requirements, if these investments should be deemed affiliated, most insurers have likely misinterpreted the guidance regarding their reporting. Discussions among industry indicate that if it is the will of the Statutory Accounting Principles (E) Working Group to classify these investments as affiliated, it will be a change from current, prevalent practice. In addition, there is a presumption that affiliated investments are required to be reviewed by the NAIC Securities Valuation Office (SVO), and if certain CLOs are required to be reported as affiliated, they could lose their filing exempt (FE) status. If FE status is lost, the SVO may need to develop additional procedures, as it does not currently have a methodology to designate this type of asset-backed security investment structure.

Mr. Clark stated that there is a mistaken interpretation that affiliation designation based on securitizations should be based on the affiliated credit exposure of the underlying collateral. He stated this interpretation is not consistent with Model #440 or SSAP No. 25. The affiliate designation is determined based on the ability to direct activities, not credit exposure. If an entity can control the activities of another entity, then all transactions, regardless of credit exposure, should be deemed affiliated. Mr. Clark stated that there is nothing in Model #440 that would scope out securitizations, and to exclude them for any purpose, including through the insertion of an unaffiliated intermediary, is incorrect. He stated that investments without an affiliated credit exposure that are originated or managed through an affiliated entity should be deemed affiliated. The need to distinguish between affiliated and unaffiliated credit exposure, despite being on an affiliated reporting line, is an important goal of this agenda item and is achieved through the new, supplemental reporting codes. Currently, since affiliation is based on control, without the use of these reporting codes, there is no way to differentiate between various types of credit exposure. In addition, some investments could be structured in a manner that the control threshold is not met, thus an investment would not be classified as affiliated; however, it does have underlying affiliated investment involvement; i.e., affiliated origination. This agenda item would assist state insurance regulators in the identification of such circumstances. Mr. Clark stated that the specificity proposed for SSAP No. 25 does not imply that any affiliated involvement causes an investment to become affiliated; it only clarifies that a control evaluation is still required by the insurer. He stated that as an example, for affiliated investment managers who originate investments that are ultimately determined not to be affiliated, the fee structure is certainly an affiliated transaction and should have been reviewed by the state of domicile through an appropriate Model #440 filing. He stated that he would support a referral to the Valuation of Securities (E) Task Force to address FE questions regarding CLOs, as the intent was not to modify FE status of these investments.

Keith Bell (Travelers), representing interested parties, stated that the language as proposed will likely not yield the results desired by state insurance regulators, specifically the reporting of certain investments as affiliated if they are managed by an affiliated asset manager. He stated that Model #440 was drafted prior to the prevalence of securitizations, and the emphasis of the model is on equity investments, not debt investments. He stated that debt investments are the rights to contractual cashflows, which do not represent equity investments; thus, determining control based on a debt investment for the determination of affiliate classification is not consistent with current practice. He stated that interested parties do not disagree with the objectives of state insurance regulators, but they believe the added language changes the scope of affiliated transactions, and if that is the ultimate wish of state insurance regulators, alternate guidance should be considered. Mr. Bruggeman stated that the spirit of the model is that if the underlying entity is affiliated, all associated transactions should also be deemed affiliated. However, increased reporting granularity of underlying credit exposure would be achieved through the new proposed reporting codes. The proposed language is only to clarify control, and it is not modifying Model #440, nor modifying affiliated reporting requirements. Mr. Clark stated that he agrees with Mr. Bruggeman in that if a company is deemed to be affiliated, all transactions, debt, equity, or other should also be reported as affiliated transactions. He also stated that the proposed language only clarifies when control exists, not necessarily how to determine if control exists. He stated that if there is a desire to further clarify how to determine control, that
would need to be in a project separate from this agenda item. Ms. Weaver stated that the interpretive disconnect of industry could leave open the possibility of other investments to not be reported as affiliated, and she inquired if interested parties have suggestions to the proposed revisions. Mr. Bell stated that interested parties do not have any suggestions but believe the current language is not sufficient to meet the needs of state insurance regulators, as there will still be ambiguity in reporting requirements. Rose Albrizio (Equitable), representing interested parties, stated that she concurs with Mr. Bell, and there will be difficulty for industry with applying the clarified affiliated reporting standard.

In response to Mr. Clark’s comments regarding determination of control for consolidated reporting purposes, Ms. Tamayo-Sanchez stated that U.S. generally accepted accounting principles (GAAP) generally require the determination of who controls the significant activities or economics in the initial determination of control for consolidated reporting purposes. She stated that if U.S. GAAP were used as a basis to determine if a CLO should be reported as affiliated due to exercising control, they would likely not be deemed as affiliates; however, industry struggles with how to define control of these instruments for statutory reporting purposes. As the insurer likely has a very passive involvement in the underlying investment and is only involved in the investment in the event of certain default situations, an affiliated designation for statutory accounting purposes is not consistent with current processes. Accordingly, many insurers will likely need to now move many debt investments to affiliated reporting lines.

Mr. Bruggeman stated that the challenge is that the intent of the agenda item is not to change affiliated reporting requirements; however, as many insurers believe this is a change, this likely represents an interpretation disconnect between insurers and state insurance regulators. He stated that this agenda will likely: 1) communicate the scope of affiliation determination and the associated reporting desires of state insurance regulators; and 2) supplement the reporting of all investments with the proposed reporting codes. The agenda item is not changing related party or affiliation determination pursuant to Model #440, especially as some states have adopted slight variations to the model. Mr. Clark stated that he agrees with Mr. Bruggeman, and he added that the determination of control has not changed. If detailed guidance regarding the evaluation of control were desired, it should be considered in a separate agenda item; however, insurers should continue to consult with their domestic regulators in the determination of affiliation designation. Mr. Bell stated that Mr. Bruggeman’s summation of the challenge was accurate; however, many in industry would not report affiliated debt investments as affiliated transactions, as they interpret Model #440 to be limited to equity interests. He stated that the interpretation of state insurance regulators is that investments originated through, or debt issued by, an affiliated entity is an approach not commonly interpreted by industry. Mr. Clark stated that his interpretation is that if an entity is determined to be affiliated, all transactions—i.e., debt or equity issued by an affiliate—would also be classified as affiliated; and to the extent that this has not been done previously, he supports corrected reporting going forward. Ms. Tamayo-Sanchez stated that the interpretation of industry based on today’s discussion was wrong, as they believe Model #440 only requires affiliated reporting if the investment has underlying affiliated credit exposure or if the insurer has control in the underlying investment, not an asset manager who originates the investment. Ms. Albrizio stated that the guidance should be supplemented using examples to clarify which investments should be reported as affiliated, as interested parties do not believe the current guidance is adequate to ensure that the reporting desired by state insurance regulators will be achieved. Mr. Bruggeman stated he appreciates the comments of industry to help articulate the interpretation differences; however, state insurance regulators believe that if an entity is deemed to be affiliated, all investments—debt or equity—should be reported as affiliated, regardless of underlying affiliated credit exposure. With the agenda item, the investments would have supplemental reporting to help further differentiate those with varying degrees of underlying related party credit exposure. Ms. Tamayo-Sanchez, not speaking on behalf of interested parties, stated that the interpretation of applying the affiliated designation to debt instruments only when there was an underlying affiliated credit exposure was incorrect and not in line with state insurance regulator expectations. She stated that for insurers who have not been a party to
the discussions related to this agenda item, they would likely continue existing practices for the determination of affiliation designation.

Mr. Clark made a motion, seconded by Mr. Smith, to:

1. Adopt the exposed revisions in SSAP No. 25; exposed revisions, with minor edits, in SSAP No. 43R; and new reporting disclosures for investments acquired from a related party, regardless of whether the investment is captured on an “affiliate” reporting line (Attachment 5).
2. Confirm that the new reporting codes applicable for investment schedules B, D, DB, BA, DA, E2, and DL shall apply to all investments on any reporting line and are effective for year-end 2022 reporting.
3. Confirm support for the inclusion of Code 6 (no related party relationship), as exposed by the Blanks (E) Working Group (2021-22 BWG) to eliminate potential confusion on whether the absence of a code represents incomplete reporting or a non-related party relationship.
4. Direct NAIC staff to draft the following for future Statutory Accounting Principles (E) Working Group discussion: 1) possible footnote revisions pursuant to interested parties’ comments; and 2) examples for possible inclusion in SSAP No. 43R to further clarify investments that should be classified as affiliated.
5. Send a referral to the Valuation of Securities (E) Task Force, notifying of this adopted agenda item, and assess whether corresponding edits are needed to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) regarding CLO investments that may now be classified as affiliated.

The motion passed unanimously.

Ms. Gann stated that as a reminder, the Blanks (E) Working Group has a public call scheduled for May 25, and the Statutory Accounting Principles (E) Working Group has a public call scheduled for July 18 to hear comments on the exposed bond definition and related issue paper.

Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.

https://naiconline.sharepoint.com/teams/frsstatutoryaccounting/national meetings/a. national meeting materials/2022/7-summer nm/hearing/2 - sapwg minutes 5.24.22tpr.docx
Draft: 7/27/22

Statutory Accounting Principles (E) Working Group
Virtual Meeting
July 18, 2022

The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force met July 18, 2022. The following Working Group members participated: Dale Bruggeman, Chair (OH); Carrie Mears and Kevin Clark, Co-Vice Chairs (IA); Sheila Travis (AL); Kim Hudson and Susan Bernard (CA); William Arfanis and Michael Estabrook (CT); Tom Hudson and Ryllynn Brown (DE); Cindy Andersen and Eric Moser (IL); Melissa Gibson (LA); Judy Weaver (MI); Doug Bartlett and Pat Gosselin (NH); Bob Kasinow (NY); Melissa Greiner (PA); Jamie Walker (TX); Doug Stolte and David Smith (VA); and Amy Malm and Elena Vetrina (WI).

1. Considered Maintenance Agenda – Active Listing

The Working Group held a public hearing to review comments (Attachment 1) on the bond definition and issue paper exposed March 2.

a. Agenda Item 2019-21

Mr. Bruggeman directed the Working Group to agenda item 2019-21: Proposed Bond Definition. Julie Gann (NAIC) provided an overview of the project stating that an updated principles-based bond definition and a draft issue paper were exposed March 2 for a public comment period ending May 6. She stated that comments were received from interested parties as well as the industry named Lease-Backed Securities Working Group. She identified that the materials provide a review of comments received, with an NAIC staff recommended response to each comment. Ms. Gann summarized each item as follows:

- Interested parties proposed to remove the footnote that details U.S. Treasury Inflation-Indexed Securities are in scope of Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds. The footnote was originally proposed to clarify that TIPS shall be considered bonds for statutory accounting reporting. Ms. Gann stated that these investments have returns that may vary based on an outside variable (inflation), and rather than delete the footnote, she would recommend revising the footnote to detail why these investments should remain in scope of SSAP No. 26R, despite them having the possibility of varied returns. She stated proposed revisions identify that these investments possess plain vanilla inflation adjustment mechanisms and are not intended to be captured within the provisions that restrict bond classification to securities that have principal and interest payments that vary based on an underlying reference variable. In addition, Ms. Gann noted that the bond definition referred to “equity-interests” for situations in which varying contractual principal or interest had to be assessed. She stated that this provision is not intended to be limited to certain types of debt investments, and the principle concept should be applied broadly. She noted that the recommendation is to revise the guidance to reflect “referenced variables.” Michael Reis (Northwestern Mutual), representing interested parties stated that interested parties are supportive of U.S. Treasury Inflation-indexed securities remaining in scope of SSAP No. 26R; however, they have not had an opportunity to review the proposed guidance in detail, so they will submit further comments in conjunction with the updated exposure, which is anticipated to occur at the Summer National Meeting.

- Interested parties recommended changes to the proposed bond definition to include reference that Securities Valuation Office (SVO)-identified credit tenant loans (CTLs) are bonds. Ms. Gann stated that SVO-identified CTLs are, by definition, not bonds; however, they are proposed to be specifically named in
scope of SSAP No. 26R and remain eligible for bond reporting. She stated that SVO-identified CTLs are mortgage loans, not securities, and are therefore initially captured in SSAP No. 37—Mortgage Loans. However, if the mortgage loan meets certain criteria after review by the SVO, the investment is captured in scope of SSAP No. 26R. Ms. Gann stated that separating items that qualify as bonds within the bond definition and named inclusions for bond reporting, such as SVO-identified exchange-traded funds (ETFs) or CTLs, is purposeful to prevent inadvertent inference to other investments. Mr. Bruggeman stated that this distinction was previously addressed, as SVO-identified CTLs are not securities; they are mortgage loans, and while the bond definition requires investments in scope to be securities, this named inclusion to SSAP No. 26R will ensure that qualifying non-security CTLs remain in scope. Mr. Reis, representing interested parties, stated that the inclusion of SVO-identified CTLs by name meets the needs of industry, and they do not recommend additional changes at this time. John Garrison (Lease-Backed Securities Working Group) stated agreement with Mr. Reis and inquired for clarification that SVO-identified CTLs, as well as lease-backed securities that meet the safe harbor rule, which allows up to a 5% balloon payment, qualify for reporting in scope of SSAP No. 26R as an issuer obligation. Mr. Clark stated that the nuance being discussed is that the principles-based bond definition applies to securities. As it is currently written, a lease-backed security where the full repayment of principal is supported by a lease to a single operating entity, which allows up to a 5% balloon payment, would qualify as an issuer obligation under the bond definition. Lease-backed securities that do not meet the safe harbor provision are required to be assessed as asset-backed securities (ABS) and only reported as bonds if they qualify. These bond definition components do not apply to SVO-identified CTLs, which are mortgage loans, as these items are reported as bonds only after verification from the SVO that set criteria has been obtained.

- Interested parties proposed to clarify that the assessment of “all returns” in excess of principal repayments are required to be considered interest should only apply to equity-backed ABS. Ms. Gann stated that the inclusion of excess returns as interest should not be limited, as restricting the analysis based on naming convention or broad security classifications would likely result in the misapplication of the guidance. Accordingly, the interested parties’ proposed change to restrict consideration of “all returns” to equity-backed ABS was not recommended, but revisions were proposed to clarify that the restrictions for variations in principal or interest payments applies to any debt investment in scope and can be in response to any underlying reference variable.

- Interested parties’ proposed revisions to clarify that a first loss position, and not just issued tranches, can be considered when assessing substantive credit enhancements. Ms. Gann stated that the initial read of the interested parties’ proposed edits could be interpreted to impact the residual guidance previously adopted, which requires residual tranches to be reported on Schedule BA—Other Long-Term Invested Assets. However, NAIC staff agree that whether a loss position is issued as a separate tranche or retained by the issuer does not impact the assessment of whether the loss position provides substantive credit enhancement to debt tranche holders. Ms. Gann stated that the interested parties’ revisions were reflected, with modifications to clarify that debt tranches are required to have contractual principal and interest payments to be considered for bond reporting. Mr. Reis, on behalf of interested parties, stated that NAIC staff’s proposed modification encompasses the spirit of their request; however, they will review in detail in conjunction with the upcoming exposure. Mr. Bruggeman stated that the proposed modification clarifies that the first issued debt tranche may not necessarily represent the first loss tranche, but there must be substantive credit enhancement to ensure that any issued tranche is eligible for bond reporting.

- Interested parties recommended guidance to address feeder funds, specifically a clarification that explicitly states that reporting entities should determine the source and terms of collateral in determining
whether an investment represents a creditor relationship and qualifies for bond reporting. A feeder fund is an arrangement where debt is issued from one fund (feeder fund), but that fund has an equity interest in another fund (secondary fund) that holds the underlying collateral. If the secondary fund holds qualifying debt instruments generating bond cash flows that are passed through to the holder, then the investment held from the feeder fund could in-substance be considered debt. However, if the underlying collateral in the secondary fund is equity interests, the reporting entity would have to: 1) consider the substance of the equity interests in the secondary fund in supporting the debt from the feeder fund; 2) assess whether the creditor relationship criteria is met; and 3) conclude that the investment does not reflect an in-substance equity relationship. Ms. Gann recommended that the issue paper guidance be expanded to address feeder funds. Mr. Bruggeman stated that the basic structure of feeder funds is described in the interested parties’ comments, and the revisions proposed by NAIC staff capture the particularities of these structures. Mr. Clark stated that in response to comments received by industry, their proposed edits went beyond the intent and outcomes of the small group discussions and could be read to imply that the fund intermediary could be ignored as long as the ultimate collateral were fixed income. As a result, revisions to the industry proposed language are proposed by staff to make it clear that the investor should consider the terms of the structure to ensure that the passthrough of underlying cash flows is supported. If the insertion of a feeder fund would alter the amount or timing of cashflows, that would need to be assessed in determining bond classification. Mr. Reis stated that the proposed edits appear to agree with industry requests; however, they will review in detail during the next exposure.

- Interested parties recommended that Appendix I of the bond definition, which has been reduced to two examples that do not reflect in-substance creditor relationships, be codified within the guidance instead of in an appendix. The Working Group directed NAIC staff to work with interested parties on the best approach to integrate the examples into the body of the guidance.

- Interested parties provided comments on the exposed guidance to restrict the reporting of ABS as short-term or cash equivalent investments. Ms. Gann stated support for the reporting of all ABS on the bond schedule to ensure that an avenue is not created that allows investments to bypass the bond assessments and still be reported as a short-term or cash equivalent bond. She stated that short-term and cash equivalent investments receive favorable treatment, as there is a minimal risk-based capital (RBC) factor and there is no need to obtain an NAIC designation or credit rating provider (CRP) rating. She stated that this favorable reporting is in line with a concept that there is insignificant risk for short-term and cash equivalent investments due to the time acquired in proximity to the maturity date. However, as ABS could have elements of principal repayment contingent on sale or refinancing at maturity, or other performance factors, these securities should not be permitted to be reported as short-term or cash equivalent investments regardless of how close the maturity date is after the reporting entity acquires the investment. She stated that there is a perception that short-term ABS are not prevalent, and the only example provided so far is “Asset-Backed Commercial Paper” (ABCP). She informed that although these designs have “commercial paper” in their name, it would be erroneous to assume that these ABS resemble “commercial paper” investments. ABCP structures are very different and represent a short-term vehicle issued by a bank or other financial institution that is backed by the company’s physical assets and issued on a discount or interest-bearing basis. She said that an ABCP can be created from any type of asset-backed security, including subprime mortgages or other high-risk performing assets. She stated that it is recommended that all ABS be excluded from the short-term or cash equivalent schedules. This will require that all ABS be assessed under the bond principles and reported, if qualifying, on the bond schedule in the appropriate ABS category.
Ms. Gann stated that the industry Lease-Backed Securities Working Group letter was consistent with its July 15, 2021, comment letter, and the ultimate request is to allow “simple secured loans” issued in security form to be in scope of SSAP No. 26R as issuer credit obligations. She stated that this would likely permit all such designs, regardless of structure, contingent factors, or residual/balloon payments, to be afforded bond treatment without further analysis. She stated that if permitted, investments would likely be in scope of SSAP No. 26R that may not be in line with the goals of the principles-based bond definition. In addition, the comment letter stated a perceived inequity between municipal revenue bonds and non-municipal revenue (project finance) bonds issued by operating entities and other lease-backed structures. Ms. Gann stated that despite the concern noted by the industry Lease-Backed Securities Working Group, NAIC staff did not believe revisions were required due to the differentiation of these investments already detailed in the draft issue paper. However, if the Working Group agreed that project finance bonds issued by operating entities and lease-backed securities with balloon payments are too similar to warrant classification differences between issuer credit obligations and ABS, then NAIC staff would recommend that the Working Group identify that project finance bonds are not considered to be issued by operating entities for bond reporting purposes. If a structure is not considered to be issued by an operating entity, then the investment would be required to follow the guidance for an ABS classification, including assessments for substantive credit enhancement and meaningful cash flows.

Mr. Clark stated that the distinction between an issuer obligation and ABS is that issuer obligations have repayment that is supported by the creditworthiness of an operating entity. However, for lease-backed securities, the ultimate repayment is generally reliant upon other avenues – generally liquidation or refinancing of the underlying collateral. Mr. Clark stated that those that are not fully supported by an operating entity would be required to review the ABS criteria. However, in terms of project finance, while the investment may appear similar to an ABS, many times, the debt is issued from a standalone operating entity. He stated that the guidance differentiates between the two types of investments; however, if the distinction is too difficult to apply, then all project finance would need to be evaluated using the ABS criteria.

Mr. Garrison stated that the Lease-Backed Securities Working Group’s comments intend to request that simple, structured loans be considered issuer credit obligations. He stated that the repayment of these investments is primarily dependent upon the contractual obligation of a single rated payer, which closely mimics the proposed guidance in the principle-based bond definition. These investments may either be unsecured or secured by a claim on an asset. If these investments are issued in the form of a security, they do not represent structured securities, as they reflect debt instruments that pass through unaltered contractual cashflows to investors. Mr. Garrison stated that even if issued from a trust, the asset owned is the debt instrument, not the underlying collateral. In essence, the debt is a form of security that is not altered by the presence or the attachment to underlying collateral. Additionally, these investments do not create a structured security or transfer equity risk into debt risk. Mr. Garrison stated that classifying some unstructured investments as ABS because of a claim on an asset will cause confusion in the market. He stated that structured investments mean the underlying cashflow of an investment has been structured so that cashflows have been redistributed and that credit has been altered by creating priority and subordinate classes. These investments are primarily supported by the credit worthiness of an operating entity and do not reflect typical structured finance investments. Mr. Garrison stated that certain investments, with similar characteristics, appear to have different treatment and recommend that all credit obligations, which rely primarily on an obligation of an operating entity, be held to the same standard. He stated that as an example, lease-backed securities are typically issued by a special purpose entity and are based on the cashflows from nonfinancial assets backed by a lease or other contract with an operator. If these contractual payments, which are secured by a lien on the asset, do not at least cover 100% of the interest and 95% of the contractual principal payment, they are not considered issuer credit obligations; however, no other investments are subject to these requirements. Mr. Garrison stated that all similar asset types (project finance, equipment trust certificates, etc.) should all be treated similarly. He clarified that the comment letter was intended to be limited to simple unstructured debt, which relies primarily on a contractual repayment obligation of a single credit.
rated obligor and was not intended to open the door to other investments falling into scope of SSAP No. 26R. These investments are what many lenders consider to be optimal debt structures, as they offer the most protections to lenders. However, if state insurance regulators wish to have these investments subject to the ABS standard, then they would request a clarification that the ABS standard applies to both ABS and simple secured loans. In a response to an inquiry from Mr. Bruggeman, Mr. Garrison stated that project finance should be treated similar to other assets with comparable risks, and he added that rating agencies state that revenue bonds are also not to be considered debt of the municipality, which is a further example of disparate treatment of similar asset types.

Mr. Reis, representing interested parties, stated that the exposed bond guidance represents the prior discussions with the small group involving interested parties; however, Mr. Garrison’s discussion represents asset classification between issuer obligations and ABS, not the determination of what a bond. He stated that interested parties support the previously exposed language, as they believe it best represents assets that fall along a continuum, ones that do not cleanly fit in one particular category.

Mr. Clark stated that Mr. Garrison’s comments that categorization as ABS occurs because a loan is secured by assets is not a correct statement. He stated that the reason many of these investments are considered ABS is because recourse of the debt instrument to the operating entity does not provide full repayment of the debt. Even if the operating entity fully performs on its payment obligations, there would still be remaining principal outstanding that relies on the underlying collateral to repay. This is why these investments require review under the ABS criteria because repayment of the debt generally requires reliance on the underlying collateral. Mr. Clark stated that the other types of issuer obligations like corporate bonds or treasuries are issued directly from with full recourse to the issuing operating entities. Lease-backed investments are issued by special purpose vehicles (SPVs), with the repayment obligation being shifted to an operating entity through a lease contract. However, if repayment is not fully shifted to an operating entity through the lease, they should be precluded from being considered issuer credit obligations. Mr. Clark stated that it is his view that it makes perfect sense for this to be where the distinguishing line is drawn between issuer obligations and ABS. Ms. Gann stated that NAIC staff recommend retaining the guidance as previously exposed and not direct that project finance bonds that are issued by operating entities be required to follow the ABS criteria.

Ms. Gann stated that interested parties also provided comments on the classification of non-bond investments to Schedule BA and the appropriate measurement method for those investments. She stated that NAIC staff request direction from the Working Group to develop statutory accounting revisions to incorporate principles-based guidance for the measurement and admittance of different types of investments. Additionally, she stated that interested parties had proposed to capture New Markets Tax Credit (NMTC) investments in scope of the bond project. She recommended that NMTCs be reviewed in a separate agenda item. Mr. Bruggeman stated that he views the NMTCs similarly to federal Low-Income Housing Tax Credits (LIHTCs), and a separate discussion for these investments is most appropriate. Mr. Reis stated that interested parties support drafting guidance for investments that move to Schedule BA and support a NMTC agenda item to clarify the accounting and reporting requirements.

Mr. Clark made a motion, seconded by Mr. Bartlett, to direct NAIC staff to: 1) draft revisions as discussed during the meeting to the principles-based bond definition and issue paper, where applicable, regarding TIPS and varying contractual principal and interest payments, clarifying guidance for first loss positions in providing substantive credit enhancement; and 2) add guidance for feeder funds. It is anticipated that a revised packet, which includes the updated bond definition, issue paper, and proposed revisions to incorporate the bond concepts in SSAP No. 26R and SSAP No. 43R—Loan-Backed and Structured Securities (to be renamed “Asset Backed Securities”) will be presented for exposure at the Summer National Meeting. Additionally, the motion included direction for NAIC staff to: 1) draft measurement and admittance guidance for investments that will move from the bond schedule to Schedule BA; and 2) consider NMTCs in a separate agenda item. The motion passed unanimously.
2. Considered Maintenance Agenda – Pending Listing – Exposures

a. Agenda Item 2019-21

Mr. Bruggeman directed the Working Group to agenda item 2019-21: Bond Proposal Reporting Revisions. Ms. Gann stated that a key element of the principles-based bond project is to improve transparency and granularity to the state insurance regulators regarding investment types and investment structure. This aspect of this agenda item includes two documents for exposure summarized as follows:

- Proposed Reporting Lines – This document proposes annual statement general instructions (reporting line descriptions) for suggested reporting lines to capture issuer credit obligations and ABS on Schedule D-1. The general classifications that currently exist are proposed to be deleted, and new granular reporting lines are suggested. This document shows tracked changes to the current “Annual Statement General Instructions”; however, the document only includes revisions related to Schedule D-1. It is anticipated that other schedules are likely to be impacted by these new reporting lines, and those revisions will be drafted after considering the comments from this initial exposure.

- Schedule D-1 Annual Statement Instructions – This document details the overall approach to add a new bond reporting schedule to expand Schedule D-1 into two components. Schedule D-1-1 would reflect issuer credit obligations (items proposed to be captured in scope of SSAP No. 26R) and Schedule D-1-2 would reflect ABS (items proposed to be captured in scope of SSAP No. 43R). This separation of schedules is supported to enable different reporting columns based on the type of security. Columns that are proposed to be specific to issuer obligations and ABS are noted within the document. In addition to creating new columns, this document also details revisions to existing columns and instructions.

Ms. Gann stated that at this time, NAIC staff are not recommending a referral to the Blanks (E) Working Group, as the intent of this exposure is to gather initial feedback regarding the proposed direction, specifically adding a new schedule specific to ABS investments. Mr. Bruggeman stated that separate schedules for issuer credit obligations and ABS was the result of ongoing discussions with interested parties regarding the most efficient way to capture information elements specific to each investment type. Tip Tipton (Thrivent) stated that interested parties have been working behind the scenes to understand the goals of state insurance regulators and the changes proposed. He stated that interested parties look forward to collaborating with state insurance regulators and NAIC staff in the ultimate adoption of this proposal.

Mr. Hudson made a motion, seconded by Mr. Clark, to move agenda item 2019-21 to the active listing and expose it for a public comment period ending Oct. 7. Also included in the motion was direction to NAIC staff to notify all working groups and task forces of use of Schedule D-1 for any analysis of this exposure, so that any group affected will have an opportunity to offer input regarding the proposed revisions. The motion passed unanimously.

3. Discussed Other Matters

a. Memorandum of Support from the Financial Condition (E) Committee

Ms. Gann stated that Financial Condition (E) Committee distributed a memorandum of support (Attachment 2) for several current, interrelated initiatives focused on asset risk or spread risk within the task forces and working groups of the Committee. She stated that the clarification of investments permitted to be reported as long-term bonds, with improved transparent accounting and RBC reporting, was specifically identified. Mr. Bruggeman identified that the memorandum would be noted as received by the Working Group.
Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.

https://naiconline.sharepoint.com/teams/frsstatutoryaccounting/national meetings/a. national meeting materials/2022/7-summer nm/hearing/3 - sapwg minutes 7.18.22tpr.docx
Issue: ASU 2021-10, Government Assistance

Check (applicable entity):

- Modification of Existing SSAP
- New Issue or SSAP
- Interpretation

P/C  Life  Health
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Description of Issue: In November 2021, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2021-10, Government Assistance, Disclosures by Business Entities about Government Assistance to increase financial statement transparency regarding certain types of government assistance by increasing the disclosure of such information in the notes to the financial statements.

The new disclosure aims to increase transparency by enhancing the identification of 1) the types of assistance received, 2) an entity’s accounting for said assistance, and 3) the effects of the assistance in an entity’s financial statements. The disclosures will contain information about the nature of the transactions, which includes a general description of the transaction and identification of the form (cash or other) in which the assistance was received. In terms of the effects on the financial statement, disclosure will include identification of the specific line items in both the balance sheet and income statement and a description of the extent to which they have been impacted by any government assistance. In addition, an entity will be required to disclose information about any significant terms of the transaction with a government entity, with items including durations of such agreements and any provisions for potential recapture.

ASU 2021-10 defines “government assistance,” in a comprehensive manner to capture most types of assistance and includes examples of tax credits, cash grants or grants of other assets. The scope of this ASU is narrow as it does not apply to not-for-profit entities or benefit plans. Further narrowing in scope, the new disclosure requirements in this ASU only apply to transactions that are accounted for by analogizing either a grant or contribution model. As such, these enhanced disclosures do not apply to government transactions that are accounted for in accordance with other codification topics, such as classifying the transactions as debt in ASC 470, income taxes in ASC 740, or as revenue from contracts with customers in ASC 606.

With the specificity of these additional disclosures only applying in certain circumstances (only applicable in cases where the government assistance is not accounted for in accordance with other accounting standards – i.e., revenue in the normal course of business or debt), NAIC staff believe the occurrence of such items requiring disclosure per ASU 2021-10 will likely be relatively infrequent.

NAIC staff also note that consistent with ASU 2021-10, had the assistance been accounted for in a differing manner (e.g., as debt per SSAP No. 15—Debt and Holding Company Obligations), that the required identification and disclosures for the applicable SSAP would apply. As a final note, it is anticipated that for most entities who qualified for and received Paycheck Protection Program (PPP) loans, as authorized by the CARES Act, that the additional disclosures in this ASU still would not apply. It is believed that most insurance reporting entities accounted for PPP transactions as liabilities per SSAP No. 15. [For reference, in accordance with SSAP No. 15, debt may only be derecognized if the reporting entity was legally released from the liability (SSAP No. 15, paragraph 11), at which time the extinguishment of debt was reported as a capital gain (SSAP No. 15, paragraph 25).]
Existing Authoritative Literature:

**NAIC Staff Note** – as mentioned above, NAIC staff believe that as these additional disclosures are not applicable for transactions that are in scope of other accounting standards, and only apply when the transaction is accounted for by analogy using the grant or contribution model, the prevalence of such items will be infrequent. As such, the most appropriate location for these items is reflected in SSAP No. 24.

**SSAP No. 24—Discontinued Operations and Unusual or Infrequent Items**

Unusual or Infrequently Occurring Items

9. A material event or transaction that an entity considers to be of an unusual nature or of a type that indicates infrequency of occurrence or both shall be reported consistently with the reporting entity's reporting of continuing operations (i.e., no separate line item presentation in the balance sheet or statement of operations). Such items shall not be charged directly to surplus unless specifically addressed elsewhere within the Accounting Practices and Procedures Manual.

   a. “Unusual Nature” shall be defined as the underlying event or transaction that should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.

   b. “Infrequency of Occurrence” is defined as the underlying event or transaction that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

Disclosures [Unusual/Infrequent Items]

16. The nature and financial effects of each unusual or infrequent event or transaction shall be disclosed in the notes to the financial statements. Gains or losses of a similar nature that are not individually material shall be aggregated. This disclosure shall include the line items which have been affected by the event or transaction considered to be unusual and/or infrequent.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): NA

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to SSAP No. 24—Discontinued Operations and Unusual or Infrequent Items, incorporating certain disclosures from ASU 2021-10. The proposed additions will supplement existing disclosures to require that if the unusual or infrequent item is as the result of government assistance, the transaction will require identification as well as a description of the terms and provisions of the assistance received.

NAIC staff recommend incorporating the new disclosures in ASU 2020-10, modified only to require the supplemental disclosures for all entity types (as SAP disclosures do not differentiate between entity type – i.e., not-for-profit vs. other). As a final note, existing disclosures for unusual/infrequent items (captured in financial statement note #21) already contains the requirement to identify the specific line items which have been affected
by the events or transactions considered to be unusual and/or infrequent - thus that specific portion of ASU 2021-10 is not included in the proposed additions below.

**Proposed Revisions to SSAP No. 24**

**Disclosures [Unusual/Infrequent Items]**

16. The nature, including a general description of the transactions, and financial effects of each unusual or infrequent event or transaction shall be disclosed in the notes to the financial statements. Gains or losses of a similar nature that are not individually material shall be aggregated. This disclosure shall include the line items which have been affected by the event or transaction considered to be unusual and/or infrequent. If the unusual or infrequent item is as the result of government assistance (as defined in ASU 2021-10, *Government Assistance, Disclosures by Business Entities about Government Assistance*) disclosure shall additionally include the form in which the assistance has been received (for example, cash or other assets), and information regarding significant terms and conditions of the transaction, with items including, to the extent applicable, the duration or period of the agreement, and commitments made by the reporting entity, provisions for recapture, or other contingencies.

**Relevant Literature**

24. This statement adopts ASU 2021-10, *Government Assistance: Disclosure by Business Entities about Government Assistance*, with modification to require disclosure by all entity types.

**Staff Review Completed by:** Jim Pinegar - NAIC Staff, January 2022

*Recommendation:*
NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to SSAP No. 24—*Discontinued Operations and Unusual or Infrequent Items*, incorporating certain disclosures from ASU 2021-10. The proposed additions will supplement existing disclosures to require that if the unusual or infrequent item is as the result of government assistance, the transaction will require identification as well as a description of the terms and provisions of the assistance received.

**Status:**
On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 24—*Discontinued Operations and Unusual or Infrequent Items*, as illustrated above, which incorporate certain disclosures from ASU 2021-10 to supplement existing disclosures regarding unusual or infrequent items.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Hearing/4 - 22-04 - ASU 2021-10 Govt Assistance.docx

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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: ASU 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities

Check (applicable entity):

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<td>New Issue or SSAP Interpretation</td>
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Description of Issue: In November 2021, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities. This ASU was issued as part of FASB’s post-implementation review to address issues that have been found during the implementation of the new lease guidance from ASU 2016-02, Leases (Topic 842). Topic 842 generally requires the capitalization of leases, which is calculated by discounting the lease payments utilizing the implicit rate in the lease, or if not determinable, the lessee’s incremental borrowing rate. However, the standard also provides nonpublic entities with a practical expedient, permitting the use of a risk-free rate (e.g., U.S. Treasury Rate) for the capitalization calculation. As the risk-free rate is generally lower than anyone’s incremental borrowing rate, stakeholders expressed concerns that the calculation of present value (utilizing the practical expedient) often results in recognition of lease liabilities and right-of-use assets that are greater than those recognized by their public counterparts. To alleviate this concern, the guidance in ASU 2021-09 broadens the practical expedient so nonpublic lessees may make the risk-free rate election by class of underlying asset, rather than at the entity-wide level – thus the entity more able to apply the practical expedient when beneficial. An entity that makes the risk-free rate election is required to disclose which asset classes it has elected to apply a risk-free rate. The guidance provided in this ASU is specific to the financing lease treatment under U.S. GAAP, and since SSAP No. 22R—Leases requires nearly all leases to be treated as operating leases for statutory accounting, adoption of this guidance would be unnecessary.

Existing Authoritative Literature:
The ASUs related to Topic 842 have previously been rejected in SSAP No. 22R—Leases.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): ASC Topic 842 was the result of a joint project between FASB and the International Accounting Standards Board.

Recommendation: NAIC staff recommends the Working Group move this agenda item to the active listing, categorized as a SAP clarification and expose revisions to reject ASU 2021-05 in SSAP No. 22R—Leases. Under statutory accounting almost all leases are classified as operating leases, thus this U.S. GAAP guidance is not necessary. Proposed Revision to SSAP No. 22R ( Relevant Literature section – paragraph 52):

i. ASU 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities
   (Rejected in its entirety.)

Staff Review Completed by: Jake Stultz, NAIC Staff – January 2022
Status:
On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as a SAP clarification, and exposed revisions, as illustrated above, to reject ASU 2021-09 in SSAP No. 22R—Leases.

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: ASU 2021-07, Compensation – Stock Compensation

Check (applicable entity):

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Description of Issue: In October 2021, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2021-07, Compensation – Stock Compensation (Topic 718), Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards to offer nonpublic companies a practical expedient to one of the several inputs necessary for option-priced modeling. When equity share options or similar instruments are granted in a share-based payment transaction, the fair value (which is used to determine expense recognition at inception and during any subsequent award modification) is estimated using an option-pricing model valuation technique.

In terms of option-priced models, the Black-Scholes-Merton model is considered to be one of the most widely used as it has less complexity than other pricing models. However, despite its reduced complexity, it (and various other pricing models) requires numerous inputs which typically include exercise price, expected dividend rate, risk-free interest rate, expected term, expected share price volatility, and current share price. For public entities, the determination of these values is generally readily available, however for nonpublic entities, many of these inputs are not easily determinable.

Of these inputs, private company stakeholders have indicated that three of these inputs (exercise price, expected dividend rate, and risk-free interest rate) are easy to obtain. However, stakeholders indicated that the remaining three inputs (expected share price volatility, expected term, and current share price) can be costly and difficult to estimate. Topic 718 already provides nonpublic entities with practical expedients for expected share price volatility and expected term. However, prior to ASU 2021-07, a practical expedient was not available for estimating the current price input. The current price input is often considered the most costly and complex input to determine and audit for nonpublic entities, primarily because an active market for those entities’ shares does not exist and therefore a readily determinable market price is not available.

ASU 2021-07 provides a practical expedient for nonpublic entities to determine the current price by utilizing a “reasonable application of a reasonable valuation method.” The practical expedient describes several characteristics of a reasonable valuation method and will include 1) consideration of the value of all tangible and intangible assets, 2) the present value of future anticipated cash flows, 3) the market value of similar entities, 4) recent arm’s-length transactions involving the sale or transfer of stock/equity interests, and 5) other relevant factors that affect the valuation or have a material economic effect on the entity. The calculation of share price must be timely in it cannot be more than 12 months stale, and all available information after the date of calculation that may materially affect the valuation of the entity must be considered for any value updates.

One final note - this ASU provides a practical expedient (not an accounting alternative) to one of the inputs used for nonpublic companies in their option-pricing modeling. Also, as mentioned previously, this is the third such practical expedient permitted in Topic 718, of which the previous two (expected share price volatility and expected term) have previously been adopted and are currently permissible for use in SSAP No. 104R—Share-Based Payments (further detailed in the “Existing Authoritative Literature” section).
Existing Authoritative Literature: ASU 2021-07 offers a third practical expedient for the inputs utilized in option-pricing models. As previously mentioned, the prior two practical expedients are permissible in SSAP No. 104R and are included herein for reference:

Practical Expedient Regarding Volatility: Topic 718 (paragraph 718-10-30-20) recognizes nonpublic entities may not be able to reasonably estimate the fair value as it is not practicable to estimate share volatility, a component of the fair value calculation. Adoption of this first practical expedient to address this circumstance occurred through the Working Group’s adoption of FAS 123R, Share-Based Payment. The applicable paragraph in SSAP No. 104R has been included with relevant guidance bolded.

52. A reporting entity may not be able to reasonably estimate the fair value of its equity share options, nonemployee awards and similar instruments because it is not practicable for the reporting entity to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options, nonemployee awards and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity’s share price (the calculated value). A reporting entity’s use of calculated value shall be consistent between employee share-based payment transactions and nonemployee share-based payment transactions. Throughout the remainder of this statement, provisions that apply to accounting for share options, nonemployee awards and similar instruments at fair value also apply to calculated value.

Practical Expedient Regarding Expected Term: Topic 718 (paragraph 718-10-30-20A) recognizes nonpublic entities may not be able to reasonably account for the expected term of a share-based payment. Adoption of a second practical expedient to address this circumstance occurred through the Working Group’s adoption, with modification, of ASU 2016-09, Improvements to Employee Share-Based Payment Accounting. The applicable paragraphs from SSAP No. 104R have been included below:

53. For an award that meets the conditions in paragraph 54, a reporting entity may make an entity-wide accounting policy election to estimate the expected term using the following practical expedient:

   a. If vesting is only dependent upon a service condition, a reporting entity shall estimate the expected term as the midpoint between the employee’s requisite service period or the nonemployee’s vesting period and the contractual term of the award.

   b. If vesting is dependent upon satisfying a performance condition, an entity first would determine whether the performance condition is probable of being achieved.

      i. If the reporting entity concludes that the performance condition is probable of being achieved, the entity shall estimate the expected term as the midpoint between the employee’s requisite service period or the nonemployee’s vesting period and the contractual term.

      ii. If the reporting entity concludes that the performance condition is not probable of being achieved, the reporting entity shall estimate the expected term as either:

         (a) The contractual term if the service period is implied (that is, the requisite service period or the nonemployee’s vesting period is not explicitly stated but inferred based on the achievement of the performance condition at some undetermined point in the future).

         (b) The midpoint between the employee’s requisite service period or the nonemployee’s vesting period and the contractual term if the requisite service period is stated explicitly.
54. A reporting entity that elects to apply the practical expedient in paragraph 53 shall apply the practical expedient to a share option or similar award that has all of the following characteristics:
   a. The share option or similar award is granted at the money.
   b. The grantee has only a limited time to exercise the award (typically 30-90 days) if the grantee no longer provides goods or terminates service after vesting.
   c. The grantee can only exercise the award. The grantee cannot sell or hedge the award.
   d. The award does not include a market condition.

A reporting entity that elects to apply the practical expedient in paragraph 53 may always elect to use the contractual term as the expected term when estimating the fair value of a nonemployee award as described in paragraph 42. However, a reporting entity must apply the practical expedient in paragraph 53 for all nonemployee awards that have all the characteristics listed in this paragraph if that reporting entity does not elect to use the contractual term as the expected term and that reporting entity elects the accounting policy election to apply the practical expedient in paragraph 53.

ASU 2021-07 also supplements existing disclosure requiring that if this new practical expedient is utilized, its use shall be disclosed. NAIC staff have determined that additional disclosures in SSAP No. 104R are likely not necessary as existing SAP disclosures reference the disclosures in FASB Codification 718-10-50-2 as required – which is the location for FASB’s new disclosure regarding use of this practical expedient.

Disclosures

113. An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand all of the following:
   a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders;
   b. The effect of compensation costs arising from share-based payment arrangements on the income statement;
   c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period; and
   d. The cash flow effects resulting from share-based payment arrangements.

114. The disclosures in paragraph 113 are for annual audited statutory financial statements only. This statement adopts FASB Codification 718-10-50-2 for the minimum disclosure information needed to achieve the objective in paragraph 113 of this statement, noting that a reporting entity may need to disclose additional information to achieve the objectives.

As final reference, SSAP No. 104R has predominantly adopted, with modification from U.S. GAAP guidance regarding share-based payment guidance, as detailed below.

126. This statement adopts with modification the U.S. GAAP guidance for share-based payment transactions reflected in FASB Accounting Standards Codification (ASC) Topic 718, Compensation – Stock Compensation, as modified by the ASUs listed in paragraphs 126.a through 126.e, excluding the guidance in ASC Subtopic 718-40, Employee Stock Ownership Plans (ESOPs). Statutory accounting guidance for ESOPs is addressed in SSAP No. 12—Employee Stock Ownership Plans. This adoption with modification includes the related implementation guidance reflected within the FASB Codification Topic 718 not reflected within this standard. The U.S. GAAP guidance adopted with modification reflects the adoption with modification of the following ASUs:
a. **ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting.** The revisions from ASU 2018-07 expand the scope of ASC 718 to include share-based payment transactions for acquiring goods and services from nonemployees. With ASU 2018-17, ASC 505-50, Equity – Equity Payments to Nonemployees was superseded.

b. **ASU 2017-09, Scope of Modification Accounting**

c. **ASU 2016-09, Improvements to Employee Share-Based Payment Accounting**

d. **ASU 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period**

e. **ASU 2010-13, Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Current of the Market in Which the Underlying Equity Security Trades**

127. The statutory accounting guidance for share-based payments is intended to be consistent with U.S. GAAP. Adopted modifications to U.S. GAAP guidance are as follows:

a. GAAP references to “public and nonpublic” guidance have been eliminated. However, entities that report share-payment transactions under U.S. GAAP as “public” entities shall not report different amounts between U.S. GAAP and SAP. (For example, if a reporting entity reports “fair value” under U.S. GAAP, that entity shall not utilize a “calculated or intrinsic” amount under statutory accounting.

b. Prepaid assets are nonadmitted.

c. GAAP references are revised to reference applicable statutory accounting guidance.

d. GAAP reporting line items (either explicitly provided in the statement or adopted by reference – such as the GAAP implementation guidance) shall be replaced to reference applicable statutory annual statement line items. (For example, GAAP references to “other comprehensive income” shall be reflected within “Surplus - Unassigned Funds”).

e. GAAP guidance to calculate earnings per share is not applicable to statutory accounting and has not been included within the statement.

f. GAAP effective date and transition, and transition disclosures have not been incorporated. Reporting entities shall follow the effective date and transition elements provided within this statement.

g. Inclusion of guidance specific to statutory for consolidated/holding company plans.

128. The adoption with modification of FASB Codification Topic 718 detailed in paragraph 126 of this statement reflects adoption with modification of the following pre-codification GAAP standards:

a. **FAS 123R, Share-Based Payment (FAS 123R);**

b. **FAS 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (FAS 150) – (Adopted only to the extent referenced in FAS 123R for classifying instruments as equity or liability for application in this statement. Adopted guidance is reflected in Exhibit A);**

c. **FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally issued in Exchange for Employee Services under FASB Statement No. 123(R) (FAS 123R-1);**

d. **FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R) (FSP FAS 123R-2);**
129. The adoption with modification of FASB Codification Topic 718 in this statement reflects rejection of
the following pre-codification GAAP standards:

a. FASB Staff Position (FSP) FAS 123(R)-3: Transition Election Related to Accounting for the
Tax Effects of Share-Based Payment Awards (FSP FAS 123R-3); and

b. FASB Staff Position (FSP) EITF 03-6-1: Determining Whether Instruments Granted in
Share-Based Payment Transactions Are Participating Securities (FSP EITF 03-6-1).

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E)
Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): N/A

NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP
clarification, and expose revisions to SSAP No. 104R—Share-Based Payments to incorporate the practical
expedient for the current price input, a required component for the option-pricing models – models in which
are utilized in the determination of fair value for share-based payments. Integration of this third practical
expedient is consistent with previous decisions by the Working Group to adopt the prior two practical expedients
regarding option-pricing modeling input permitted by FASB. The language proposed by NAIC staff directs that
the practical expedient is only available when a reporting entity is not able to reasonable estimate the current fair value.
While this language is technically broader than what was adopted by FASB (as ASU 2021-07 directly references
non-public companies), the proposed language is consistent with prior Working Group adoptions and by default,
should not be utilized by public entities – as they would be able to reasonable estimate fair value, which is likely
the publicly traded share price.

Proposed Revisions to SSAP No. 104R

52. A reporting entity may not be able to reasonably estimate the fair value of its equity share options,
nonemployee awards and similar instruments because it is not practicable for the reporting entity to
estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share
options, nonemployee awards and similar instruments based on a value calculated using the historical
volatility of an appropriate industry sector index instead of the expected volatility of the entity’s share price
(the calculated value). A reporting entity’s use of calculated value shall be consistent between employee
share-based payment transactions and nonemployee share-based payment transactions. Throughout the remainder of this statement, provisions that apply to accounting for share options, nonemployee awards and similar instruments at fair value also apply to calculated value.

53. For an award that meets the conditions in paragraph 54, a reporting entity may make an entity-wide accounting policy election to estimate the expected term using the following practical expedient:

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b. If vesting is dependent upon satisfying a performance condition, an entity first would determine whether the performance condition is probable of being achieved.

i. If the reporting entity concludes that the performance condition is probable of being achieved, the entity shall estimate the expected term as the midpoint between the employee’s requisite service period or the nonemployee’s vesting period and the contractual term.

ii. If the reporting entity concludes that the performance condition is not probable of being achieved, the reporting entity shall estimate the expected term as either:

   (a) The contractual term if the service period is implied (that is, the requisite service period or the nonemployee’s vesting period is not explicitly stated but inferred based on the achievement of the performance condition at some undetermined point in the future).

   (b) The midpoint between the employee’s requisite service period or the nonemployee’s vesting period and the contractual term if the requisite service period is stated explicitly.

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a. The share option or similar award is granted at the money.

b. The grantee has only a limited time to exercise the award (typically 30-90 days) if the grantee no longer provides goods or terminates service after vesting.

c. The grantee can only exercise the award. The grantee cannot sell or hedge the award.

d. The award does not include a market condition.

A reporting entity that elects to apply the practical expedient in paragraph 53 may always elect to use the contractual term as the expected term when estimating the fair value of a nonemployee award as described in paragraph 42. However, a reporting entity must apply the practical expedient in paragraph 53 for all nonemployee awards that have all the characteristics listed in this paragraph if that reporting entity does not elect to use the contractual term as the expected term and that reporting entity elects the accounting policy election to apply the practical expedient in paragraph 53.

55. If a reporting entity is not able to reasonably estimate the current share price (fair value), as a practical expedient, a reporting entity may use a value determined by the reasonable application of a reasonable valuation method as the current price of its underlying share for purposes of determining the fair value of an award that is classified as equity at grant date or upon a modification. The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, shall be made on the facts and circumstances as of the measurement date. Factors to be considered under a reasonable valuation method include, as applicable:
a. The value of tangible and intangible assets

b. The present value of anticipated future cash flows

c. The market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged by the entity for which the stock is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount in an arm’s length transaction)

d. Recent arm’s length transactions involving the sale or transfer of stock or equity interest

e. Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the entity, its stockholders, or its creditors

f. The entity’s consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers.

Effective Date and Transition

130. This statement was effective January 1, 2013, with interim and annual financial reporting thereafter. Early adoption was permitted for December 31, 2012, financial statements with interim and annual reporting thereafter. At the time of initial adoption of this statement, reporting entities with existing share-based payment instruments that applied the guidance in SSAP No. 13—Stock Options and Stock Purchase Plans were to apply the requirements of SSAP No. 104 prospectively to new awards and to awards modified, repurchased or cancelled after the required effective date. Those reporting entities were to continue to account for any portion of awards outstanding at the date of initial application using the statutory accounting principles originally applied to those awards (e.g., SSAP No. 13).

131. Since the initial adoption of SSAP No. 104, subsequent revisions were effective as follows:

a. ASU 2021-07, Compensation – Stock Compensation, Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards. This SAP clarification is effective.

b. ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting: Nonsubstantive revisions effective January 1, 2020, with early application permitted.

c. ASU 2017-09, Scope of Modification Accounting: Nonsubstantive revisions effective January 1, 2018, applicable to modifications that occur on or after the effective date, with early application permitted.

d. ASU 2016-09, Improvements to Employee Share-Based Payment Accounting: Nonsubstantive revisions effective December 31, 2017, with early adoption permitted. The adoption included the transition provisions from ASU 2016-19, although not duplicated within this statement.

e. ASU 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period: Nonsubstantive revisions effective January 1, 2016, with early adoption permitted.

f. ASU 2010-13, Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Current of the Market in Which the Underlying Equity Security Trades: Captured in the original adoption of SSAP No. 104, effective January 1, 2013.
Status:
On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 104R—Share-Based Payments to incorporate a practical expedient for the current price input, a required component for option-pricing models which are utilized in the determination of fair value for share-based payments.

https://naiconline.sharepoint.com/teams/FRSSstatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Hearing/6 - 22-06 - ASU 2021-07 Stock Compensation.docx
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: ASU 2021-08, Business Combinations

Check (applicable entity):

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Description of Issue: In October 2021, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2021-08, Business Combinations, Accounting for Contract Assets and Contract Liabilities from Contracts with Customers to require acquiring entities to apply Topic 606 (the topic that specifies the accounting for revenue and liabilities resulting from contacts with customers), when valuing and recognizing contract related assets and liabilities in a business combination.

Prior to the issuance of ASU 2021-08, acquirers would generally only recognize such items based on their fair values on the date of acquisition. When assessing liabilities at fair value, acquirers would generally only recognize an acquiree’s deferred revenue (i.e., a contract liability), to the extent the acquirer had a legal obligation to perform a service or remit a product. However, to only recognize a contract liability to the extent of a legal obligation is contrary to Topic 606 as it states that performance obligations may (and often) extend beyond legal obligations—with examples including implied promises and customer business practices within the contract with a customer, regardless of whether such promises were legally enforceable.

This ASU noted that the amendments will enhance comparability of the business results from before and after the acquisition (as presumably in most cases, the Topic 606 liability of the acquiree would transfer from the acquiree to the acquirer) and thus continuity of presentation would be retained. It is also important to note that the application of Topic 606 (rather than applying fair value standards) for acquired contract liabilities will generally result in a larger liability being recognized by the acquirer. This is because in cases where a provider receives cash in advance of performing a service or providing a product, in many instances some or all of the advanced funds have been spent prior to the date of acquisition, and thus the acquirer, using fair value measurement techniques, will not designate value to the spent funds. However again, the primary goal of these amendments is to improve comparability by providing consistent recognition and measurement guidance for revenue contracts - regardless of if those contracts were or were not acquired in a business combination.

The statutory accounting guidance for business combinations is found in SSAP No. 68—Business Combinations and Goodwill and requires business combinations be reported at cost, which in an arms-length transaction; is presumably fair value. SSAP No. 68 also requires that for entities (other than insurance reporting entities), the acquirer use the acquiree’s U.S. GAAP book value for the determination of statutory goodwill. The calculation of statutory goodwill, while beyond the scope of this agenda item, is important to briefly comment on as it adds an additional level of conservatism not recognized by U.S. GAAP – as it requires the recognition of goodwill for the amount of cost in excess of the acquiree’s book value (as opposed to fair value under U.S. GAAP).

So, in essence, for statutory accounting, other than the reporting of statutory goodwill, the acquiree’s book value of all associated assets (and liabilities) are reported on the acquirer’s books. As ASU 2021-08 requires the acquirer to utilize the acquiree’s book value, measured via Topic 606, for contract liabilities, the practice (unless the acquiree has not previously or has incorrectly applied Topic 606) conceptually consistent statutory accounting requirements, requires a measurement method previously rejected by statutory accounting.
Existing Authoritative Literature: As previously mentioned, the statutory guidance for business combinations is contained in SSAP No. 68 - relevant paragraphs, with applicable guidance is included below.

SSAP No. 68

Business Combinations

2. A business combination shall be accounted for as either a statutory purchase or a statutory merger. Business combinations that create a parent-subsidiary relationship shall be accounted for as a statutory purchase. Business combinations where equity of one entity is issued in exchange for the equity of another entity, which is then canceled, and prospectively only one entity exists, shall be accounted for as a statutory merger.

Statutory Purchases of SCA Investments

3. The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another. It shall be used for all purchases of SCA entities including partnerships, joint ventures, and limited liability companies. The acquiring reporting entity shall record its investment at cost. Cost is defined 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. Contingent consideration issued in a purchase business combination that is embedded in a security or that is in the form of a separate financial instrument shall be recorded by the issuer at fair value at the acquisition date.

4. For those acquired SCA entities accounted for in accordance with paragraphs 8.b.i., 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97, and joint venture, partnership or limited liability company entities accounted for in accordance with paragraph 8 of SSAP No. 48, goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity's share of the book value of the acquired entity. When the cost of the acquired entity is greater than the reporting entity's share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity's share of the book value, negative goodwill exists. Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other-than-invested assets. All other goodwill shall be reported in the carrying value of the investment.

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity's share of the GAAP net book value of the acquired entity, adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 in the case of acquired entities valued in accordance paragraphs 8.b.ii. or 8.b.iv. of SSAP No. 97. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with, paragraph 8.b.i. of SSAP No. 97 shall determine the amount of positive or negative goodwill created by the business combination using the insurer's share of the statutory book value of the acquired entity.

6. For those acquired SCA entities accounted for in accordance with paragraph 8.b.i. of SSAP No. 97 under the statutory purchase method, the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements. Therefore, pushdown accounting is not permitted.

As mentioned above, utilizing an acquiree’s book value is likely consistent with current practice, however, all previous Topic 606 guidance has been rejected for statutory accounting as insurance contracts are explicitly excluded from its scope. The rejections are noted within the body of statutory guidance in SSAP No. 47—Uninsured Plans.
SSAP No. 47

Relevant Literature

15. This statement rejects ASU 2014-09, Revenue from Contracts with Customers; ASU 2015-14, Revenue From Contracts With Customers; ASU 2016-08, Revenue From Contracts with Customers: Principal versus Agent Considerations (Reporting Revenue Gross versus Net); ASU 2016-10, Revenue from Contracts with Customers: Identifying Performance Obligations and Licensing; ASU 2016-12, Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients; ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers; ASU 2018-18, Collaborative Arrangements (Topic 808), Clarifying the Interaction between Topic 808 and Topic 606, and ASU 2021-02, Franchisors—Revenue from Contracts with Customers.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): As previously mentioned, all ASUs related to ASC Topic 606 have been rejected by the Working Group.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): ASC Topic 606 and IFRS 15 are the result of the joint project between the FASB and IASB to improve financial reporting by creating common revenue recognition guidance.

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as SAP clarifications to:

1) Expose revisions to SSAP No. 47—Uninsured Plans to reject ASU 2021-08 for statutory accounting. This recommendation is consistent with how the prior ASUs related to Topic 606 have been treated.

2) Expose revisions to SSAP No. 68—Business Combinations and Goodwill to reject the ASU 2021-08 for statutory accounting, while noting that rejection does not impact the determination of U.S. GAAP book value in an acquired entity. NAIC staff note that as all prior Topic 606 guidance has been rejected for statutory accounting, the explicit rejection of this ASU should not be construed to mean that the U.S. GAAP net book value (which is utilized for the determination of statutory goodwill) will need to be modified by the guidance required in this ASU. The intent is to not modify any U.S. GAAP requirements for the determination of U.S. GAAP net book value within this standard.

Proposed Revisions to SSAP No. 47

Relevant Literature

15. This statement rejects ASU 2014-09, Revenue from Contracts with Customers; ASU 2015-14, Revenue From Contracts With Customers; ASU 2016-08, Revenue From Contracts with Customers: Principal versus Agent Considerations (Reporting Revenue Gross versus Net); ASU 2016-10, Revenue from Contracts with Customers: Identifying Performance Obligations and Licensing; ASU 2016-12, Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients; ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers; ASU 2018-18, Collaborative Arrangements (Topic 808), Clarifying the Interaction between Topic 808 and Topic 606, and ASU 2021-02, Franchisors—Revenue from Contracts with Customers, and ASU 2021-08, Business Combinations, Accounting for Contract Asset and Contract Liabilities from Contracts with Customers.
Proposed Revisions to SSAP No. 68

Relevant Literature

22. This statement rejects ASU 2021-08, Business Combinations, Accounting for Contract Asset and Contract Liabilities from Contracts with Customers, however the rejection of which shall not modify the U.S. GAAP accounting standards as required within this standard, ASU 2019-06, Intangibles—Goodwill and Other Business Combinations, and Non-for-Profit Entities, ASU 2017-04, Simplifying the Test for Goodwill Impairment, ASU 2016-03, Intangibles—Goodwill and Other, Business Combinations, Consolidation, Derivatives and Hedging; ASU 2014-02, Accounting for Goodwill (a consensus of the Private Company Council), ASU 2012-02, Testing Indefinite-Lived Intangible Assets for Impairment, ASU 2011-08, Testing Goodwill for Impairment and ASU 2010-28, When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts; Accounting Principles Board Opinion No. 16, Business Combinations; FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises, an amendment of APB Opinion No. 16; Accounting Principles Board Opinion No. 17, Intangible Assets; FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises; FASB Statement No. 141, Business Combinations; and FASB Statement No. 142, Goodwill and Other Intangible Assets The following related interpretative pronouncements are also rejected: [NAIC Staff Note, the remainder of this paragraph has been omitted for brevity.]

Staff Review Completed by: Jim Pinegar - NAIC Staff, February 2022

Status:
On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 47—Uninsured Plans and SSAP No. 68—Business Combinations and Goodwill to reject ASU 2021-08 for statutory accounting. In addition, the proposed revisions to SSAP No. 68 include notations that the rejection of ASU 2021-08 does not impact the determination of U.S. GAAP book value in an acquired entity. The proposed revisions are illustrated above, under the recommended action.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Hearing/7 - 22-07 - ASU 2021-08 Business Combinations.docx
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

**Issue:** Effective Derivatives – ASU 2017-12

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**Description of Issue:**
To be consistent with what is permitted under U.S. GAAP, this agenda item has been prepared to consider expanding the statutory accounting principles (SAP) guidance in SSAP No. 86—Derivatives in the determination of highly effective hedging derivatives. In 2017, the FASB issued Accounting Standard Update (ASU) 2017-12: Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities to reduce complexity and align hedge accounting with risk management activities. The Working Group previously considered limited revisions from this ASU, mostly on documentation requirements, which occurred in agenda item 2018-30: SSAP No. 86 – Hedge Effectiveness Documentation. That agenda item was identified as limited-scope and noted further consideration of ASU 2017-12, potentially in a broader derivative project, would subsequently occur. With the focus of other projects, and COVID-19 impacts, this broader derivative project is still pending.

NAIC staff have been contacted by industry and regulators requesting further consideration of ASU 2017-12, particularly with regards to the permitted derivative arrangements that U.S. GAAP allows as highly effective hedges. Due to the revisions from ASU 2017-12, there is a disconnect between U.S. GAAP and SAP regarding certain types of effective hedging relationships. This is problematic as it results in inconsistent documentation of hedging transactions, as well as hinders reporting entities in electing to enter hedging transactions as the benefits are not currently permitted to be reflected in statutory financials.

Although NAIC staff agree that the determination of whether a hedge is highly effective should be consistent between U.S. GAAP and SAP, it is important to highlight that accounting for effective hedges varies greatly between U.S. GAAP and SAP. The effective hedging relationships permitted under ASU 2017-12 have been identified to expand upon these differences and could result with reporting elements that were not originally intended with the statutory accounting guidance adopted under SSAP No. 86. Although consistent effective hedge assessments between U.S. GAAP and SAP are desired, NAIC staff note that it is appropriate to identify how the expanded U.S. GAAP effective hedge assessments would be reflected within statutory financials and identify areas where clarifications or modifications may be needed as part of the process to consider the expanded effective hedge provisions. To be clear, the expanded hedge relationships permitted within ASU 2017-12 do not create the statutory accounting issues identified within this agenda item, however, the expanded effective hedging relationships would exacerbate the reporting issues within SSAP No. 86. (For example, although existing SAP guidance permits derivative adjustments to the hedged item, which can be a liability, such transactions are currently limited as the maturity of the hedging instruments (derivative) likely mirrors the hedged item’s maturity. This is because the matching of maturities under the current SAP guidance facilitates an easier effective hedge determination.) With the ASU’s expanded provisions for “partial term hedges” (as discussed within), adjustments will occur to the hedged item prior to its maturity, resulting in direct impacts to the presentation of the hedged item in statutory financial statements – which may not be easily identifiable to users.)
Overview of U.S. GAAP and SAP Derivative Reporting:

Under U.S. GAAP, the decision to document a hedge as effective has no impact on the balance sheet measurement of the derivative. Under U.S. GAAP, all derivatives are always reported at fair value; therefore, there is no “off-balance sheet” derivative risk exposure. As highly effective hedging derivatives are an income statement matching tool, when a fair value hedge is effective, the change in fair value of the derivative offsets the change in fair value of the hedged item in the income statement. For cash flow hedges, changes in the fair value of the derivative are reported through other comprehensive income (OCI) and amortized into earnings. When a derivative is not identified as highly effective, the matching of changes through the income statement simply does not occur. Regardless of whether a derivative is used in a highly effective hedge, under U.S. GAAP all derivatives are fully recognized on the balance sheet with fair value changes or cash flows from the derivatives fully recognized either to income or OCI.

Under SAP, the determination of an effective hedge has a significant impact on the reported value of derivatives and the presentation of derivatives in the financial statements. As the statutory guidance permits derivatives to mirror the measurement method of the hedged item, if the hedged item is reported at amortized cost, then a highly effective derivative is also reported at amortized cost. (Under U.S. GAAP, the reporting basis of the hedged item in a fair value hedge is made to match the derivative (i.e., fair value). The opposite is true under SAP.) It should be noted that SSAP No. 86 was originally drafted based on an assumption that it would predominantly be used for the hedging of assets reported at amortized cost or fair value. Hedges of liabilities, particularly reserve liabilities valued using statutory reserve requirements, do not fit neatly into the amortized cost or fair value framework permitted by SSAP No. 86. Such liabilities are not valued using either fair value or amortized cost, therefore reporting the hedging instrument at amortized cost still creates reporting mismatches. Furthermore, adjustments to the hedged item, as permitted under SSAP No. 86, can result with a financial statement presentation that appears to show a reduction of a liability, although the reporting entity’s contractual obligation has not been reduced.

If using an amortized cost measurement method, the initial recognition of the derivative is at cost (which could be zero), and subsequent changes in the fair value of the derivative are not recognized. So, if the fair value of the derivative was to move to a liability position (effectively offsetting a fair value increase in a hedged item), the derivative liability is not recognized. The derivative side of this transaction is considered an off-balance sheet surplus risk that exists until the hedging relationship expires. If a hedging relationship was no longer highly effective, the derivative would be recognized at fair value. At that time, the financial statements would reflect the derivative position that was outstanding. (For a derivative in a liability position, this would be a negative impact to surplus.) As one last point, the determination of a highly effective hedge generally permits a range between 80-125%. As such, a derivative instrument’s fair value that is expected to move in conjunction within a range of 20-25% of the underlying hedged item’s fair value is considered an effective hedge. Under the SAP guidance, this means that if the fair value of the hedged asset was to increase 100 and the fair value of the hedging derivative was to decrease 120, the hedge would still be considered effective and the change in the derivative fair value would not be recognized in the financial statements. At the time the asset matured, and the derivative was closed, the reporting entity would have an additional liability of $20 that was not previously recognized on the financial statements and not offset by the corresponding increase in the hedged item.

While it is important that the impact of the SAP hedging guidance be clearly understood, as initially noted, NAIC staff agree that assessments of hedge effectiveness are preferred to be consistent between U.S. GAAP and SAP. However, by expanding the SAP guidance to permit effective hedges allowed under ASU 2017-12, pursuant to the existing measurement provisions within SSAP No. 86, there would be an increase to the off-balance sheet surplus risk noted above from the hedging activity. Also note, this increase in off-balance sheet exposure does not necessarily correlate to an increase in economic risk, as the hedging relationships allowed under the GAAP ASU are expected to allow for prudent risk management strategies that would be expected to decrease economic risk. In addition, other nuances in SAP reporting have the potential to be more pronounced under the expanded effective
hedge assessments. As detailed within the recommendation section, NAIC staff recommend review, with possible modification, of certain elements within SSAP No. 86 as part of this review of ASU 2017-12. However, these recommendations do not initially include a fundamental change in the SAP provisions that permit an amortized cost measurement method for highly effective derivatives if hedging an item not reported at fair value. Regulator and industry comments are welcome on whether a fundamental change to the measurement and reporting of derivatives should be considered to be consistent with U.S. GAAP. If there is support for a fair value measurement approach for all derivatives, then consideration of offsetting surplus adjustments for the fair value volatility – similar to what is permitted in SSAP No. 108—Derivatives Hedging Variable Annuity Guarantees would also be considered.

**Review of Effect Hedge Arrangements Permitted Under ASU 2017-12:**

The derivative arrangements / changes permitted under U.S. GAAP through ASU 2017-12 and addressed within this agenda item are identified as follows:

- Partial Term Hedging
- Last of Layer
- Hedges of Interest Rate Risk When the Hedged Item Can be Settled Before Scheduled Maturity
- Expansion of Excluded Derivative Components in Assessment of Hedge Effectiveness

**Partial Term Hedging:**

This provision allows reporting entities to enter into fair value hedges of interest rate risk for only a portion of the term of the hedged financial instrument. Prior to the ASU, these sorts of arrangements were not successful in being identified as highly effective due to offsetting changes in the fair value as a result of the difference in timing between the hedged item’s principal repayment and the maturity date of the hedging derivative. Under ASU 2017-12, an entity may measure the change in the fair value of the hedged item attributable to changes in the benchmark interest rate by “using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable.” Also, the hedged item’s assumed maturity will be the date on which the last hedged cash flow is due and payable, therefore a principal payment will be assumed to occur at the end of the specified partial term.

The example provided under U.S. GAAP involves outstanding fixed rate debt. So, if an entity was to issue $100 million of five-year, noncallable, fixed-rate debt, the entity could designate a two-year, receive-fixed, pay variable, $100 million notional interest rate swap as a fair value hedge of the interest rate risk for the first two years of the debt’s term. When calculating the change in the fair value of the debt attributable to changes in interest rate risk, the entity may assume that 1) the term of the hedged debt is two years, and 2) repayment of the outstanding debt occurs at the end of the second year. The ASU also permits use of the shortcut method to these partial-term fair value hedges of interest rate risk.

**SAP Assessment** – With the differences in reporting between U.S. GAAP/SAP, the key issue to highlight is that with SAP’s amortized cost approach at the conclusion of the hedged period, the reporting entity would close the derivative with an offsetting entry that adjusts the basis of the hedged item. When hedging a liability (such as issued debt), if the derivative were in a liability position (satisfied with a credit to cash), the mechanics would result in an offsetting entry to reduce the debt (debit to the issued debt). However, this reduction to the debt does not reflect an actual reduction of the liability that the entity is legally obligated to pay, it just reduces the amount reported as outstanding debt in the financial statements. The debt would accrete back up to the full liability with increased entries to interest expense over the remaining term of the debt. (Ultimately, under GAAP, the fair value change in the derivative and debt are recognized concurrently in the income statement. Since SAP does not report these items at fair value, the change reduces the debt at the time of derivative close, and then the debt obligation accretes back up over time with an offsetting entry to interest expense.) Although this is in line with existing SSAP No. 86 guidance, under the past effective hedge provisions, the debt obligation maturity would likely be matched with the derivative term, so there would be no lingering financial statement impact to the debt obligation after the derivative.
transaction closed. With the partial term hedge, reporting entities have the potential to present an improved financial statement presentation over the remaining life of the hedge item (e.g., debt instrument) until accreted back to the full amount. The SAP guidance also has an alternative to take the adjustment directly to IMR (instead of to the hedged item). There is uncertainty on which approach is used in practice, and whether it varies based on the hedged item (e.g., hedging an asset or liability). Although there is a limited information in Schedule DB on adjustments to the hedged item, that information is only for the current year, and it does not provide detailed information on the overall impact to the financial statements.

**Items to Consider:** Although the current guidance in SSAP No. 86 is explicit that the effective hedge adjusts the basis of the hedged item (or is reflected in IMR), the Working Group may want to consider revising this guidance to prevent a presentation that shows a reduced outstanding liability when in fact there has been no actual reduction of the obligation. Consideration could be given to directing these derivative adjustments to a specific reporting line. Although this would not change the overall financial statements, (a more favorable presentation could still exist), the debt obligation (or any liability hedged) would still be presented as the amount that corresponds to the obligation outstanding and not reflect the impact of derivative transactions. Furthermore, if a specific line was utilized, the impact of these derivative transactions would be identifiable within the financial statements. As noted, this dynamic exists under the current SSAP No. 86 guidance, but is less pronounced as the derivative term most commonly matches the debt’s obligation term. As such, the final resulting entries all occur (generally) at debt maturity. With the increased ability to establish effective hedges that do not mature at the same time as the hedged item, the impact from these derivative transactions would increase situations in which liabilities are presented that do not reflect the full outstanding obligation.

*Staff Note – The adjustment to the hedged item also occurs when effectively hedging an asset item. However, in that dynamic for a fair value hedge, the assets would only be increased to reflect the fair value change. (The offsetting entry in response to a derivative in a liability position would be a debit to the hedged asset.) Although the use of effective derivatives may facilitate an ability to increase the reported value of assets to current fair value, the amount reported for the asset would still be subject to impairment and collectability assessments. NAIC staff view this dynamic differently than a hedge of a liability when the resulting transaction reduces the amount shown as an obligation on the financial statements (debit to the liability) as nothing has occurred that has actually reduced the reporting entity’s obligation.*

**Last of Layer / Portfolio Method**

Under the “last of layer” hedge method, for a closed portfolio of prepayable financial assets, the entity may designate as the hedged item, a stated amount of the asset or assets that are not expected to be affected by prepayments, defaults and other factors affecting the timing and amount of cash flows if the designation is made in conjunction with the partial term hedging election. The “last of layer” hedge provision is permitted only for a closed portfolio of prepayable financial assets, or one or more beneficial interests secured by a portfolio of prepayable financial instruments (e.g., mortgage-backed securities). Industry comment letters to FASB have requested that liabilities, particularly insurance liabilities, be added to the scope, but that is not currently permitted under U.S. GAAP.

For this option, as part of the initial hedge documentation, an analysis shall be completed and documented to support the entity’s expectation that the hedged item (that is, the designated last of layer), is anticipated to be outstanding as of the hedged item’s assumed maturity date in accordance with the entity’s partial-term hedge election. That analysis shall incorporate the entity’s current expectations of prepayments, defaults, and other events affecting the timing and amount of cash flows associated with the closed portfolio of prepayable financial assets or beneficial interests secured by a portfolio of prepayable financial instruments. For purposes of the analysis, the entity may assume that as prepayments, defaults, and other events affecting the timing and amount of cash flows occur, they first will be applied to the portion of the closed portfolio of prepayable financial assets or one or more beneficial interest that is not part of the hedged item - (i.e., not part of the designated last layer.)
Proposed amendments to the ASU are currently being considered by the FASB to provide additional clarifying guidance. One of those elements clarifies that a closed portfolio is not limited to a single hedge. Rather, there can be multiple-layered hedges utilized in a closed portfolio. In response to this proposed clarification, the FASB is changing the name of “last of layer” and renaming it the “portfolio layer method.” Also, since the hedged item reflects a closed portfolio of assets, the FASB has clarified that the change in fair value (gain or loss) of the hedged item (portfolio of assets) attributed to the hedged risk shall not adjust the carrying value of the individual assets in the portfolio. Instead, that amount shall be maintained on a closed portfolio basis and amortized to earnings, with amortization beginning when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. However, the gain or loss shall be fully amortized prior to the assumed maturity date of the hedged item. *(Note: FASB has identified that allocating adjustments to individual assets may lead to uneconomic results if an asset is sold or removed from a closed portfolio. They have also noted that an allocation election would lead to a lack of comparability across entities and potential for earning management.)*

A key aspect to note is that the GAAP guidance will allow a single derivative to hedge different portfolio layers. In the event one layer was to no longer be considered highly effective, the portion of the derivative to hedge that layer would be removed, and the effective hedge for the remaining layers could continue.

**SAP Assessment:** For the last of layer / portfolio method, the overall accounting guidance under U.S. GAAP is consistent with existing derivative structures, just expanded on what can be designated as the hedged item and an exception that the entity shall not adjust the basis of the individual items combined into the portfolio. The biggest aspect with this change will be the assessment and documentation to confirm hedge effectiveness. This hedging option will require more work and documentation then a hedge of a single asset. However, if a reporting entity is effectively hedging under GAAP, without the SAP provisions for hedge accounting, then a reporting entity would have to recognize the hedging derivatives at fair value, which would create surplus volatility in their SAP financials.

**Items to Consider:** Although it seems that the derivative transaction is generally consistent with what would be anticipated under SSAP No. 86, except on a portfolio basis, there are key elements that should be addressed to facilitate the application of these methods under SAP:

- Incorporating the last of layer / portfolio method into SAP will require discussion (and likely revisions) to ensure that individual assets are not adjusted at hedge termination, and that a portfolio approach is utilized. This would be consistent with the current direction of FASB to clarify the guidance in a subsequent ASU. If revisions are not incorporated to have a “portfolio” basis for adjustment, then revisions will be needed on how to allocate the resulting gain/loss to the individual assets within the closed portfolio.

- Guidance should be considered to limit this derivative strategy to the same scope permitted under U.S. GAAP. This would require an explicit prohibition of the last of layer / portfolio method to liabilities, including insurance liabilities. Although the “framework” of U.S. GAAP derivative guidance is adopted in SSAP No. 86, statutory accounting guidance permits hedging transactions to be classified as highly effective when they would not be permitted that classification under U.S. GAAP. As such, limiting application to the same parameters of U.S. GAAP would be a new addition to SSAP No. 86.

- A key aspect of this proposed method (and of the excluded components expansion discussed below) is that under U.S. GAAP derivatives are permitted to be bifurcated in terms of effectiveness. That is, if a portion of a derivative were deemed to be highly effective in hedging an item, the fair value change related to that portion would be recognized in the income statement to match the fair value change of the hedged item. Fair value changes to other portions of the derivative that were not highly effective would still be recognized, but without the matching concept to the same reporting location as the fair value changes of the hedged item. Under SSAP No. 86, the guidance is explicit that a derivative is not bifurcated as to hedge effectiveness. So, a derivative shall be either classified as an effective hedge and permitted for amortized cost reporting (if consistent with the valuation of the hedged item) or classified as an ineffective hedge and
reported at fair value. To mirror U.S. GAAP on the ability to designate a portion of a derivative, revisions would need to be considered to the current SSAP No. 86 guidance. If revisions permit the bifurcating of derivatives, then consideration would have to occur on how bifurcated derivatives would be reported in the Schedule DB – Derivative Instruments. (Particularly, on whether the derivative BACV should reflect a combined fair value (FV) and amortized cost (AC) reported value or whether the derivative shall be divided and reported separately based on portions held at FV and AC.) NAIC staff have heard that bifurcating derivatives does already occur in practice, as the guidance in SSAP No. 86 - Exhibit B for the exclusion of the time value of money implies that it should be permitted. From initial information received from industry, in those limited situations it is believed that the derivative is reported on a single line with a combined BACV that reflects a combination of FV and AC. However, NAIC staff believe these instances are uncommon, but would become more prominent if the last of layer / portfolio method approach was adopted for statutory accounting.

- Lastly, it is proposed that this method only be incorporated once the proposed ASU is finalized. (The last of layer is detailed in the 2017 ASU, but the clarifying guidance is in a current proposed ASU which is expected to be finalized by the end of the year.)

**Fair Value Hedges of Interest Rate Risk in Which the Hedged Item Can be Settled Before Scheduled Maturity:**

Under these U.S. GAAP revisions, an entity may consider only how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity. (For example, an entity may consider only how changes in the benchmark interest rate affect an obligor’s decision to call a debt instrument - when it has a right to do so.) The entity need not consider other factors that would affect this decision (for example, credit risk) when assessing hedge effectiveness.

With this provision, U.S. GAAP guidance has also been added to specify the measurement of the hedged item. This guidance indicates that the factors incorporated for the purpose of adjusting the carrying amount of the hedged item shall be the same factors that the entity incorporated for the purpose of assessing hedge effectiveness. For example, if an entity considers only how changes in the benchmark interest rate affect an obligor’s decision to prepay a debt instrument when assessing hedge effectiveness, it shall also only consider that factor when adjusting the carrying amount of the hedged item. The election to consider only how changes in the benchmark interest rate affect an obligor’s decision to prepay a debt instrument does not affect an entity’s election to use either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows determined at hedge inception for purposes of measuring the change in fair value of the hedged item. With this guidance, an investor is not required to consider all factors that will affect the decision to settle the financial instrument before its scheduled maturity when assessing hedge effectiveness and measuring the change in fair value of the debt attributed to changes in the benchmark interest rate. This change was made as estimating the fair value of the prepayment option to the level of precision required in the current reporting and regulatory environment is virtually impossible because an entity is required to incorporate credit and all other idiosyncratic factors that would affect the prepayment option. It was noted that allowing a prepayment option to be modeled considering only the change in the benchmark interest rate more closely aligns the accounting for those hedges with an entity’s risk management activities and more accurately reflects the change in the fair value of the hedged item attributable to interest rate risk.

_SAP Assessment:_ Existing guidance in SSAP No. 86 incorporates the prior criteria for fair value hedges from U.S. GAAP, which includes guidance that has been eliminated in the ASU. The U.S. GAAP guidance has been expanded to specifically capture elements related to assessing effectiveness of prepayable instruments.

_Items to Consider:_ Like other elements, the change in assessment of effectiveness, and determining the measurement / adjustment to the hedged item will require SAP consideration as to the offsetting measurement aspects and how those should be recognized in the financial statements.
Expansion of Excluded Derivative Components from Assessment of Hedge Effectiveness

Industry has also requested consideration of the FASB guidance that expands the ability to exclude components of a derivative from the assessment of hedge effectiveness. Under prior U.S. GAAP (which is adopted in SSAP No. 86), the guidance permitted the exclusion of the time value of money, and the guidance in the ASU has expanded that prior capability to also allow exclusion of the portion of the fair value of a currency swap attributable to a cross-currency basis spread.

**SAP Assessment:** The current guidance in SSAP No. 86, Exhibit B – Assessment of Hedging Effectiveness incorporates U.S. GAAP guidance from FAS 133, with a significant portion addressing the exclusion of a hedging instrument’s time value from the assessment of hedging effectiveness. This old U.S. GAAP guidance has been revised from ASU 2017-12, to expand the potential exclusions and update the related guidance. As previously noted, the existing guidance in Exhibit B appears to contradict the guidance in SSAP No. 86 that specifically indicates that derivatives shall not be bifurcated for effectiveness. (The guidance in Exhibit B notes that changes in the excluded components would be included in unrealized gains and losses – which would represent a fair value measurement for these pieces, even if the derivative was classified as highly effective and reported at amortized cost.)

**Items to Consider:** Although the SSAP No. 86 Exhibit B guidance has incorporated prior U.S. GAAP guidance for excluding components, the guidance for these permissions does not align with the guidance in the body of SSAP No. 86. To ensure clear and consistent application, revisions would need to be considered to specify the reporting when changes in the fair value of a derivative are separated and treated differently.

**Existing Authoritative Literature:**

**SSAP No. 86—Derivatives** is the authoritative source of guidance for determining hedge effectiveness and reporting derivatives for statutory accounting. Key aspects to highlight from this SSAP for consideration as part of this agenda item:

- U.S. GAAP and SAP differ with regards to the reporting of derivatives. Under U.S. GAAP, all derivatives are reported at fair value. When a derivative represents a highly effective hedge, the process to recognize changes in fair value through the income statement in earnings or OCI is designed to mirror the recognition of fair value changes in the hedged item. (Under U.S. GAAP, highly effective hedges result in an income statement matching mechanism.) Under SAP, derivatives are reported differently based on whether they are used in a highly effective hedge. If highly effective, then the derivative measurement method mirrors the measurement method of the hedged item – which could be amortized cost. If not highly effective, then the derivative measurement method is fair value.

- Under U.S. GAAP, a fair value hedge approach requires that the hedged item be reported at fair value. (This allows for the matching of fair value changes of the hedged item and the hedging instrument (derivative) through the income statement.) This is not a required element under SAP. This GAAP-to-SAP difference makes sense as it allows companies that have highly effective hedges under U.S. GAAP to also identify those relationships as highly effective under SAP even though SAP uses an amortized cost (or other non-fair value) measurement method for hedged items.

- Assessment and determination of hedge effectiveness has generally been consistent between U.S. GAAP and SAP. The guidance in SSAP No. 86, Exhibit B – Assessment of Hedging Effectiveness, identifies the intent to remain consistent with U.S. GAAP with respect to assessing hedge effectiveness.

- Although the guidance in SSAP No. 86 prescribes the general concepts for hedges, as well as the measurement guidance for derivatives based on whether they are (or not) highly effective, the application guidance is detailed in Exhibit C – Specific Hedge Accounting Procedures for Derivatives. These procedures are SAP specific due to the fundamental differences in measurement and recognition of derivatives between U.S. GAAP and SAP.
Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):

- Agenda item 2018-30: SSAP No. 86 – Hedge Effectiveness Documentation considered the revised hedge effectiveness documentation provisions incorporated within ASU 2017-12, Derivatives and hedging. The revisions from this agenda item were adopted Nov. 15, 2018 and were effective Jan. 1, 2019, with early adoption permitted. U.S. GAAP filers could only early adopt if they also early-adopted ASU 2017-12.

- Agenda item 2017-33 was drafted to continue the overall accounting and reporting changes in ASU 2017-12 as potential substantive revisions. This item is still pending for statutory accounting. Although still pending, it is recommended that the 2021 limited-scope edits requested by industry be captured in this new agenda item, with agenda item 2017-33 retained as a broader scope project to review other derivative concepts, or subsequently disposed if no longer needed.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Staff Recommendation:
It is recommended that the Working Group move this agenda item to the active listing, categorized as new SAP concepts, and direct NAIC staff to work with regulators and industry in assessing and developing revisions to facilitate effective hedge assessments consistently between SAP and U.S. GAAP. As this guidance will reflect a change from the original concepts reflected in SSAP No. 86, it is recommended that the revisions be detailed in an issue paper for historical reference. This issue paper is recommended to be completed concurrently or subsequently to the consideration of SSAP revisions. The anticipated revisions from this agenda item are considered to reflect new SAP concepts as the effective hedge relationships that will be assessed have not been allowed under existing statutory accounting guidance.

As detailed within this agenda item, the discussion, and potential revisions, are expected to encompass the following elements:

- Appropriate reporting lines for effective hedges when the hedged item is a liability.

- Recognition of hedged-item adjustments (to a closed portfolio) when the last-of-layer / portfolio method of hedging is used.

- Scope limitations of the last of layer / portfolio method to mirror U.S. GAAP.

- The potential bifurcation of derivatives, and how such items should be reported for statutory accounting, when only portions of derivatives are permitted to be designated as effective. (This pertains to potential mixed-measurement reporting values.)

As detailed above, the Working Group also welcomes comments from regulators and industry on whether a fundamental change in SAP for derivative measurement (to be more consistent with U.S. GAAP) should be considered. Although specific revisions are not yet detailed, it is recommended that this agenda item be exposed to solicit comments and feedback on the overall summary and potential revisions to be considered.

Status:
On December 11, 2021, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as substantive, and directed NAIC staff to work with regulators and industry in assessing
and developing revisions to facilitate effective hedge assessments consistently between U.S. GAAP and statutory accounting.

On April 4, 2022, the Statutory Accounting Principles (E) Working Group exposed two documents for public comment. The first document (labeled 21-20 SSAP No. 86 – Exhibit A 3-2-22), proposes revisions in the form of a new Exhibit A (which will replace both Exhibit A and Exhibit B of SSAP No. 86 that adopts with modification U.S. GAAP guidance in determining hedge effectiveness. The second document (labeled 21-20 SSAP No. 86 – Excluded Components - 3-17-22), proposes measurement methods for excluded components in hedging instruments. The Working Group also directed staff to continue to work with industry representatives on other elements within ASU 2017-12: Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities.

Review of U.S. derivative guidance and the application to SAP is complex with many facets. This initial document considers consistency in the determination of hedge effectiveness between U.S. GAAP and SAP. The second element pertaining to the accounting and reporting of hedging instruments, including excluded components, will be considered separately, as that guidance has been historically different.

1) **Assessment of Hedge Effectiveness – Consistency with U.S. GAAP**

NAIC staff agrees that the assessment of hedge effectiveness for derivatives should be consistent between U.S. GAAP and SAP. This would ensure that transactions identified to be highly effective hedges under U.S. GAAP would also be identified as highly effective hedges under statutory accounting. If a hedging instrument results with offsetting changes (or other permitted aspects) to a hedged item pursuant to the guidelines under U.S. GAAP to qualify as a highly effective hedge, the same assessment as a highly effective hedge should occur under SAP.

NAIC staff highlights that the current guidance in SSAP No. 86 in Exhibit A – Discussion of Hedge Effectiveness and Exhibit B – Assessment of Hedging Effectiveness have not been significantly updated since the original issuance of FAS 133, *Accounting for Derivative Instruments and Hedging Activities* and SSAP No. 86. Exhibit A continues to reference guidance issued by the Derivatives Implementation Group (DIG) in E7 and E8, which were not considered official FASB positions, although these DIG provisions (and other clarifications) have been incorporated into the FASB Codification as authoritative. NAIC staff highlights that the list of components permitted to be excluded from the assessment of hedge effectiveness captured in the FASB Codification (815-20-25-82) differs from the statutory accounting guidance in SSAP No. 86, Exhibit B. The statutory accounting guidance in Exhibit B reflects original guidance from FAS 133, paragraph 63, but the statutory accounting guidance has not been updated to reflect provisions from the DIG E19 incorporated into the FASB Codification or the revisions from ASU 2017-12 that pertain to cross-currency basis spread.

To ensure consistency with U.S. GAAP in the assessment of hedge effectiveness, NAIC staff recommends that the Working Group consider adoption, with modification, of U.S. GAAP guidance pertaining to the criteria for initial and subsequent hedge effectiveness detailed in the FASB Accounting Standards Codification (ASC) paragraphs 815-20-25-72 through 815-20-35-20, as modified through the issuance of ASU 2017-12. Although the U.S. GAAP guidance for the assessment and determination of hedge effectiveness is proposed to be adopted, this action recommends statutory modifications to specify that the accounting and reporting of hedging instruments, including excluded components of the instruments, shall follow statutory specific guidance detailed in SSAP No. 86. The intent of this guidance is to clarify that the determination of whether a hedging instrument qualifies as an effective hedge shall converge with U.S. GAAP, but that the measurement method shall continue to follow statutory specific provisions. The proposed adoption only extends to revisions incorporated through ASU 2017-12, as such, any subsequent U.S. GAAP edits would continue to require statutory accounting consideration before they were considered adopted.

Exposure and request for comments - Excerpts of the U.S. GAAP guidance proposed to be adopted are recommended to replace the existing guidance in Exhibit A and Exhibit B of SSAP No. 86. However, these excerpts do not reflect the full U.S. GAAP guidance referenced. This reduction of quoted guidance is simply to manage the extent of detail captured in SSAP No. 86. With exposure of the proposed excerpts and adoption language, the Working Group requests comments on whether certain paragraphs should be removed as unnecessary in the Exhibit and whether other guidance from the referenced U.S. GAAP would be beneficial to be incorporated. (NAIC staff notes that the U.S. GAAP themes previously captured within Exhibit A and B have been retained – with updated ASC language.) Unless noted with tracked changes, the cited paragraphs are proposed to be incorporated directly from U.S. GAAP. (The tracked changes most commonly update GAAP references or paraphrase topics captured in GAAP references.)
EXHIBIT A – DISCUSSION OF HEDGE EFFECTIVENESS

The guidance within this exhibit reflects the adoption, with modification, of FASB Accounting Standards Codification (ASC) 815-20-25-72 through 815-20-35-20, as revised through the issuance of ASU 2017-12: Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities (ASU 2017-12) (issued on August 28, 2017). This adoption captures the U.S. GAAP guidance for the assessment and determination of hedge effectiveness, with modification to require the accounting and reporting of hedging instruments, including excluded components of hedging instruments to follow specific statutory accounting guidance in SSAP No. 86. The intent of this guidance is to clarify that the determination of whether a hedging instrument and derivative transaction qualifies as an effective hedge shall converge with U.S. GAAP, but that the measurement and reporting of effective hedge transactions shall follow statutory specific provisions. The adoption only extends to revisions incorporated to the FASB ASC through ASU 2017-12, therefore any subsequent U.S. GAAP edits to the ASC would require statutory accounting adoption before application. The guidance within this Exhibit reflects excerpts from the U.S. GAAP ASC, but do not reflect the full U.S. GAAP guidance referenced in the adopted language. The exclusion of cited guidance is to manage the extent of detail included within SSAP No. 86. Excerpts not duplicated within from the cited U.S. GAAP guidance are considered adopted unless subject to the specific accounting and reporting statutory exclusion. This Exhibit intends to supplement the guidance in SSAP No. 86 on hedge effectiveness. In any event in which this Exhibit could be interpreted as conflicting with the SSAP No. 86 guidance, the guidance in the body of SSAP No. 86 shall be followed.

(Staff Note: Tracked changes show proposed revisions to the U.S. GAAP guidance.)

Hedge Effectiveness Criteria Applicable to Both Fair Value Hedges and Cash Flow Hedges

1. This guidance addresses hedge effectiveness criteria applicable to both fair value hedges and cash flow hedges. (815-20-25-74)

2. To qualify for hedge accounting, the hedging relationship, both at inception of the hedge and on an ongoing basis, shall be expected to be highly effective in achieving either of the following: (815-20-25-75)
   a. Offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated (if a fair value hedge)
   b. Offsetting cash flows attributable to the hedged risk during the term of the hedge (if a cash flow hedge), unless the hedging instrument is used to modify the contractually specified interest receipts or payments associated with a recognized financial asset liability from one variable rate to another variable rate, except as indicated in paragraph 815-20-25-50

3. If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, either of the following conditions shall be met: (815-20-25-76)
   a. The increases (or decreases) in the fair value of the hedging instrument are expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item (if a fair value hedge).
   b. The cash inflows (outflows) from the hedging instrument are expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction (if a cash flow hedge).
4. There would be a mismatch between the change in fair value or cash flows of the hedging instrument and the change in fair value or cash flows of the hedged item or hedged transaction in any of the following circumstances, among others: (815-20-25-77)

a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction, to the extent that those bases do not move in tandem

b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in any of the following:

i. Notional amounts

ii. Maturities

iii. Quantity

iv. Location (not applicable for hedging relationships in which the variability in cash flows attributable to changes in a contractually specified component is designated as the hedged risk)

v. Delivery Dates

5. An entity shall consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations: (815-20-25-79)

a. Prospective considerations. The entity's expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows, which is forward looking, must be assessed on a quantitative basis at hedge inception unless one of the exceptions detailed in ASU 2017-12, paragraph 815-20-25-3(b)(2)(iv)(01) is met. Prospective assessments shall be subsequently performed whenever financial statements or earnings are reported and at least every three months. The entity shall elect at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(03) whether to perform subsequent retrospective and prospective hedge effectiveness assessments on a quantitative or qualitative basis. See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of hedge effectiveness. A quantitative assessment can be based on regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. The quantitative prospective assessment of hedge effectiveness shall consider all reasonably possible changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument and the hedged items for the period used to assess whether the requirement for expectation of highly effective offset is satisfied. The quantitative prospective assessment may not be limited only to the likely or expected changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument or the hedged items. Generally, the process of formulating an expectation regarding the effectiveness of a proposed hedging relationship involves a probability-weighted analysis of the possible changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument and the hedged items for the hedge period. Therefore, a probable future change in fair value will be more heavily weighted than a reasonably possible future change. That calculation technique is consistent with the definition of the term expected cash flow in FASB.

1 Reference to this ASU 2017-12 guidance is consistent with the guidance in SSAP No. 86, paragraph 42, footnote 5.
b. Retrospective evaluations. An assessment of effectiveness may be performed on a quantitative or qualitative basis on the basis of the entity’s election at hedge inception—
in accordance with paragraph 815-20-25-3(b)(2)(iv)(03). That assessment shall be performed whenever financial statements or earnings are reported, and at least every three months. See paragraphs 815-20-35-2 through 35-4 for further guidance. At inception of the hedge, an entity electing a dollar-offset approach to perform retrospective evaluations on a quantitative basis may choose either a period-by-period approach or a cumulative approach in designating how effectiveness of a fair value hedge or of a cash flow hedge will be assessed retrospectively under that approach, depending on the nature of the hedge initially documented in accordance with paragraph 815-20-25-3. For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances. See paragraphs 815-20-35-5 through 35-6 for further guidance.

Skipping 815-20-25-79A

6. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship. An entity shall use the quantitative effectiveness assessment method defined at hedge inception consistently for the periods that the entity either elects or is required to assess hedge effectiveness on a quantitative basis. (815-20-25-80)

7. This Subtopic guidance does not specify a single method for assessing whether a hedge is expected to be highly effective. The method of assessing effectiveness shall be reasonable. The appropriateness of a given method of assessing hedge effectiveness depends on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, an entity shall assess effectiveness for similar hedges in a similar manner, including whether a component of the gain or loss on a derivative instrument is excluded in assessing effectiveness for similar hedges. Use of different methods for similar hedges shall be justified. The mechanics of isolating the change in time value of an option discussed beginning in paragraph 13 815-20-25-98 also shall be applied consistently. (815-20-25-81)

8. In defining how hedge effectiveness will be assessed, an entity shall specify whether it will include in that assessment all of the gain or loss on a hedging instrument. An entity may exclude all or a part of the hedging instrument’s time value from the assessment of hedge effectiveness, as follows: (815-20-25-82)

a. If the effectiveness of a hedge with an option is assessed based on changes in the option’s intrinsic value, the change in the time value of the option would be excluded from the assessment of hedge effectiveness.

b. If the effectiveness of a hedge with an option is assessed based on changes in the option’s minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract shall be excluded from the assessment of hedge effectiveness.

c. An entity may exclude any of the following components of the change in an option’s time value from the assessment of hedge effectiveness:

i. The portion of the change in time value attributable to the passage of time (theta)
ii. The portion of the change in time value attributable to changes due to volatility (vega).

iii. The portion of the change in time value attributable to changes due to interest rates (rho).

d. If the effectiveness of a hedge with a forward contract or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price shall be excluded from the assessment of hedge effectiveness.

e. An entity may exclude the portion of the change in fair value of a currency swap attributable to a cross-currency basis spread.

9. No other components of a gain or loss on the designated hedging instrument shall be excluded from the assessment of hedge effectiveness nor shall an entity exclude any aspect of a change in an option's value from the assessment of hedge effectiveness that is not one of the permissible components of the change in an option's time value. For example, an entity shall not exclude from the assessment of hedge effectiveness the portion of the change in time value attributable to changes in other market variables (that is, other than rho and vega). (815-20-25-83)

Note – The following ASC Paragraphs 815-20-25-83A and 83B would not be considered adopted under the proposed language as they address measurement and recognition. SAP measurement and recognition guidance will be captured in the body of the SSAP or Appendix C.

For fair value and cash flow hedges, the initial value of the component excluded from the assessment of effectiveness shall be recognized in earnings using a systematic and rational method over the life of the hedging instrument. Any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method shall be recognized in other comprehensive income. Example 31 beginning in paragraph 815-20-25-235 illustrates this approach for a cash flow hedge in which the hedging instrument is an option and the entire time value is excluded from the assessment of effectiveness. (815-20-25-83A)

For fair value and cash flow hedges, an entity alternatively may elect to record changes in the fair value of the excluded component currently in earnings. This election shall be applied consistently to similar hedges in accordance with paragraph 815-20-25-81 and shall be disclosed in accordance with paragraph 815-10-50-4EEEEE. (815-20-25-83B)

10. If the critical terms of the hedging instrument and of the hedged item or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be perfectly effective if all of the following criteria are met:

a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase. Location differences do not need to be considered if an entity designates the variability in cash flows attributable to changes in a contractually specified component as the hedged risk and the requirements in paragraphs 815-20-25-22A through 25-22B of the FASB Codification are met. (815-20-25-84)

b. The fair value of the forward contract at inception is zero.
c. Either of the following criteria is met:

i. The change in the discount or premium on the forward contract is excluded from the assessment of effectiveness pursuant to paragraphs 7-815-20-25-81 through 25-83.

ii. The change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

11. In a cash flow hedge of a group of forecasted transactions in accordance with paragraph 28a of the SSAP guidance 815-20-25-15(a)(2), an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph 10a 815-20-25-84(a) if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month. (815-20-25-84A)

12. If all of the criteria in paragraphs 10-11 815-20-25-84 through 25-84A are met, an entity shall still perform and document an assessment of hedge effectiveness at the inception of the hedging relationship and, as discussed beginning in paragraph 815-20-35-9, on an ongoing basis throughout the hedge period. No quantitative effectiveness assessment is required at hedge inception if the criteria in paragraphs 10-11 815-20-25-84 through 25-84A are met (see paragraph 815-20-25-3(b)(2)(iv)(01)). (815-20-25-85)

Skipped paragraphs 815-20-25-86 to 815-20-25-97

Computing Changes in an Option’s Time Value

13. In computing the changes in an option's time value that would be excluded from the assessment of hedge effectiveness, an entity shall use a technique that appropriately isolates those aspects of the change in time value. Generally, to allocate the total change in an option's time value to its different aspects—the passage of time and the market variables—the change in time value attributable to the first aspect to be isolated is determined by holding all other aspects constant as of the beginning of the period. Each remaining aspect of the change in time value is then determined in turn in a specified order based on the ending values of the previously isolated aspects. (815-20-25-98)

14. Based on that general methodology, if only one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta), that aspect shall be the first aspect for which the change in time value is computed and would be determined by holding all other parameters constant for the period used for assessing hedge effectiveness. However, if more than one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta and vega), an entity shall determine the amount of that change in time value by isolating each of those two aspects in turn in a prespecified order (one first, the other second). The second aspect to be isolated would be based on the ending value of the first isolated aspect and the beginning values of the remaining aspects. The portion of the change in time value that is included in the assessment of effectiveness shall be determined by deducting from the total change in time value the portion of the change in time value attributable to excluded components. (815-20-25-99)

Skipped paragraphs 815-20-25-100 and 815-20-25-101

Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap

15. The conditions for the shortcut method do not determine which hedging relationships qualify for hedge accounting; rather, those conditions determine which hedging relationships qualify for a shortcut
version of hedge accounting that assumes perfect hedge effectiveness. If all of the applicable conditions in the list in paragraph 17 815-20-25-104 are met, an entity may assume perfect effectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability (or a firm commitment arising on the trade [pricing] date to purchase or issue an interest-bearing asset or liability) and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 17c 815-20-25-104[e]) provided that, in the case of a firm commitment, the trade date of the asset or liability differs from its settlement date due to generally established conventions in the marketplace in which the transaction is executed. The shortcut method's application shall be limited to hedging relationships that meet each and every applicable condition. That is, all the conditions applicable to fair value hedges shall be met to apply the shortcut method to a fair value hedge, and all the conditions applicable to cash flow hedges shall be met to apply the shortcut method to a cash flow hedge. A hedging relationship cannot qualify for application of the shortcut method based on an assumption of perfect effectiveness justified by applying other criteria. The verb \textit{match} is used in the specified conditions in the list to mean \textit{be exactly the same or correspond exactly}. (815-20-25-102)

16. Implicit in the conditions for the shortcut method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows. In applying the shortcut method, an entity shall consider the likelihood of the counterparty’s compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. (815-20-25-103)

17. All of the following conditions apply to both fair value hedges and cash flow hedges: (815-20-25-104)

a. The notional amount of the interest rate swap matches the principal amount of the interest-bearing asset or liability being hedged.

b. If the hedging instrument is solely an interest rate swap, the fair value of that interest rate swap at the inception of the hedging relationship must be zero, with one exception. The fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship’s inception, the transaction price of the swap was zero in the entity’s principal market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction. The guidance in the preceding sentence is applicable only to transactions considered \textit{at market} (that is, transaction price is zero exclusive of commissions and other transaction costs, as discussed in paragraph 820-10-35-9B). If the hedging instrument is solely an interest rate swap that at the inception of the hedging relationship has a positive or negative fair value, but does not meet the one exception specified in this paragraph, the shortcut method shall not be used even if all the other conditions are met.

c. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in (e), the premium for the mirror-image call or put option shall be paid or received in the same manner as the premium on the call or put option embedded in the hedged item based on the following:

i. If the implicit premium for the call or put option embedded in the hedged item is being paid principally over the life of the hedged item (through an adjustment of the interest rate), the fair value of the hedging instrument at the inception of the hedging relationship shall be zero (except as discussed previously in (b) regarding differing prices due to the existence of a bid-ask spread).
ii. If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium), the fair value of the hedging instrument at the inception of the hedging relationship shall be equal to the fair value of the mirror-image call or put option.

d. The formula for computing net settlements under the interest rate swap is the same for each net settlement. That is, both of the following conditions are met:

i. The fixed rate is the same throughout the term.

ii. The variable rate is based on the same index and includes the same constant adjustment or no adjustment. The existence of a stub period and stub rate is not a violation of the criterion in (d) that would preclude application of the shortcut method if the stub rate is the variable rate that corresponds to the length of the stub period.

e. The interest-bearing asset or liability is not prepayable, that is, able to be settled by either party before its scheduled maturity, or the assumed maturity date if the hedged item is measured as a partial-term hedge of interest rate risk in which the assumed maturity of the hedged items occur on the date in which the last hedged cash flow is due and payable, in accordance with paragraph 815-25-35-13B, with the following qualifications:

i. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option (put option) if the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image call option (put option).

ii. The call option embedded in the interest rate swap is considered a mirror image of the call option embedded in the hedged item if all of the following conditions are met:

(a.) The terms of the two call options match exactly, including all of the following:

(1.) Maturities

(2.) Strike price (that is, the actual amount for which the debt instrument could be called) and there is no termination payment equal to the deferred debt issuance costs that remain unamortized on the date the debt is called

(3.) Related notional amounts

(4.) Timing and frequency of payments

(5.) Dates on which the instruments may be called.

(b.) The entity is the writer of one call option and the holder (purchaser) of the other call option.

f. Any other terms in the interest-bearing financial instruments or interest rate swaps meet both of the following conditions:
i. The terms are typical of those instruments.

ii. The terms do not invalidate the assumption of perfect effectiveness.

18. All of the following incremental conditions apply to fair value hedges only: (815-20-25-105)

   a. The expiration date of the interest rate swap matches the maturity date of the interest-bearing asset or liability or the assumed maturity date if the hedged item is measured as a partial-term hedge of interest rate risk in which the assumed maturity of the hedged items occur on the date in which the last hedged cash flow is due and payable in accordance with paragraph 815-25-35-13B.

   b. There is no floor or cap on the variable interest rate of the interest rate swap.

   c. The interval between repricings of the variable interest rate in the interest rate swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

   d. For fair value hedges of a proportion of the principal amount of the interest-bearing asset or liability, the notional amount of the interest rate swap designated as the hedging instrument (see (a) in paragraph 815-20-25-104) matches the portion of the asset or liability being hedged.

   e. For fair value hedges of portfolios (or proportions thereof) of similar interest-bearing assets or liabilities, both of the following criteria are met:

      i. The notional amount of the interest rate swap designated as the hedging instrument matches the aggregate notional amount of the hedged item (whether it is all or a proportion of the total portfolio).

      ii. The remaining criteria for the shortcut method are met with respect to the interest rate swap and the individual assets or liabilities in the portfolio.

   f. The index on which the variable leg of the interest rate swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.

19. All of the following incremental conditions apply to cash flow hedges only: (815-20-25-106)

   a. All interest receipts or payments on the variable-rate asset or liability during the term of the interest rate swap are designated as hedged.

   b. No interest payments beyond the term of the interest rate swap are designated as hedged.

   c. Either of the following conditions is met:

      i. There is no floor or cap on the variable interest rate of the interest rate swap.

      ii. The variable-rate asset or liability has a floor or cap and the interest rate swap has a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. For purposes of this paragraph, comparable does
not necessarily mean equal. For example, if an interest rate swap's variable rate is based on LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the interest rate swap would be comparable to a 12 percent cap on the asset.

d. The repricing dates of the variable-rate asset or liability and the hedging instrument must occur on the same dates and be calculated the same way (that is, both shall be either prospective or retrospective). If the repricing dates of the hedged item occur on the same dates as the repricing dates of the hedging instrument but the repricing calculation for the hedged item is prospective whereas the repricing calculation for the hedging instrument is retrospective, those repricing dates do not match.

e. For cash flow hedges of the interest payments on only a portion of the principal amount of the interest-bearing asset or liability, the notional amount of the interest rate swap designated as the hedging instrument (see paragraph 815-20-25-104(a)) matches the principal amount of the portion of the asset or liability on which the hedged interest payments are based.

f. For a cash flow hedge in which the hedged forecasted transaction is a group of individual transactions (as permitted by paragraph 28a of the SSAP guidance paragraph 815-20-25-15(a)), if both of the following criteria are met:
   i. The notional amount of the interest rate swap designated as the hedging instrument (see paragraph (a)) matches the notional amount of the aggregate group of hedged transactions.
   ii. The remaining criteria for the shortcut method are met with respect to the interest rate swap and the individual transactions that make up the group. For example, the interest rate repricing dates for the variable-rate assets or liabilities whose interest payments are included in the group of forecasted transactions shall match (that is, be exactly the same as) the reset dates for the interest rate swap.

g. The index on which the variable leg of the interest rate swap is based matches the contractually specified interest rate designated as the interest rate being hedged for that hedging relationship.

20. The shortcut method may be applied to a hedging relationship that involves the use of an interest rate swap-in-arrears provided all of the applicable conditions are met. (815-20-25-107)

21. Any discount or premium in the hedged debt's carrying amount (including any related deferred issuance costs) is irrelevant to and has no direct impact on the determination of whether an interest rate swap contains a mirror-image call option under paragraph 17c.i.(e). Typically, the call price is greater than the par or face amount of the debt instrument. The carrying amount of the debt is economically unrelated to the amount the issuer would be required to pay to exercise the call embedded in the debt. (815-20-25-108)

22. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on an interest rate swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on an interest rate swap designated as a cash flow hedge. An interest rate swap’s fair value comes from its net settlements. The fixed and variable interest rates on an interest rate swap can be changed without affecting the net settlement if both are changed by the same amount. That is, an interest rate swap with a payment based on LIBOR and a receipt based on a
fixed rate of 5 percent has the same net settlements and fair value as an interest rate swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent. (815-20-25-109)

23. Comparable credit risk at inception is not a condition for assuming perfect effectiveness even though actually achieving perfect offset would require that the same discount rate be used to determine the fair value of the swap and of the hedged item or hedged transaction. To justify using the same discount rate, the credit risk related to both parties to the swap as well as to the debtor on the hedged interest-bearing asset (in a fair value hedge) or the variable-rate asset on which the interest payments are hedged (in a cash flow hedge) would have to be the same. However, because that complication is caused by the interaction of interest rate risk and credit risk, which are not easily separable, comparable creditworthiness is not considered a necessary condition for assuming perfect effectiveness in a hedge of interest rate risk. (815-20-25-111)

*Skipped paragraphs 815-20-25-112 through 815-20-25-143*

**Hedge Effectiveness – After Designation**

24. If a fair value hedge or cash flow hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test on either a quantitative basis (using either a dollar-offset test or a statistical method such as regression analysis) or a qualitative basis.—See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of effectiveness. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. At least quarterly, the hedging entity shall determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment.) (815-20-35-2)

**Effectiveness Assessment on a Qualitative Basis**

25. An entity may qualitatively assess hedge effectiveness if both of the following criteria are met: (815-20-35-2A)

a. An entity performs an initial quantitative test of hedge effectiveness on a prospective basis (that is, it is not assuming that the hedging relationship is perfectly effective at hedge inception as described in paragraph 815-20-25-3(b)(i)(iv)(D)(i)(A) through (H)), and the results of that quantitative test demonstrate highly effective offset.

b. At hedge inception, an entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

26. An entity may elect to qualitatively assess hedge effectiveness in accordance with paragraph 25 815-20-35-2A on a hedge-by-hedge basis. If an entity makes this qualitative assessment election, only the quantitative method specified in an entity’s initial hedge documentation must comply with paragraph 7815- 20-25-81. (815-20-35-2B)

27. When an entity performs qualitative assessments of hedge effectiveness, it shall verify and document whenever financial statements or earnings are reported and at least every three months that the facts and circumstances related to the hedging relationship have not changed such that it can assert qualitatively that the hedging relationship was and continues to be highly effective. While not all-inclusive, the following is a list of indicators that may, individually or in the aggregate, allow an entity to continue to assert qualitatively that the hedging relationship is highly effective: (815-20-35-2C)
a. An assessment of the factors that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis has not changed such that the entity can continue to assert qualitatively that the hedging relationship was and continues to be highly effective. This shall include an assessment of the guidance in paragraph 815-20-25-100 when applicable.

b. There have been no adverse developments regarding the risk of counterparty default.

28. If an entity elects to assess hedge effectiveness on a qualitative basis and then facts and circumstances change such that the entity no longer can assert qualitatively that the hedging relationship was and continues to be highly effective in achieving offsetting changes in fair values or cash flows, the entity shall assess effectiveness of that hedging relationship on a quantitative basis in subsequent periods. In addition, an entity may perform a quantitative assessment of hedge effectiveness in any reporting period to validate whether qualitative assessments of hedge effectiveness remain appropriate. In both cases, the entity shall apply the quantitative method that it identified in its initial hedge documentation in accordance with paragraph (b)(2)(iv)(03). (815-20-35-2D)

29. When an entity determines that facts and circumstances have changed and it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective, the entity shall begin performing subsequent quantitative assessments of hedge effectiveness as of the period that the facts and circumstances changed. If there is no identifiable event that led to the change in the facts and circumstances of the hedging relationship, the entity may begin performing quantitative assessments of effectiveness in the current period. (815-20-35-2E)

30. After performing a quantitative assessment of hedge effectiveness for one or more reporting periods as discussed in paragraphs 815-20-35-2D through 35-2E, an entity may revert to qualitative assessments of hedge effectiveness if it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods. See paragraphs 815-20-55-79G through 55-79N for implementation guidance on factors to consider when determining whether qualitative assessments of effectiveness can be performed after hedge inception. (815-20-35-2F)

**Quantitative Hedge Effectiveness Assessments After Hedge Designation**

31. Quantitative assessments can be based on regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. (815-20-35-2G)

32. If an entity elects at the inception of a hedging relationship to use the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship both of the following conditions shall be met: (815-20-35-3)

   a. Those regression analysis calculations shall generally incorporate the same number of data points.

   b. That entity must periodically update its regression analysis (or other statistical analysis).

33. Electing to use a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period. (815-20-35-4)

34. In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a
A dollar-offset approach, an entity shall use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges): (815-20-35-5)

a. Period-by-period approach. The period-by-period approach involves comparing the changes in the hedging instrument’s fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item’s fair value (or hedged transaction’s cash flows) attributable to the risk hedged that have occurred during the same period. If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods before the period being assessed are not relevant.

b. Cumulative approach. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument’s fair values (or cash flows) to the cumulative changes in the hedged item’s fair value (or hedged transaction’s cash flows) attributable to the risk hedged.

35. If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period. (815-20-35-6)

Assessing Effectiveness Based on Whether the Critical Terms of the Hedging Instrument and the Hedged Items Match

36. If, at inception, the critical terms of the hedging instrument and the hedged forecasted transaction are the same (see paragraphs 10-11815-20-25.84 through 25.84A), the entity can conclude that changes in cash flows attributable to the risk being hedged are expected to be completely offset by the hedging derivative. Therefore, subsequent assessments can be performed by verifying and documenting whether the critical terms of the hedging instrument and the forecasted transaction have changed during the period in review. (815-20-35-9)

37. Because the assessment of hedge effectiveness in a cash flow hedge involves assessing the likelihood of the counterparty’s compliance with the contractual terms of the derivative instrument designated as the hedging instrument, the entity must also assess whether there have been adverse developments regarding the risk of counterparty default, particularly if the entity planned to obtain its cash flows by liquidating the derivative instrument at its fair value. (815-20-35-10)

38. If there are no such changes in the critical terms or adverse developments regarding counterparty default, the entity may conclude that the hedging relationship is perfectly effective. In that case, the change in fair value of the derivative instrument can be viewed as a proxy for the present value of the change in cash flows attributable to the risk being hedged. (815-20-35-11)

39. However, the entity must assess whether the hedging relationship is expected to continue to be highly effective using a quantitative assessment method (either a dollar-offset test or a statistical method such as regression analysis) if any of the following conditions exist: (815-20-35-12)

a. The critical terms of the hedging instrument or the hedged forecasted transaction have changed.
b. There have been adverse developments regarding the risk of counterparty default.

**Possibility of Default by the Counterparty to Hedging Derivative**

40. For an entity to conclude on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity shall not ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative instrument. In complying with the requirements of paragraph 2b815-20-25-75(b), the entity shall assess the possibility of whether the counterparty to the derivative instrument will default by failing to make any contractually required payments to the entity as scheduled in the derivative instrument. In making that assessment, the entity shall also consider the effect of any related collateralization or financial guarantees. The entity shall be aware of the counterparty’s creditworthiness (and changes therein) in determining the fair value of the derivative instrument. Although a change in the counterparty’s creditworthiness would not necessarily indicate that the counterparty would default on its obligations, such a change shall warrant further evaluation. (815-20-35-14)

41. If the likelihood that the counterparty will not default ceases to be probable, an entity would be unable to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective in achieving offsetting cash flows. (815-20-35-15)

42. In contrast, a change in the creditworthiness of the derivative instrument’s counterparty in a fair value hedge would have an immediate effect because that change in creditworthiness would affect the change in the derivative instrument's fair value, which would immediately affect both of the following: (815-20-35-16)

   a. The assessment of whether the relationship qualifies for hedge accounting
   b. The amount of mismatch between the change in the fair value of the hedging instrument and the hedged item attributable to the hedged risk recognized in earnings under fair value hedge accounting.

43. Paragraph 16815-20-25-103 states that, in applying the shortcut method, an entity shall consider the likelihood of the counterparty’s compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. That paragraph explains that implicit in the criteria for the shortcut method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows. (815-20-35-18)

**Change in Hedge Effectiveness Method When Hedge Effectiveness if Assessed on a Quantitative Basis**

44. If the entity identifies an improved method of assessing hedge effectiveness in accordance with the guidance in paragraph 6815-20-25-80 and wants to apply that method prospectively, it shall do both of the following: (815-20-35-19)

   a. Discontinue the existing hedging relationship
   b. Designate the relationship anew using the improved method.

45. The new method of assessing hedge effectiveness shall be applied prospectively and shall also be applied to similar hedges unless the use of a different method for similar hedges is justified. A change in the method of assessing hedge effectiveness by an entity shall not be considered a change in accounting
principle as defined in Topic 250SSAP No. 3—Accounting Changes and Corrections of Errors. (815-20-35-20)

U.S. GAAP ASC Excerpts Proposed to be Excluded from Exhibit A

This information is included to illustrate the guidance within the adopted ASC references that are not proposed to be captured in Exhibit A. The guidance within these paragraphs would be considered part of the statutory adoption unless they include specific accounting and reporting guidance. Comments are requested on whether any of the following paragraphs should be explicitly captured in Exhibit A.

Skipping 815-20-25-79A

815-20-25-79A See paragraphs 815-20-25-139 through 25-142 about the timing of hedge effectiveness assessments required by paragraph 815-20-25-79 for a private company that is not a financial institution or a not-for-profit entity (except for a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market).

Skipped paragraphs 815-20-25-36 through 815-20-25-97

815-20-25-86 The remainder of this guidance on hedge effectiveness criteria applicable to both fair value hedges and cash flow hedges is organized as follows:

a. Hedge effectiveness when the hedging instrument is an option or combination of options
b. Hedge effectiveness when hedged exposure is more limited than hedging instrument
c. Hedge effectiveness during designated hedge period
d. Assuming perfect effectiveness in a hedge with an interest rate swap (the shortcut method).

Hedge Effectiveness When the Hedging Instrument Is an Option or Combination of Options

815-20-25-87 The hedge effectiveness criteria applicable to options and combinations of options are organized as follows:

a. Determining whether a combination of options is net written
b. Hedge effectiveness of written options
c. Hedge effectiveness of options in general.

Determining Whether a Combination of Options Is Net Written

815-20-25-88 This guidance addresses how an entity shall determine whether a combination of options is considered a net written option subject to the requirements of paragraph 815-20-25-94. A combination of options (for example, an interest rate collar) entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate or other term. Furthermore, a derivative instrument that results from combining a written option and any other non-option derivative instrument shall be considered a written option. The determination of whether a combination of options is considered a net written option depends in part on whether strike prices and notional amounts of the options remain constant.
Assessment of Hedge Effectiveness

Strike Prices and Notional Amounts Remain Constant

815-20-25-89 For a combination of options in which the strike price and the notional amount in both the written option component and the purchased option component remain constant over the life of the respective component, that combination of options would be considered a net purchased option or a zero cost collar (that is, the combination shall not be considered a net written option subject to the requirements of paragraph 815-20-25-94) provided all of the following conditions are met:

a. No net premium is received.

b. The components of the combination of options are based on the same underlying.

c. The components of the combination of options have the same maturity date.

d. The notional amount of the written option component is not greater than the notional amount of the purchased option component.

815-20-25-90 If the combination of options does not meet all of those conditions, it shall be subject to the test in paragraph 815-20-25-94. For example, a combination of options having different underlying indexes, such as a collar containing a written floor based on three-month U.S. Treasury rates and a purchased cap based on three-month London Interbank Offered Rate (LIBOR), shall not be considered a net purchased option or a zero cost collar even though those rates may be highly correlated.

Strike Prices and Notional Amounts Do Not Remain Constant

815-20-25-91 If either the written option component or the purchased option component for a combination of options has either strike prices or notional amounts that do not remain constant over the life of the respective component, the assessment to determine whether that combination of options can be considered not to be a written option under paragraph 815-20-25-88 shall be evaluated with respect to each date that the strike prices or the notional amounts change within the contractual term from inception to maturity.

815-20-25-92 Even though that assessment is made on the date that a combination of options is designated as a hedging instrument (to determine the applicability of paragraph 815-20-25-94), it shall consider the receipt of a net premium (in cash or as a favorable rate or other term) from that combination of options at each point in time that either the strike prices or the notional amounts change, such as either of the following circumstances:

a. If strike prices fluctuate over the life of a combination of options and no net premium is received at inception, a net premium will typically be received as a favorable term in one or more reporting periods within the contractual term from inception to maturity.

b. If notional amounts fluctuate over the life of a combination of options and no net premium is received at inception, a net premium or a favorable term will typically be received in one or more periods within the contractual term from inception to maturity.

815-20-25-93 In addition, a combination of options in which either the written option component or the purchased option component has either strike prices or notional amounts that do not remain constant over the life of the respective component shall satisfy all of the conditions in paragraph 815-20-25-89 to be considered not to be a written option (that is, to be considered to be a net purchased option or zero cost collar) under paragraph 815-20-25-88. For example, if the notional amount of the written option component is greater than the notional amount of the purchased option component at any date that the notional amount changes within the contractual term from inception to maturity, the combination of options shall be
considered to be a written option under paragraph 815-20-25-88 and, thus, subject to the criteria in the following paragraph.

Hedge Effectiveness of Written Options

815-20-25-94 If a written option is designated as hedging a recognized asset or liability or an unrecognized firm commitment (if a fair value hedge) or the variability in cash flows for a recognized asset or liability or an unrecognized firm commitment (if a cash flow hedge), the combination of the hedged item and the written option provides either of the following:

a. At least as much potential for gains as a result of a favorable change in the fair value of the combined instruments (that is, the written option and the hedged item, such as an embedded purchased option) as exposure to losses from an unfavorable change in their combined fair value (if a fair value hedge)

b. At least as much potential for favorable cash flows as exposure to unfavorable cash flows (if a cash flow hedge).

815-20-25-95 The written-option test in the preceding paragraph shall be applied only at inception of the hedging relationship and is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide either of the following:

a. At least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage (if a fair value hedge)

b. At least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the same percentage (if a cash flow hedge).

815-20-25-96 The time value of a written option (or net written option) may be excluded from the written-option test if, in defining how hedge effectiveness will be assessed, the entity specifies that it will base that assessment on only changes in the option’s intrinsic value. In that circumstance, the change in the time value of the options would be excluded from the assessment of hedge effectiveness in accordance with paragraph 815-20-25-82(a).

815-20-25-97 When applying the written-option test to determine whether there is symmetry of the gain and loss potential of the combined hedged position for all possible percentage changes in the underlying, an entity is permitted to measure the change in the intrinsic value of the written option (or net written option) combined with the change in fair value of the hedged item.

Skipped paragraphs 815-20-25-100 and 815-20-25-101

Hedge Effectiveness When Hedged Exposure Is More Limited Than Hedging Instrument

815-20-25-100 An entity may designate as the hedging instrument in a fair value hedge or cash flow hedge a derivative instrument that does not have a limited exposure comparable to the limited exposure of the hedged item to the risk being hedged. However, to make that designation, in accordance with paragraph 815-20-25-75, the entity shall establish that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated. See paragraph 815-20-25-79(a) for additional guidance on prospective considerations of hedge effectiveness in this circumstance.
Hedge Effectiveness during Designated Hedge Period

815-20-25-101 It is inappropriate under this Subtopic for an entity to designate a derivative instrument as the hedging instrument if the entity expects that the derivative instrument will not be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated, unless the entity has documented undertaking a dynamic hedging strategy in which it has committed itself to an ongoing repositioning strategy for its hedging relationship.

Application of Prepayable Criterion

815-20-25-112 An interest-bearing asset or liability shall be considered prepayable under the provisions of paragraph 815-20-25-104(e) if one party to the contract has the right to cause the payment of principal before the scheduled payment dates unless either of the following conditions is met:

a. The debtor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always greater than the then fair value of the contract absent that right.

b. The creditor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always less than the then fair value of the contract absent that right.

815-20-25-113 However, none of the following shall be considered a prepayment provision:

a. Any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent upon the occurrence of a specific event related to the debtor’s credit deterioration or other change in the debtor’s credit risk, such as any of the following:

   1. The debtor’s failure to make timely payment, thus making it delinquent
   2. The debtor's failure to meet specific covenant ratios
   3. The debtor's disposition of specific significant assets (such as a factory)
   4. A declaration of cross-default
   5. A restructuring by the debtor.

b. Any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent upon the occurrence of a specific event that meets all of the following conditions:

   1. It is not probable at the time of debt issuance.
   2. It is unrelated to changes in benchmark interest rates, contractually specified interest rates, or any other market variable.
   3. It is related either to the debtor’s or creditor’s death or to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor.

   c. Contingent acceleration clauses that permit the debtor to accelerate the maturity of an outstanding note only upon the occurrence of a specified event that meets all of the following
conditions:

1. It is not probable at the time of debt issuance.
2. It is unrelated to changes in benchmark interest rates, contractually specified interest rates, or any other market variable.
3. It is related to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor.

815-20-25-114 Furthermore, a right to cause a contract to be prepaid at its then fair value would not cause the interest-bearing asset or liability to be considered prepayable because that right would have a fair value of zero at all times and essentially would provide only liquidity to the holder.

815-20-25-115 Application of this guidance to specific debt instruments is illustrated in paragraph 815-20-55-75.

Application of the Shortcut Method to a Portfolio of Hedged Items

815-20-25-116 Portfolio hedging cannot be used to circumvent the application of the shortcut method criteria beginning in paragraph 815-20-102 to a fair value hedge of an individual interest-bearing asset or liability. A portfolio of interest-bearing assets or interest-bearing liabilities cannot qualify for the shortcut method if it contains an interest-bearing asset or liability that individually cannot qualify for the shortcut method.

815-20-25-117 The fair value hedge requirements of paragraph 815-20-25-12(b)(1) ensure that the individual items in a portfolio share the same risk exposure and have fair value changes attributable to the hedged risk that are expected to respond in a generally proportionate manner to the overall fair value changes of the entire portfolio. That requirement restricts the types of portfolios that can qualify for portfolio hedging; however, it also permits the existence of a mismatch between the change in the fair value of the individual hedged items and the change in the fair value of the hedged portfolio attributable to the hedged risk in portfolios that do qualify. As a result, the assumption of perfect effectiveness required for the shortcut method generally is inappropriate for portfolio hedges of similar assets or liabilities that are not also nearly identical (except for their notional amounts). Application of the shortcut method to portfolios that meet the requirements of paragraph 815-20-25-12(b)(1) is appropriate only if the assets or liabilities in the portfolio meet the same stringent criteria in paragraphs 815-20-25-104(e), 815-20-25-104(g), and 815-20-25-105(a) as required for hedges of individual assets and liabilities.

Application of Whether the Shortcut Method Was Not or No Longer Is Appropriate

815-20-25-117A In the period in which an entity determines that use of the shortcut method was not or no longer is appropriate, the entity may use a quantitative method to assess hedge effectiveness and measure hedge results without redesignating the hedging relationship if both of the following criteria are met:

a. The entity documented at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(04) which quantitative method it would use to assess hedge effectiveness and measure hedge results if the shortcut method was not or no longer is appropriate during the life of the hedging relationship.
b. The hedging relationship was highly effective on a prospective and retrospective basis in achieving offsetting changes in fair value or cash flows attributable to the hedged risk for the periods in which the shortcut method criteria were not met.

815-20-25-117B If the criterion in paragraph 815-20-25-117A(a) is not met, the hedging relationship shall be considered invalid in the period in which the criteria for the shortcut method were not met and in all subsequent periods. If the criterion in paragraph 815-20-25-117A(a) is met, the hedging relationship shall be considered invalid in all periods in which the criterion in paragraph 815-20-25-117A(b) is not met.

815-20-25-117C If an entity cannot identify the date on which the shortcut criteria ceased to be met, the entity shall perform the quantitative assessment of effectiveness documented at hedge inception for all periods since hedge inception.

815-20-25-117D The terms of the hedged item and hedging instrument used to assess effectiveness, in accordance with paragraph 815-20-25-117A(b), shall be those existing as of the date that the shortcut criteria ceased to be met. For cash flow hedges, if the hypothetical derivative method is used as a proxy for the hedged item, the value of the hypothetical derivative shall be set to zero as of hedge inception.

Hedge Effectiveness Criterion Applicable to Fair Value Hedges Only—Effectiveness Horizon

815-20-25-118 In documenting its risk management strategy for a fair value hedge, an entity may specify an intent to consider the possible changes (that is, not limited to the likely or expected changes) in value of the hedging derivative instrument and the hedged item only over a shorter period than the derivative instrument's remaining life in formulating its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged. The entity does not need to contemplate the offsetting effect for the entire term of the hedging instrument.

Consideration of Prepayment Risk Using the Last-Of-Layer Method

815-20-25-118A In a fair value hedge of interest rate risk designated under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity may exclude prepayment risk when measuring the change in fair value of the hedged item attributable to interest rate risk.

Hedge Effectiveness Criteria Applicable to Cash Flow Hedges Only

815-20-25-119 The hedge effectiveness criteria applicable to cash flow hedges only are organized as follows:

a. Consideration of the time value of money

b. Consideration of counterparty credit risk

c. Additional considerations for options in cash flow hedges

d. Assuming perfect hedge effectiveness in a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap recorded under the simplified hedge accounting approach.

Consideration of the Time Value of Money

815-20-25-120 In assessing the effectiveness of a cash flow hedge, an entity generally shall consider the time value of money, especially if the hedging instrument involves periodic cash settlements.
An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

Consideration of Counterparty Credit Risk

For a cash flow hedge, an entity shall consider the likelihood of the counterparty’s compliance with the contractual terms of the hedging derivative instrument that require the counterparty to make payments to the entity. Paragraph 815-20-35-14 states that, for an entity to conclude on an ongoing basis that a cash flow hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity shall not ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative instrument. See paragraphs 815-20-35-14 through 35-18 for further guidance.

Additional Considerations for Options in Cash Flow Hedges

When an entity has documented that the effectiveness of a cash flow hedge will be assessed based on changes in the hedging option’s intrinsic value pursuant to paragraph 815-20-25-82(a), that assessment (and the related cash flow hedge accounting) shall be performed for all changes in intrinsic value—that is, for all periods of time when the option has an intrinsic value, such as when the underlying is above the strike price of the call option.

When a purchased option is designated as a hedging instrument in a cash flow hedge, an entity shall not define only limited parameters for the risk exposure designated as being hedged that would include the time value component of that option. An entity cannot arbitrarily exclude some portion of an option’s intrinsic value from the hedge effectiveness assessment simply through an articulation of the risk exposure definition. It is inappropriate to assert that only limited risk exposures are being hedged (for example, exposures related only to currency-exchange-rate changes above $1.65 per pound sterling as illustrated in Example 26 [see paragraph 815-20-55-205]).

If an option is designated as the hedging instrument in a cash flow hedge, an entity may assess hedge effectiveness based on a measure of the difference, as of the end of the period used for assessing hedge effectiveness, between the strike price and forward price of the underlying, undiscounted. Although assessment of cash flow hedge effectiveness with respect to an option designated as the hedging instrument in a cash flow hedge shall be performed by comparing the changes in present value of the expected future cash flows of the forecasted transaction to the change in fair value of the derivative instrument (aside from any excluded component under paragraph 815-20-25-82), that measure of changes in the expected future cash flows of the forecasted transaction based on forward rates, undiscounted, is not prohibited. With respect to an option designated as the hedging instrument in a cash flow hedge, assessing hedge effectiveness based on a similar measure with respect to the hedging instrument eliminates any difference that the effect of discounting may have on the hedging instrument and the hedged transaction. Pursuant to paragraph 815-20-25-3(b)(2)(iv), entities shall document the measure of intrinsic value that will be used in the assessment of hedge effectiveness. As discussed in paragraph 815-20-25-80, that measure must be used consistently for each period following designation of the hedging relationship.
Assessing Hedge Effectiveness Based on an Option's Terminal Value

815-20-25-126 The guidance in paragraph 815-20-25-129 addresses a cash flow hedge that meets all of the following conditions:

a. The hedging instrument is a purchased option or a combination of only options that comprise either a net purchased option or a zero-cost collar.

b. The exposure being hedged is the variability in expected future cash flows attributed to a particular rate or price beyond (or within) a specified level (or levels).

c. The assessment of effectiveness is documented as being based on total changes in the option’s cash flows (that is, the assessment will include the hedging instrument’s entire change in fair value, not just changes in intrinsic value).

815-20-25-127 This guidance has no effect on the accounting for fair value hedging relationships. In addition, in determining the accounting for seemingly similar cash flow hedging relationships, it would be inappropriate to analogize to this guidance.

815-20-25-128 For a hedging relationship that meets all of the conditions in paragraph 815-20-25-126, an entity may focus on the hedging instrument’s terminal value (that is, its expected future pay-off amount at its maturity date) in determining whether the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. An entity’s focus on the hedging instrument’s terminal value is not an impediment to the entity’s subsequently deciding to designate that cash flow hedge before the occurrence of the hedged transaction. If the hedging instrument is a purchased cap consisting of a series of purchased caplets that are each hedging an individual hedged transaction in a series of hedged transactions (such as caplets hedging a series of hedged interest payments at different monthly or quarterly dates), the entity may focus on the terminal value of each caplet (that is, the expected future pay-off amount at the maturity date of each caplet) in determining whether each of those hedging relationships is expected to be highly effective in achieving offsetting cash flows. The guidance in this paragraph applies to a purchased option regardless of whether at the inception of the cash flow hedging relationship it is at the money, in the money, or out of the money.

815-20-25-129 A hedging relationship that meets all of the conditions in paragraph 815-20-25-126 may be considered to be perfectly effective if all of the following conditions are met:

a. The critical terms of the hedging instrument (such as its notional amount, underlying, maturity date, and so forth) completely match the related terms of the hedged forecasted transaction (such as the notional amount, the variable that determines the variability in cash flows, the expected date of the hedged transaction, and so forth).

b. The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity’s exposure is being hedged.

c. The hedging instrument’s inflows (outflows) at its maturity date completely offset the change in the hedged transaction’s cash flows for the risk being hedged.

d. The hedging instrument can be exercised only on a single date—its contractual maturity date.

The condition in (d) is consistent with the entity’s focus on the hedging instrument’s terminal value. If the holder of the option chooses to pay for the ability to exercise the option at dates before the maturity date (for example, by acquiring an American-style option), the hedging relationship would not be perfectly effective.
815-20-25-129A In a hedge of a group of forecasted transactions in accordance with paragraph 815-20-25-15(a)(2), an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph 815-20-25-129(a) if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month.

Hedge Effectiveness of a Net-Purchased Combination of Options

815-20-25-130 The guidance in the following paragraph addresses a cash flow hedging relationship that meets both of the following conditions:

a. A combination of options (deemed to be a net purchased option) is designated as the hedging instrument.

b. The effectiveness of the hedge is assessed based only on changes in intrinsic value of the hedging instrument (the combination of options).

815-20-25-131 The assessment of effectiveness of a cash flow hedging relationship meeting the conditions in the preceding paragraph may be based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument (the combination of options). Thus, the assessment can exclude ranges of changes in the underlying for which there is no change in the hedging instrument’s intrinsic value.

Hedge Accounting Provisions Applicable to Certain Private Companies

Assuming Perfect Hedge Effectiveness in a Cash Flow Hedge of a Variable-Rate Borrowing with a Receive-Variable, Pay-Fixed Interest Rate Swap Recorded under the Simplified Hedge Accounting Approach


815-20-25-134 The conditions for the simplified hedge accounting approach determine which cash flow hedging relationships qualify for a simplified version of hedge accounting. If all of the conditions in paragraphs 815-20-25-135 and 815-20-25-137 are met, an entity may assume perfect effectiveness in a cash flow hedging relationship involving a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap.

815-20-25-135 Provided all of the conditions in paragraph 815-20-25-137 are met, the simplified hedge accounting approach may be applied by a private company except for a financial institution as described in paragraph 942-320-50-1. An entity may elect the simplified hedge accounting approach for any receive-variable, pay-fixed interest rate swap, provided that all of the conditions for applying the simplified hedge accounting approach specified in paragraph 815-20-25-137 are met. Implementation guidance on the conditions set forth in paragraph 815-20-25-137 is provided in paragraphs 815-20-55-79A through 55-79B.

815-20-25-136 In applying the simplified hedge accounting approach, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed by the date on which the first annual financial statements are available to be issued after hedge inception.
815-20-25-137 An eligible entity under paragraph 815-20-25-135 must meet all of the following conditions to apply the simplified hedge accounting approach to a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap:

a. Both the variable rate on the swap and the borrowing are based on the same index and reset period (for example, both the swap and borrowing are based on one-month London Interbank Offered Rate [LIBOR] or both the swap and borrowing are based on three-month LIBOR).

b. The terms of the swap are typical (in other words, the swap is what is generally considered to be a “plain-vanilla” swap), and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap.

c. The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.

d. The swap’s fair value at inception (that is, at the time the derivative was executed to hedge the interest rate risk of the borrowing) is at or near zero.

e. The notional amount of the swap matches the principal amount of the borrowing being hedged. In complying with this condition, the amount of the borrowing being hedged may be less than the total principal amount of the borrowing.

f. All interest payments occurring on the borrowing during the term of the swap (or the effective term of the swap underlying the forward starting swap) are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged.

815-20-25-138 A cash flow hedge established through the use of a forward starting receive-variable, pay-fixed interest rate swap may be permitted in applying the simplified hedge accounting approach only if the occurrence of forecasted interest payments to be swapped is probable. When forecasted interest payments are no longer probable of occurring, a cash flow hedging relationship will no longer qualify for the simplified hedge accounting approach and the General Subsections of this Topic shall apply at the date of change and on a prospective basis.

Timing of Hedge Documentation for Certain Private Companies If Simplified Hedge Accounting Approach Is Not Applied

Concurrent Hedge Documentation

815-20-25-139 Concurrent with hedge inception, a private company that is not a financial institution as described in paragraph 942-320-50-1 shall document the following:

a. The hedging relationship in accordance with paragraph 815-20-25-3(b)(1)

b. The hedging instrument in accordance with paragraph 815-20-25-3(b)(2)(i)

c. The hedged item in accordance with paragraph 815-20-25-3(b)(2)(ii), including (if applicable) firm commitments or the analysis supporting a last-of-layer designation in paragraph 815-20-25-3(c), or forecasted transactions in paragraph 815-20-25-3(d)

d. The nature of the risk being hedged in accordance with paragraph 815-20-25-3(b)(2)(iii).
815-20-25-140  A private company that is not a financial institution is not required to perform or document the following items concurrent with hedge inception but rather is required to perform or document them within the time periods discussed in paragraph 815-20-25-142:

a. The method of assessing hedge effectiveness at inception and on an ongoing basis in accordance with paragraph 815-20-25-3(b)(2)(iv) and (vi)

b. Initial hedge effectiveness assessments in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) through (04).

815-20-25-141 Example 1A beginning in paragraph 815-20-55-80A illustrates hedge documentation when the critical terms of the hedging instrument and hedged forecasted transaction match. Although that Example illustrates the documentation of the method of assessing hedge effectiveness, private companies that are not financial institutions may complete hedge documentation requirements in accordance with paragraphs 815-20-25-139 through 25-140.

Hedge Effectiveness Assessments

815-20-25-142 For a private company that is not a financial institution, the performance and documentation of the items listed in paragraph 815-20-25-140, as well as required subsequent quarterly hedge effectiveness assessments, may be completed before the date on which the next interim (if applicable) or annual financial statements are available to be issued. Even though the completion of the initial and ongoing assessments of effectiveness may be deferred to the date on which financial statements are available to be issued the assessments shall be completed using information applicable as of hedge inception and each subsequent quarterly assessment date when completing this documentation on a deferred basis. Therefore, the assessment should be performed to determine whether the hedge was highly effective at achieving offsetting changes in fair values or cash flows at inception and in each subsequent quarterly assessment period up to the reporting date.

Hedge Accounting Provisions Applicable to Certain Not-for-Profit Entities

815-20-25-143 Not-for-profit entities (except for not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market) may apply the guidance on the timing of hedge documentation and hedge effectiveness assessments in paragraphs 815-20-25-139 through 25-142. Specifically, those entities shall document the items listed in paragraph 815-20-25-139 concurrent with hedge inception, but they may perform and document the items listed in paragraph 815-20-25-140 and perform the required subsequent quarterly hedge effectiveness assessments in accordance with paragraph 815-20-25-142 within the time periods discussed in paragraph 815-20-25-142.

Review of U.S. derivative guidance and the application to SAP is complex with many facets. This document is the second of two initial documents and focuses on the accounting and reporting of hedging instruments, including excluded components.

2) Measurement of Excluded Components In Hedging Instruments

Existing guidance in SSAP No. 86, paragraph 40, Exhibit B – Assessment of Hedging Effectiveness, and Exhibit C – Specific Hedge Accounting Procedures for Derivatives address components permitted to be excluded when determining hedge effectiveness and/or the measurement of excluded components. Key elements to note with regards to the existing guidance:

- Components permitted for exclusion in Exhibit B were adopted from U.S. GAAP (FAS 133, paragraph 63) at the time of initial SSAP adoption. Although these have not been updated since original issuance, NAIC staff is proposing (in the Hedge Effectiveness review document) to continue the adoption of U.S. GAAP in determining hedge effectiveness. This will ensure that hedging instruments identified as effective hedges under U.S. GAAP will be considered effective hedges under statutory accounting principles.

- The guidance in paragraph 40 and Exhibit B appears to adopt U.S. GAAP with the treatment of accounting for excluded components at fair value, with changes in fair value recognized as unrealized gains or losses.

- The existing guidance adopted from U.S. GAAP (in paragraph 40 and Exhibit B) is contradictory to guidance in SSAP No. 86, paragraph 23 and Exhibit C. Pursuant to paragraph 23, entities should not bifurcate the effectiveness of derivatives and a derivative instrument is either classified as an effective hedge or an ineffective hedge. If classified as an effective hedge, then the measurement method of the hedged item is used for the hedging instrument (e.g., amortized cost). This guidance does not seemingly permit reporting entities to report part of a hedging instrument at amortized cost, with excluded components reported at fair value. (However, NAIC staff believes this may in fact occur in practice under the provisions of paragraph 40 and Exhibit B.)

- Furthermore, the guidance in Exhibit C for foreign currency swaps and forwards identifies that premiums / discounts shall be amortized into income over the life of the contract. This treatment is different than the fair value / change in unrealized recognition for excluded component detailed in paragraph 40 and Exhibit B. (This guidance has been part of Exhibit C since the original adoption of the SSAP and reflects a difference from U.S. GAAP.)

Interested parties have identified that the SAP treatment of excluded components related to foreign currency transactions are hindering the ability to engage in those transactions and have requested consideration to 1) clarify the inconsistent guidance in SSAP No. 86, and 2) consider SAP specific measurement methods for excluded components to prevent surplus volatility from derivative transactions.

As background information, the classification of derivatives as highly effective is ultimately an income-statement matching tool. Although all derivatives are reported at fair value under U.S. GAAP, if effective hedges, then changes in fair value are allocated to either net income or other comprehensive income (OCI) in a manner that matches and predominantly offsets the fluctuations from the hedged item. (For example, under U.S. GAAP, a fair value hedge requires both the hedging instrument and the hedged item to be reported at fair value, so fluctuations on one of offset by the other.) Under SAP, as the hedged items are not commonly reported at fair value, the guidance in SSAP No. 86 permits the derivative to reflect a measurement method that is more akin to the hedged item. (So, if hedging a bond at amortized cost, the
hedge instrument would also be reported at amortized cost. This prevents fair value fluctuations from the highly effective hedge from causing ‘noise’ in the financial statements throughout the hedge duration.)

Interested parties have communicated that requiring excluded components for foreign currency hedges to be recognized at fair value, with changes in fair value recognized as unrealized gains / losses, the financial statements show volatility that is not reflective of the underlying hedging transaction:

- For foreign currency forward contracts that have a premium / discount (e.g., forward point – difference between the forward contract rate and the spot rate at derivative execution), the amount required is set at origination. Although the change in spot rate over the hedge term could result with a fair value change of the forward point / premium, this change in fair value does not impact the required amount that was set at derivative execution. (Under Exhibit C, the existing guidance would require amortization of the premium, but this is conflicting with paragraph 40 and Exhibit B.) Regardless of if the derivative is terminated early or is identified as ineffective, there is no change to the amount required from the forward point determined at derivative execution. (As such, requiring recognition at fair value, and the change of fair value, does not result with a presentation of the amount owed by the reporting entity.)

- For a foreign currency swap with a cross-currency basis spread, the fair value changes are captured as part of the foreign currency periodic interest accruals. (A forward contract does not have periodic interest accruals, which is why the premium / forward point is proposed to be amortized under the prior example). Furthermore, regardless of if the derivative transaction continues to be effective, at the time of derivative maturity, the cross-currency basis spread is zero. The only time a reporting entity would be obligated to provide payment for a cross-currency basis spread is if the currency swap is terminated prior to maturity. Interested parties have noted that this is unlikely for the following reasons:

  o Most foreign bond exposures come through private investments that are generally more difficult to sell, providing a disincentive to selling the bond exposure.

  o The investment was originally acquired as the risk profile of the foreign bond was attractive to the reporting entity over the term of the investment. So, unless the bond issuer is having significant credit deterioration, it is unlikely an insurer will sell the bond.

  o In the event the foreign bond is terminated early, the derivative would also be terminated early. This will result in both items being removed from the balance sheet, and the offsetting economics would be recognized together in the same period. (So, in this situation, even if a cross-currency basis spread is obligated, it would be offset by the foreign currency impact of the bond.)

  o Industry representatives have identified that it would be even more unlikely for the derivative to be sold while retaining the foreign bond, however, if that was to occur, then the existing guidance for derivative termination would occur.

After considering the scenarios and industry comments for foreign currency excluded components, NAIC staff agrees that requiring these foreign currency excluded components to be reported at fair value, with changes in fair value recognized as unrealized gains / losses throughout the derivative term, results with financial statement impacts that are not reflective of the derivative transactions. Ultimately, the fair value recognition of these components creates surplus volatility / noise, that is not reflective of the intent, nor the final outcome of the derivative instrument. NAIC staff highlights that the key exception to this conclusion would be for scenarios in which a reporting entity was to elect to terminate a derivative in advance of the maturity date. Although existing guidance requires recognition at fair value with the impact in net income.
(realized gain/loss) at the time of such termination, NAIC staff believes it would be more appropriate to require recognition at fair value at the time that an entity has decided to terminate a hedging instrument prior to its maturity date. This would be consistent with other statutory accounting guidance that requires recognition at fair value (other than amortized cost) at the time such decisions are made. NAIC staff believe this would be appropriate in situations in which both the hedging instrument and hedged item would be terminated together and situations in which the hedging instrument is terminated while the hedged item continues to be held.

Although the prior discussion, and current industry comments, were focused on foreign currency excluded components, NAIC staff highlights that U.S. GAAP permits other elements to be excluded from the assessment of hedge effectiveness. These include the following:

a. If the effectiveness of a hedge with an option is assessed based on changes in the option’s intrinsic value, the change in the time value of the option would be excluded from the assessment of hedge effectiveness.

b. If the effectiveness of a hedge with an option is assessed based on changes in the option’s minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract shall be excluded from the assessment of hedge effectiveness.

c. An entity may exclude any of the following components of the change in an option’s time value from the assessment of hedge effectiveness:

i. The portion of the change in time value attributable to the passage of time (theta)
ii. The portion of the change in time value attributable to changes due to volatility (vega)
iii. The portion of the change in time value attributable to changes due to interest rates (rho).

Even if specific guidance is established for the foreign currency forward point and the cross-currency basis spread, statutory accounting guidance would still need clarification on the accounting and reporting for the other excluded components. If these excluded components are reported at fair value, with changes in unrealized gain/loss, NAIC staff highlights that the guidance should be clear in SSAP No. 86 and in the Schedule DB reporting instructions. Based on preliminary information, it seems current reporting for effective hedges is likely inconsistent for hedging instruments that have excluded components. NAIC staff has the impression that the following two options may currently be occurring:

- BACV reflects amortized cost. This would be consistent with SSAP No. 86, paragraph 23, but would be contrary to paragraph 40 and Exhibit B. (This would mean that the excluded components are not being recognized in the statutory financial statements.)

- BACV reflects a combination of amortized cost and fair value for the excluded components. This would be consistent with SSAP No. 86, paragraph 40 and Exhibit B, but would present an odd representation in Schedule DB as a derivative reported as an effective hedge would have an unrealized gain/loss, and the amount shown as an unrealized gain or loss would only be a specific portion of the change in fair value and could not be calculated from the information reported.

Unless subsequent information and discussion supports a different approach for the non-foreign currency excluded components detailed above, NAIC staff agrees that reporting these components at fair value, with fair value changes recognized through unrealized gains/losses is appropriate. In order to facilitate this recognition, NAIC staff recommends clarifications to SSAP No. 86 to specify the commingled reporting of BACV for effective hedges with excluded components, as well as revisions to Schedule DB to capture information on excluded components in new electronic-only columns. NAIC staff also recommends a new disclosure that captures information on all excluded components by classification type.
Proposed SSAP Revisions To Incorporate / Clarify Guidance for Excluded Components

Derivatives Used in Hedging Transactions

22. Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and are permitted to be valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet or no longer meet the criteria of an effective hedge, or that meet the required criteria but the entity has chosen not to apply hedge accounting, shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting)\(^1\).

23. Entities shall not bifurcate the effectiveness of derivatives. A derivative instrument is either classified as an effective hedge or an ineffective hedge. Entities must account for the derivative using fair value accounting if it is deemed to be ineffective or becomes ineffective. **Derivative instruments classified as effective with excluded components in determining hedge effectiveness pursuant to Exhibit A, paragraph _____, shall account for the derivative and excluded components pursuant to the guidance in paragraph 40.** Entities may redesignate a derivative in a hedging relationship even though the derivative was used in a previous hedging relationship that proved to be ineffective. A change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a termination of the derivative instrument. An entity shall prospectively discontinue hedge accounting for an existing hedge if any one of the following occurs:

a. Any criterion in paragraphs 26-38 is no longer met;

b. The derivative expires or is sold, terminated, or exercised (the effect is recorded as realized gains or losses or, for effective hedges of firm commitments or forecasted transactions, in a manner that is consistent with the hedged transaction – see paragraph 24);

c. The entity removes the designation of the hedge; or

d. The derivative is deemed to be impaired in accordance with paragraph 18. A permanent decline in a counterparty's credit quality/rating is one example of impairment required by paragraph 18, for derivatives used in hedging transactions.

Hedg Effectiveness

39. The measurement of hedge effectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 41.

40. The gain or loss on a derivative designated as a hedge and assessed to be effective is reported consistently with the hedged item. **(Therefore, if the hedged item is reported at amortized cost, and the hedging instrument is consistent with that measurement method, fluctuations in fair value would not be recognized as unrealized gains or losses for either the hedging item or hedging instrument.)** If an entity's defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in Exhibit BA, paragraph _____), specific accounting treatment shall be followed for the that excluded component: __ of the gain or loss shall be recognized as an unrealized gain

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\(^1\) Pursuant to paragraph 19, the gross reported value of a derivative and the determination of unrealized gains or losses shall exclude the impact of financing premiums. Premiums payable or receivable from the acquisition or writing of a derivative shall not be reflected in the gross reporting of derivatives or in determining the fair value change in a derivative.
or loss. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the changes in the option’s time value would be recognized in unrealized gains or losses. Time value is equal to the fair value of the option less its intrinsic value.

a. If the excluded component pertains to the difference between a foreign currency spot price and the forward or future price (e.g., a forward spot rate), then this premium / discount shall be amortized into income over the life of the contract or hedged program. (This guidance addresses the excluded component in Exhibit A, paragraph 8d.)

b. If the excluded component pertains to a foreign currency swap cross-currency basis spread, the impact of fair value changes shall be reflected as a component of the foreign currency swap’s periodic interest accrual. (This guidance addresses the excluded component in Exhibit A, paragraph 8e.)

c. For all other excluded components, the excluded component shall be measured and reported at fair value, with changes in fair value recognized as unrealized gains or losses. (This guidance shall be applied to excluded components detailed in Exhibit A, paragraphs 8a-8c.)

41. Hedging instruments with excluded components shall be identified in the financial statement investment schedule (Schedule DB) and shall be disclosed pursuant to paragraph 41g.

Proposed New Disclosure Paragraph (This is proposed as a new subparagraph 41g with reordering of subsequent paragraphs.)

g. For hedging instruments with excluded components for determining hedge effectiveness:

i. In the investment schedule, identify hedging instruments with excluded components, and report the current fair value of the excluded component, the fair value of the excluded component that is reflected in the reported BACV for the hedging instrument (this item would not be applicable for foreign-currency forwards and currency swaps where the forward points or cross-currency basis, respectively, are the excluded component), and the change in fair value reported as an unrealized gains/loss. (Note – These items will be proposed in electronic columns to Schedule DB.)

ii. In the notes to the financial statements, provide information on the aggregate excluded components by category: Time Value, Intrinsic Value, Forward Points and Cross Currency Basis Spread. The aggregate amounts reported should include the following (as applicable): current fair value, recognized unrealized gain/loss, the fair value reflected in BACV, and for the excluded forward points (e.g., forward spot rates), the aggregate amount owed at maturity, along with current year and remaining amortization. (Note – These items will be captured in a blanks proposal / template.)

Proposed Edits to Exhibit C – Foreign Currency Swaps and Forwards

Note: Only Specific Excerpts Included

Specific hedge accounting procedures for derivative instruments are outlined below.

1. Call and Put Options, Warrants, Caps, and Floors:

a. Accounting at Date of Acquisition (purchase) or Issuance (written): The premium paid or received for purchasing or writing a call option, put option, warrant, cap or floor shall either be (i) recorded as an asset (purchase) or liability (written) on the Derivative line on the
Assets (or) Liabilities pages or (ii) combined with the hedged item(s) individually or in the aggregate;

b. Statement Value:

i. Open derivatives hedging items recorded at amortized cost:

(a) Options, warrants, caps, and floors purchased or written shall be valued at amortized cost in a manner consistent with the hedged item. *(Components of a hedging instrument excluded from the determination of hedge effectiveness shall be recognized at fair value, with changes in fair value recognized as unrealized gains/losses throughout the duration of the hedging instrument. These components are not captured within the guidance for effective hedges detailed within this section.)*

(b) The amortization period and methods used shall result in a constant effective yield over the life of the hedged item or program. (For floating rate hedged items, the estimated effective yield shall be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change). Specific treatment includes:

1. Holdings in derivatives purchased or written within a year of maturity or expiry need not be amortized;

2. For hedges of forecasted transactions or firm commitments, the derivative may be recorded at cost until the hedged transaction occurs or it is determined that the hedge was not effective (see (d) in this section 1.b.i.);

3. For other derivatives, the amortization period is usually from date of acquisition (issuance) of the derivative to maturity of the hedged item or program.

(c) For hedges where the cost of the derivative is combined with the hedged item, the statement value is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate;

(d) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until (1) the hedged transaction occurs or (2) it is determined that the hedge was not effective (when the derivative is valued in accordance with (e) in this section);

(e) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or the designated portion of the derivative shall be valued at its current fair value with gains and losses recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

d. Gain/Loss on Termination of an option, warrant, cap or floor accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):

i. Exercise of an Option: The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;
ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction, except for excluded components, will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination. For hedging instruments with excluded components in determining hedge effectiveness, the unrealized gain/loss from the change in fair value of the excluded component shall be realized upon the closing transaction. This gain/loss shall not be used to adjust the basis or proceeds of the hedged item.

iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

iv. Upon the redesignation of a derivative from a currently effective hedging relationship:

(a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.

(b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.

(c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.

2. Swaps, Collars, and Forwards (see also discussion in Introduction above):

a. Accounting at Date of Opening Position:

i. Any premium paid or received at date of opening shall either be (a) recorded on the Derivative line on the Assets (or) Liabilities pages or (b) combined with the hedged item(s), individually or in the aggregate;

b. Statement Value:

i. Open derivatives hedging items recorded at amortized cost:

(a) Swaps, collars, and forwards shall be valued at amortized cost in a manner consistent with hedged item. (Components of a hedging instrument excluded from the determination of hedge effectiveness not addressed in 2.b.iii shall be recognized at fair value, with changes in fair value of the excluded component recognized as unrealized gains/losses throughout the duration of the hedging instrument. These components are not captured within the guidance for effective hedges detailed within this section.)

(b) The amortization period and methods used shall result in a constant effective yield over the life of the hedged item or program. (For floating rate hedged items the estimated effective yield shall be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
(1) Holdings in derivatives purchased or written within a year of maturity or expiry need not be amortized;

(2) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until (a) the hedged transaction occurs or (b) it is determined that the hedge was not effective (see (5) in this section 2.b.i.);

(3) For other derivatives the amortization period is usually from date of acquisition (issuance) of the derivative to maturity of the hedged item or program;

(4) For hedges where the cost of the derivative is combined with the hedged item, the statement value is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate;

(5) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or a designated portion of the derivative shall be valued at its current fair value with gains and losses recorded in unrealized gains or unrealized losses to the extent that it ceased to be an effective hedge. Upon redesignation into an effective hedging relationship, the derivative’s mark to fair value through unrealized gain or loss shall be reversed.

ii. Open derivatives hedging items recorded at fair value (where gains and losses on the hedged item are recognized as adjustments to unassigned funds (surplus)):

(a) Swaps, collars, or forwards shall be valued at current fair value with changes in fair value recognized currently consistent with the hedged item; this will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

(b) For hedges where the derivative is combined with the hedged item, the fair value of the derivative and hedge item shall be determined and reported separately, either individually or in the aggregate. The cost (book value) basis used to figure gain/loss on the derivative is zero.

iii. Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars where fair value accounting is not being used:

(a) The foreign exchange premium (discount) on the currency contract shall be amortized into income over the life of the contract or hedge program. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened. For forward contracts, an excluded component representing a foreign exchange premium (discount) (forward points) on the currency contract shall be amortized into income over the life of the contract or hedge program. Amortization is not required if the contract was entered into within a year of maturity. For foreign currency swaps, an excluded component representing a cross-currency basis spread is recognized into income through the foreign currency swap’s periodic interest accruals.
Amortization is not required if the contract was entered into within a year of maturity.

(b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as done to translate the hedged item.

(c) The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate.

(d) The statement value of the derivative equals the amortized cost plus:

1. For forward contracts, the amortized (premium) discount plus the cumulative unrealized gain/(loss) on the contract.

2. For foreign currency swaps, the cumulative unrealized gain/(loss) on the contract. The cross-currency basis spread is recorded through the Investment Income Due and Accrued or Other Liabilities, as a component of the foreign currency swap’s periodic interest accrual.

The cumulative unrealized gain/loss equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened.

(e) Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on derivatives hedging forecasted transactions or firm commitments shall be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs.

(f) For hedges where the cost of the foreign currency contract is combined with the hedged item, the statement value on Schedule DB is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate.

(g) If during the life of the currency contract it or a designated portion of the currency contract is not effective as a hedge, the derivative shall be recorded at fair value and valuation at amortized cost shall cease. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss (surplus adjustment) will be recognized equal to the difference between the carrying value of the derivative on the balance sheet and the fair value of the derivative if either of the following occur:

1. During the life of the currency contract it or a designated portion of the currency contract is not effective as a hedge.

2. The entity decides to terminate the derivative in advance of scheduled maturity.

    notional amount or designated notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.

iv. Open derivatives hedging items recorded at fair value, where gains and losses on the hedged item are recognized currently in earnings: swaps, collars and forwards
shall be valued at current fair value with changes in fair value recognized currently in earnings together with the gains and losses on the hedged item.

(a) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, recognition of changes in fair value through earnings ceases. The derivative shall continue to be valued at its current fair value, but thereafter gains or losses shall be recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

c. Cash Flows and Income:
   i. Where the cost of the derivative is not combined with the hedged item:
      (a) Amortization of premium paid or received on derivatives is an adjustment to net investment income or another appropriate caption within operating income consistent with the reporting of the hedged item;

      (b) Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as net investment income or another appropriate caption within operating income.

   ii. Where the cost of the derivative is combined with the hedged item, the cash flows and income of the derivative on Schedule DB is zero. All related amortization and cash flow accounting shall be reported with the hedged item instead of with the derivative.

d. Gain/Loss on Termination of a swap, collar or forward accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):
   i. Exercise—The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;

   ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction, except for excluded components, will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination;

   iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

   iv. Upon the redesignation of a derivative from a currently effective hedging relationship:
      (a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.

      (b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.
(c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: SSAP No. 48 – Alternative Valuation of Minority Ownership Interests

Check (applicable entity):

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Description of Issue: SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies establishes the statutory accounting principles for investments in joint ventures, partnerships, or limited liability companies (herein collectively referred to as SSAP No. 48 investments). This agenda item is presented to review the alternative valuation methods permitted in limited circumstances where the investee has a minor ownership interest (less than 10%) or lacks control as discussed in paragraphs 15 and 16 (see Authoritative Literature), and where audited U.S. GAAP basis financial statements are not available.

In general, SSAP No. 48 requires a financial statement audit for admission of investments with a more than minor ownership interest or where control is present. If an investee owns greater than 10% measured at the holding company level, or can exercise control, the SSAP No. 48 investment is to be reported using the equity method as defined in SSAP No. 48—Investments in Subsidiary, Controlled and Affiliated Entities, which effectively directs the valuation based on the nature of the operations (e.g., requiring statutory accounting for insurance operations or U.S. GAAP accounting for other various entities). Embedded in SSAP No. 97, the proxy for SSAP No. 48 investments in which the investor owns greater than 10% or can exercise control, is the requirement for a statutory or a U.S. GAAP financial statement audit. (The requirement for audited financial statements in these instances is not proposed to be the subject of discussion.)

If insurer has less than 10% ownership (minor ownership interest) or lacks control the preference is to use audited U.S. GAAP financial statements. However, when audited U.S. GAAP financial statements are not available, paragraph 9 provides the following three alternatives, which includes: 1) investee’s audited foreign GAAP with an audited U.S. GAAP reconciliation footnote, 2) audited IFRS financial statements, or 3) audited U.S. tax equity financial statements. The permissible exceptions for when audited U.S. GAAP basis financials are not available are detailed in paragraph 9 below:

9. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16 may be recorded based on either of the valuation methodologies allowed under paragraphs 9.a. or 9.b. If either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

   a. Non U.S. joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10% and for which audited U.S. GAAP basis financial statements of the investee are not available, may be recorded based on:

      i. the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee's equity and income to U.S. GAAP within the investee’s audited foreign GAAP prepared financial statements or,
ii the IFRS basis equity as set forth in the investee’s audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).

b. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity. For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 18 and 19. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

NAIC staff believe the intent of the U.S. GAAP audit exceptions provided in paragraph 9 was meant to accommodate limited situations where an insurer has a minor ownership interest and or lacks control and therefore, they are unable to require or entice the entity to acquire a U.S. GAAP audit. NAIC staff note this distinction, as SSAP No. 48, paragraph 9 currently permits that if an insurer owns less than 10% or lacks control, they are permitted the exceptions which still require audits if audited U.S. GAAP basis financial statements are unavailable. It is important to note that technically SSAP No. 48, paragraph 16 could permit a significant ownership percentage and as long as an insurer has rebutted control of the investment, they would be permitted to use the paragraph 9 exceptions, that is if the insurer could articulate why audited U.S. GAAP basis financials statements were not available.

This agenda item has been drafted to propose two alternative clarifications to SSAP No. 48. The first option presented is to propose deletion of the U.S. GAAP audit exception provided in SSAP No. 48, paragraph 9.b as this exception does not appear to be utilized by insurers. The second option presented is to retain the U.S. GAAP audit exception in paragraph 9.b but clarify that the U.S. tax basis audit is to reside at the investee level – that is the investee must have an audit in order for this valuation be permitted for admission of the investment. This clarification would eliminate any ambiguity regarding the level at which the audit is required.

Existing Authoritative Literature: While a significant portion of the potentially impacted paragraphs have been included above, all relevant SSAP No. 48 guidance is included below, with pertinent items bolded for emphasis.

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in any joint ventures, partnerships, and limited liability companies, including investments in certified capital companies (CAPCO) per INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO), whether or not it is considered to be controlled by or affiliated with the reporting entity. Single real estate property investments that are wholly-owned by an LLC that is directly and wholly-owned by the reporting entity, and that meet the criteria established in SSAP No. 40R—Real Estate Investments, are excluded from this statement. This statement does not address the accounting for investments in partnerships and limited liability companies that invest in Low-Income Housing Tax Credit Properties as discussed in SSAP No. 93—Low-Income Housing Tax Credit Property Investments. However, investments in certain state Low-Income Housing Tax Credit Property Investments that do not fall within the scope of SSAP No. 93 are covered by the requirements of this statement.

SUMMARY CONCLUSION

2. Investments in joint ventures shall include investments in corporate joint ventures and unincorporated joint ventures (also referred to as undivided interests in ventures). A corporate joint venture is defined as a corporation owned and operated by a small group (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A corporate joint venture
usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An unincorporated joint venture is similar in its purpose but is not incorporated.

3. **Investments in partnerships shall include investments in general partnership interests and limited partnership interests.** A general partnership is defined as an association in which each partner has unlimited liability. Each partner assumes joint and several liability for all partnership debts. A limited partnership shall be defined as a partnership having two classes of partners: (a) general partners who manage the partnership, subject to the partnership agreement, and have personal liability for the general obligations of the partnership and (b) limited partners who are passive investors and have no personal liability beyond their investment.

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

5. Investments in the ventures defined in paragraphs 2-4 meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement. Investments in joint ventures, partnerships, and limited liability companies shall be reported in Other Invested Assets in the financial statements.

6. **Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, paragraphs 8.b.i. through 8.b.iv.** (The equity method calculation may result with a negative valuation of the investment; therefore, the SSAP No. 97 equity method calculation shall occur regardless of whether the investment is supported by an audit and the reporting entity will nonadmit the investment.) A reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 35.a.

7. Investments reported using an equity method from SSAP No. 97, paragraph 8.b.ii. through 8.b.iv. may have fiscal year ends, not calendar year ends. To recognize a change to the reporting year-end of an equity method investee, including changes in, or the elimination of, previously existing differences (lag period) due to the reporting entity’s ability to obtain financial results from a reporting period that is more consistent with, or the same as, that of the reporting entity’s, the guidance included in FASB Emerging Issues Task Force No. 06-9: Reporting a Change in (or the elimination of) a Previously Existing Difference Between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or Between the Reporting Period of an Investor and That of an Equity Method Investee that defines such reporting period changes as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors shall be followed.

8. Joint ventures, partnerships and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16, shall be recorded based on the underlying audited U.S. GAAP equity of the investee. The investment shall be nonadmitted if the audited financial statements include substantial doubt about the entity’s ability to continue as a going concern. Additionally, the investment shall be nonadmitted on the basis/contents of the audit opinion as detailed in paragraph 21 of SSAP No. 97.

9. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16 may be recorded based on either of the valuation methodologies allowed under paragraphs 9.a. or 9.b. If either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.
a. Non U.S. joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10% and for which audited U.S. GAAP basis financial statements of the investee are not available, may be recorded based on:

i. the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee’s equity and income to U.S. GAAP within the investee’s audited foreign GAAP prepared financial statements or,

ii. the IFRS basis equity as set forth in the investee’s audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).

b. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity. For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 18 and 19. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

10. The amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in paragraph 3 of SSAP No. 68—Business Combinations and Goodwill) plus subsequent capital contributions to the investee. The carrying amount of the investment shall be adjusted for the amortization of the basis difference (difference between the cost and the underlying GAAP equity), as well as to recognize the reporting entity’s share of: (i) the audited U.S. GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any distributions received, or (ii) if audited U.S. GAAP basis financial statements of the investee are not available, the earnings or losses of the investee after the date of acquisition, adjusted for any distributions received, based on either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. A reporting entity’s share of adjustments, excluding changes in capital contributions to the investee, that are recorded directly to the investee’s stockholders’ equity shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded to unrealized capital gains and losses on investments.

11. Entities may recognize their investment in joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest based on an unaudited basis for investment determination (i.e., foreign GAAP, IFRS, or tax basis as allowed under paragraph 9) if annual audited information is not complete as of the annual statement filing deadline. The recorded investment shall be adjusted for annual audit adjustments, if any, as soon as annual audited information is available. 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.

15. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

16. Control as defined in paragraph 15 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 interests 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 rights as a shareholder to the investee.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):
In May 2008, in agenda item 2007-34R: SSAP 48, the Working Group adopted revisions in SSAP No. 48 permitting the use of an audited U.S. tax basis equity valuation method in cases where the insurer is a minor interest or lacks control and audited U.S. GAAP financial statements of the investee were not available.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group:
None

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose two possible options for the U.S. GAAP audit exception in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Option #1 proposes to delete the audited U.S. tax basis equity as a permissible valuation method as this method does not appear to be utilized by insurers. Option #2 proposes to retain the audited U.S. tax basis equity valuation method but clarifies that the audit must reside at the investee level.

Option 1: Delete the valuation method permitted in SSAP No. 48, paragraph 9b.

9. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16 may be recorded based on either of the valuation methodologies allowed under paragraphs 9.a. or 9.b. If either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

   a. Non U.S. joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10% and for which audited U.S. GAAP basis financial statements of the investee are not available, may be recorded based on:

      i. the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee’s equity and income to U.S. GAAP within the investee’s audited foreign GAAP prepared financial statements or,

      ii. the IFRS basis equity as set forth in the investee’s audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).
b. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity. For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 18 and 19. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

Option 2: Retain the alternative valuation method but clarify that the required U.S. tax basis equity audit is to reside at the investee level.

9. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16 may be recorded based on either of the valuation methodologies allowed under paragraphs 9.a. or 9.b. If either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

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ii. the IFRS basis equity as set forth in the investee’s audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).

b. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity. The U.S. tax basis equity audit shall occur at the investee level. For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 18 and 19. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

Staff Review Completed by: Jim Pinegar—NAIC Staff, February 2022

Status:
On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed two possible options for the U.S. GAAP audit exception in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. The options are described below while the revisions are illustrated above in the recommended action.

Option #1 proposes to delete the audited U.S. tax basis equity as a permissible valuation method as this method does not appear to be utilized by insurers.
Option #2 proposes to retain the audited U.S. tax basis equity valuation method but clarifies that the audit must reside at the investee level.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Hearing/11 - 22-02 - SSAP No. 48 - Alt Valuation Minority Ownership.docx
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Issue: Conceptual Framework – Updates

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Description of Issue: In December 2021, the Financial Accounting Standards Board (FASB) issued two new chapters of its conceptual framework. The conceptual framework is a body of interrelated objectives and fundamentals that provides the FASB with a foundation for setting standards and concepts to consider when it resolves questions or develops/modify accounting and reporting guidance.

It is important to note that the Statements of Financial Accounting Concepts are not authoritative and do not establish new or change existing U.S. GAAP. Per the FASB chair, these concepts are “a tool for the Board to use in setting standards that improve the understandability of information entities provide to existing and potential investors, lenders, donors, and other resource providers.”

This agenda item reviews and summarizes each of the two newly issued concept chapters and reviews their potential impact on statutory accounting. Again, while the conceptual framework statements are not authoritative, they are the guiding principles for standard setting and these new updates have superseded chapters currently referenced in the Accounting Practices and Procedures Manual (AP&P Manual). In addition, and most notably, in the case of one of these chapters, FASB changed certain key fundamental definitions, specifically the definition of an asset and a liability, which have historically been mirrored by statutory accounting.

Update 1:
FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements introduced updated definitions of certain key elements used in financial reporting – the definition of an asset and liability. The chapter states that assets and liabilities have conceptual and definitional primacy because assets and liabilities (and changes in those elements) are foundational to all the other items reported in the financial statements. To correctly identify and represent an asset or liability is the beginning basis for all financial reporting and due to their importance, updates to both financial statement elements have been adopted. A summary of each, comparing the historical and current definitions, is provided below:

Changes regarding the definition of an ASSET:

- **Historical definition**: a probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events.

- **Historical Characteristics: Three essential characteristics**:
  1. it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows,
  2. a particular enterprise can obtain the benefit and control others’ access to it, and
  3. the transaction or other event giving rise to the enterprise's right to or control of the benefit has already occurred.

- **New Definition**: a present right of an entity to an economic benefit.
➢ Current Characteristics: Two essential characteristics:

1. it is a present right, and
2. the right is to an economic benefit.

The combination of these two characteristics allows an entity to obtain the economic benefit and control others’ access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others’ access to the benefit to which the entity is entitled. For clarity, an “economic benefit” represents services or other items of economic value and generally result in net cash inflows to the entity.

Commentary regarding definitional changes:
The current definition of an asset no longer includes the term probable or the phrases future economic benefit and past transactions or events. The FASB concluded that the term probable has historically been misunderstood as implying that a future benefit must be probable to a certain threshold before the definition of an asset was met. Thus, if the probability of a future benefit was low, an asset could not be recognized. FASB also struck the phrase future economic benefit as this phrase often was interpreted that the asset must represent a certain future economic benefit (such as eventual cash inflows), however with this update, FASB clarified that the asset represents the rights to the benefit, not the actual benefit itself – nor the probability of realization.

Finally, FASB struck the phrase as the result of past transactions or events. It was concluded that if the asset represents a present right, by default, the right must have occurred as the result of a past transaction or event and thus this phraseology was deemed redundant and unnecessary.

Changes regarding the definition of a LIABILITY:

- **Historical definition:** are [certain or] probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

- **Historical Characteristics:** Three essential characteristics:

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

- **New Definition:** a present obligation of an entity to transfer an economic benefit.

- **Current Characteristics:** Two essential characteristics:

  1. it is a present obligation, and
  2. the obligation requires an entity to transfer or otherwise provide economic benefit to others. (For the purposes of this characteristic, transfer is typically used to describe obligations to pay cash or convey assets, while the term provide is used to describe obligations to provide services or stand by to do so).

Commentary regarding definitional changes:
The current definition of a liability no longer includes the term probable or the phrase in the future as a result of past transactions or events. The FASB concluded that the term probable has historically been understood as implying that a future obligation must meet a probability to a certain threshold before the definition of a liability was met. Thus, if the probability of a future transfer of an asset (or the requirement to provide a service) was low,
a liability would likely not be recognized. In removing the term *probable* (and replacing it with “present obligation”), FASB concluded that in almost all situations, the presence of an obligation will be apparent. It stated that most present obligations are legally enforceable, including obligations arising from binding contracts, agreements, statutes, or other legal or contractual means. Chapter 4 also discusses the prevalence of certain business risks and how to assess if they result in the recognition of a liability. It concluded that while certain businesses pose risk of future events occurring that will cause them to transfer an economic benefit (an asset), the risk itself does not represent a present obligation because exposure to a potential negative consequence does not constitute a present obligation.

However, FASB also stated situations lacking clear legal or contractual evidence of a present obligation may pose particular challenges that may make it difficult to discern whether a present obligation exists. In these settings, the FASB stated that constructive obligations or other noncontractual obligations are created by circumstance rather than by explicit agreement. In the absence of an explicit agreement, sufficient information to distinguish a present obligation is likely only available at the specific standards level. Thus, the FASB concluded that the specific facts and circumstances at the standards level (or in the case of statutory accounting, at the SAP level) must be utilized to determine whether the entity has created a constructive obligation and must recognize a liability.

FASB also struck the phrase as the result of *past transactions or events*. It was concluded that if the liability represents a *present right*, by default, the right must have occurred as the result of a past transaction or event and thus this phraseology was deemed redundant and unnecessary.

**Update 2:**

FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 7, Presentation* identifies factors that the FASB will consider when deciding how items should be displayed on the financial statements. Chapter 7 describes the information to be included in the financial statements and how appropriate presentation can contribute to the objective of financial reporting – to communicate financial information about an entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources (goods and services) to the entity. These decisions typically involve buying or selling of goods/services or holding equity and debt instruments as well as providing or settling loans or other forms of credit. This chapter articulates that the financial statements meet a “general purpose” and should not be considered to meet all purposes for possible users – and thus a common set of conceptual standards is appropriate.

Chapter 7 also describes the importance of financial statement notes, or supplementary information so that financial statement users are provided with a more complete picture of an entity’s accounting policy or any particular unique circumstance or event. In terms of general reporting, the conceptual statement relays that a distinction between nonhomogeneous items should be depicted in the financial statements with different reporting line items and subtotals and that the information should be provided based on recognition and measurement standards. In essence, reporting should be sufficiently aggregated, but not aggregated to a level in which the information is too consolidated for general use and understanding. Once reported, then any significant accounting policy or circumstance would further be defined with accompanying notes.

The chapter broadly states that to meet the objectives of financial reporting, line items should be distinct based on the information being provided – as the information should distinguish between various types of transactions/events and should assist users in their estimates in the amounts and timing of future cash flows or the entity’s ability to provide other economic value. The financial statements should depict the results of different types of transactions, including changes in events or other circumstances that may vary the frequency or predictability of performance based on many items, including changes in economic conditions.

In summary, while Chapter 7 does supersede sections of *Statement of Financial Accounting Concept 5*, it did not result in fundamental changes to the principal concepts of financial reporting. The chapter articulates the need for complete financial reporting, describes the interconnectedness of a ‘complete set of financial statements’ and relays the importance of these documents as the information in the financial statements is the primary (and typically the
sole) source for analyzing current and potential future performance of an organization and its ability to meet its long-term financial objectives. At a high level, the chapter discusses what information should broadly be categorized as revenues, expenses, gains, and losses and to the extent equity is impacted by operations as well as changes in owners’ equity through investments or distributions.

In terms of the impact to statutory accounting, the updated concepts in this chapter are not expected to modify current guidance, other than to update references to superseded accounting concepts.

**Existing Authoritative Literature:**

### NAIC Staff Note

- the Preamble contains reference to certain concept statements in footnotes 2 and 4 and have been bolded below for ease of identification. It is important to note that while these footnotes currently reference superseded conceptual statements, the conceptual statements noted do not represent adopted guidance - they are noted as reference for overarching guiding principles regarding financial reporting.

### Preamble

**IV. Statutory Accounting Principles Statement of Concepts**

25. This document states the fundamental concepts on which statutory financial accounting and reporting standards are based. These concepts provide a framework to guide the National Association of Insurance Commissioners (NAIC) in the continued development and maintenance of statutory accounting principles ("SAP" or "statutory basis") and, as such, these concepts and principles constitute an accounting basis for the preparation and issuance of statutory financial statements by insurance companies in the absence of state statutes and/or regulations.

26. The NAIC and state insurance departments are primarily concerned with statutory accounting principles that differ from GAAP reflective of the varying objectives of regulation. Recodification of areas where SAP and GAAP are parallel is an inefficient use of limited resources.

27. SAP utilizes the framework established by GAAP. **FN2** This document integrates that framework with objectives exclusive to statutory accounting. The NAIC’s guidance on SAP is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting outlined herein. Those GAAP pronouncements that are not applicable to insurance companies will not be adopted by the NAIC. For those principles that do not differ from GAAP, the NAIC must specifically adopt those GAAP Pronouncements to be included in statutory accounting. GAAP Pronouncements do not become part of SAP until and unless adopted by the NAIC.

28. The body of statutory accounting principles is prescribed in the statutory hierarchy of accounting guidance. This hierarchy provides the framework for judging the presentation of statutory financial statements in conformance with statutory accounting principles.

29. Statutory requirements vary from state to state. While it is desirable to minimize these variations, to the extent that they exist it is the objective of NAIC statutory accounting principles to provide the standard against which the exceptions will be measured and disclosed if material.

**FN 2 - The GAAP framework applicable to insurance accounting is set forth in Statements of Financial Accounting Concepts One, Two, Five, and Six. These documents, promulgated by the Financial Accounting Standards Board, set forth the objectives and concepts which are used in developing accounting and reporting standards.**

**V. Statutory Hierarchy**

42. The following Hierarchy is not intended to preempt state legislative and regulatory authority.
Level 1

SSAPs, including U.S. GAAP reference material to the extent adopted by the NAIC from the FASB Accounting Standards Codification (FASB Codification or GAAP guidance)

Level 2

Consensus positions of the Emerging Accounting Issues (E) Working Group as adopted by the NAIC (INTs adopted before 2016)

Interpretations of existing SSAPs as adopted by the Statutory Accounting Principles (E) Working Group (INTs adopted in 2016 or beyond)

Level 3

NAIC Annual Statement Instructions

Purposes and Procedures Manual of the NAIC Investment Analysis Office

Level 4

Statutory Accounting Principles Preamble and Statement of Concepts FN4

Level 5

Sources of nonauthoritative GAAP accounting guidance and literature, including: (a) practices that are widely recognized and prevalent either generally or in the industry, (b) FASB Concept Statements, (c) AICPA guidance not included in FASB Codification, (d) International Financial Reporting Standards, (e) Pronouncements of professional associations or regulatory agencies, (f) Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids, and (g) Accounting textbooks, handbooks and articles

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

44. Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established statutory accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting a statutory accounting principle that appears appropriate when applied in a manner similar to the application of an established statutory principle to an analogous transaction or event. In the absence of a SSAP or another source of established statutory accounting principles, the preparer, regulator or auditor of statutory financial statements may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes the Statutory Accounting Principles Statement of Concepts and GAAP reference material and accounting literature identified in Level 5. The appropriateness of other accounting literature depends on its relevance to the particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, the Statutory Accounting Principles Statement of Concepts would be more authoritative than any other sources of accounting literature. Similarly, FASB Concepts Statements would normally be more influential than other sources of nonauthoritative GAAP pronouncements.

FN 4 - The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concepts Statements One, Two, Five and Six to the extent they do not conflict with the concepts
outlined in the statement. However, for purposes of applying this hierarchy the FASB Concepts Statements shall be included in Level 5 and only those concepts unique to statutory accounting as stated in the statement are included in Level 4.

SSAP No. 4—Assets and Nonadmitted Assets

<table>
<thead>
<tr>
<th>NAIC Staff Note</th>
<th>this SAP contains the definition of the financial statement element of an Asset. Relevant items have been bolded below for ease of identification.</th>
</tr>
</thead>
</table>

2. For purposes of statutory accounting, an asset shall be defined as: probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.

3. As stated in the Statement of Concepts, “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,” and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:

   a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or


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

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of assets, but are specifically identified within the Accounting Practices and Procedures Manual as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.

5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

FN1 - FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

FN2 - If assets of an insurance entity are pledged or otherwise restricted by the action of a related party, the assets are not under the exclusive control of the insurance entity and are not available to satisfy policyholder obligations due to these encumbrances or other third-party interests. Thus, pursuant to
paragraph 2(c), such assets shall not be recognized as an admitted asset on the balance sheet. Additional guidance for assets pledged as collateral is included in INT 01-31.

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

**NAIC Staff Note** – this SAP contains the definition of the financial statement element of a Liability. Relevant items have been bolded below for ease of identification.

2. A liability is defined as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).

3. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity's financial statements when incurred.

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

**FN1 - FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements,** states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement 5, Accounting for Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): While slightly different, the updated FASB asset & liability definitions do closer align with IFRS definitions. While IFRS retains the phrase “as a result of past events,” it also explicitly retains the term “control,” which is now implicit with the FASB updates. The elimination of the explicit term “control” was a deliberate action of the FASB as they noted that the notion of control has been historically misunderstood (control is to the right that gives rise to the economic benefit rather than to the economic benefits themselves). For reference **IFRS Chapter 4 – The Elements of Financial Statements,** defines an asset as a present economic resource controlled by the entity as a result of past events; with the economic resource representing a right that has the potential to produce economic benefits. Additionally, the chapter defines a liability as a present obligation of an entity to transfer an economic resource as a result of past events.

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to the Preamble, SSAP No. 4—Assets and Nonadmitted Assets and SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets, as illustrated below and in the issue papers, to incorporate updates from Chapter 4, Elements of Financial Statements and Chapter 7, Presentation of the FASB’s Conceptual Framework for Financial Reporting.

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**Proposed edits to the Preamble:** proposed modifications reflect updates for superseded FASB Financial Accounting Concepts.

IV. **Statutory Accounting Principles Statement of Concepts**

25. This document states the fundamental concepts on which statutory financial accounting and reporting standards are based. These concepts provide a framework to guide the National Association of Insurance Commissioners (NAIC) in the continued development and maintenance of statutory accounting principles ("SAP" or "statutory basis") and, as such, these concepts and principles constitute an accounting basis for the preparation and issuance of statutory financial statements by insurance companies in the absence of state statutes and/or regulations.

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28. The body of statutory accounting principles is prescribed in the statutory hierarchy of accounting guidance. This hierarchy provides the framework for judging the presentation of statutory financial statements in conformance with statutory accounting principles.

29. Statutory requirements vary from state to state. While it is desirable to minimize these variations, to the extent that they exist it is the objective of NAIC statutory accounting principles to provide the standard against which the exceptions will be measured and disclosed if material.

**FN 2 -** The GAAP framework applicable to insurance accounting is set forth in *Statements of Financial Accounting Concepts One, Two, Five, and SixEight*. These documents, promulgated by the Financial Accounting Standards Board, set forth the objectives and concepts which are used in developing accounting and reporting standards.

V. **Statutory Hierarchy**

42. The following Hierarchy is not intended to preempt state legislative and regulatory authority.

Level 1

*SSAPs, including U.S. GAAP reference material to the extent adopted by the NAIC from the FASB Accounting Standards Codification (FASB Codification or GAAP guidance)*

Level 2

*Consensus positions of the Emerging Accounting Issues (E) Working Group as adopted by the NAIC (INTs adopted before 2016)*

*Interpretations of existing SSAPs as adopted by the Statutory Accounting Principles (E) Working Group (INTs adopted in 2016 or beyond)*

2. For purposes of statutory accounting, an asset shall be defined as: a present right of an entity to an economic benefit, probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has two or three essential characteristics: (a) it is a present right embodied in a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, and (b) the right is to an economic benefit, a particular entity can obtain the benefit and control others’ access to it FN1 FN2, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.

3. As stated in the Statement of Concepts, “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,” and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:

   a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity’s written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.
4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of assets, but are specifically identified within the Accounting Practices and Procedures Manual as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.

5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

FN1 - FASB Statement of Financial Accounting Concepts No. 86, Elements of Financial Statements, states that the combination of these two characteristics allows an entity to obtain the economic benefit and control others’ access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others’ access to the benefit to which the entity is entitled. Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

FN2 - If assets of an insurance entity are pledged or otherwise restricted by the action of a related party, the assets are not under the exclusive control of the insurance entity and are not available to satisfy policyholder obligations due to these encumbrances or other third-party interests. Thus, pursuant to paragraph 2(c), such assets shall not be recognized as an admitted asset on the balance sheet. Additional guidance for assets pledged as collateral is included in INT 01-31.

Relevant Literature


References

Relevant Issue Papers

Issue Paper No. 4—Definition of Assets and Nonadmitted Assets

Issue Paper No. 119—Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82

Issue Paper No. 16X -Updates to the Definition of an Asset

SSAP No. 5—Liabilities, Contingencies and Impairments of Assets: proposed modifications reflect an updated definition of the term Liability – to match the newly issued definition in FASB Statement of Financial Accounting Concepts No. 8

2. A liability is defined as a present obligation of an entity to transfer an economic benefit, certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).

3. A liability has three essential characteristics: (a) it is a present obligation embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, and (b) the obligation requires an entity to transfer or otherwise provide economic benefit to others duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened—This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and...
reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity’s financial statements when incurred.

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

FN1 - FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement 5, Accounting for Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

Relevant Literature

39. This statement adopts FASB Statement No. 5, Accounting for Contingencies (FAS 5), FASB Statement 114, Accounting by Creditors for Impairment of a Loan only as it amends in part FAS 5 and paragraphs 35 and 36 of FASB Statement of Financial Accounting Concepts No. 6—Elements of Financial Statements. FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5 (FIN No. 14) is adopted with the modification to accrue the loss amount as the midpoint of the range rather than the minimum as discussed in paragraph 3 of FIN No. 14. This statement adopts with modification ASU 2013-04, Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date with the same statutory modification adopted for FIN 14. This statement incorporates the definition of a liability from FASB Statement of Financial Accounting Concepts No. 8, Chapter 4, Elements of Financial Statements, paragraphs E37 and E38.

References

Relevant Issue Papers

Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets

Issue Paper No. 20—Gain Contingencies

Issue Paper No. 135—Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others

Issue Paper No. 16X – Updates to the Definition of a Liability

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to the Preamble, SSAP No. 4—Assets and Nonadmitted Assets and SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets, as illustrated in the agenda item and in the draft issue papers, to incorporate updates from Chapter 4, Elements of Financial Statements and Chapter 7, Presentation of the FASB’s Conceptual Framework for Financial Reporting.

Staff Review Completed by: Jim Pinegar—NAIC Staff, January – 2022

Status:
On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to the Preamble, SSAP No. 4—Assets and
Nonadmitted Assets and SSAP No. 3R—Liabilities, Contingencies and Impairment of Assets to incorporate 1) updates from FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 7, Presentation* which identifies factors to consider when deciding how items should be displayed on the financial statements, and 2) Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements*, which updates the definitions of an asset and a liability. The Working Group also exposed two draft issue papers for historical documentation of these SAP clarifications.

Exposure Draft

ISSUE PAPER NO. 16X – UPDATES TO THE DEFINITION OF AN ASSET

Hearing Date: 2022 Summer National Meeting or TBD
Deadline for Written Notice of Intent to speak: June 3, 2022
Deadline for Receipt of Written Comments: June 3, 2022

Location: 2022 Summer National Meeting or TBD

Notice of Public Hearing and Request for Written Comments

Basis for hearings. The Statutory Accounting Principles (E) Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) Policy Statement on Open Meetings. An individual or organization desiring to speak must notify the NAIC in writing by June 3, 2022. Speakers will be notified as to the date, location and other details of the hearings.

Oral presentation requirements. The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in this Exposure Draft by June 3, 2022. Individuals or organizations whose submission is not received by this date will only be granted permission to present at the discretion of the Working Group chair. All submissions should be addressed to NAIC staff at the address listed below.

Format of hearings. Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

Copies. Exposure drafts can be obtained on the Working Group’s Web page at (http://www.naic.org). The documents can be downloaded using Microsoft Word.

Written comments. Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to only measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the SAPWG. Comments should register agreement or disagreement with a detailed explanation, a description of the impact of the proposed guidelines, and possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments addressed to the SAPWG to the attention of Julie Gann at jgann@naic.org, Robin Marcotte at rmarcotte@naic.org, Jim Pinegar at jpinegar@naic.org, Jason Farr at jfarr@naic.org and Jake Stultz at jstultz@naic.org no later than June 3, 2022. Electronic submission is preferred. Jim Pinegar is the NAIC staff that is the project lead for this topic.

National Association of Insurance Commissioners

1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197
Statutory Issue Paper No. 16X

Updates to the Definition of an Asset

STATUS
April 4, 2022 – Exposure Draft

Original and Current Authoritative Guidance: SSAP No. 4

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper documents the SAP clarification revisions to SSAP No. 4—Assets and Nonadmitted Assets. The intent of the revisions is to align current statutory accounting guidance, specifically the definition of an “asset,” with the term utilized by the Financial Accounting Standards Board (FASB).

SUMMARY CONCLUSION

2. The statutory accounting principle clarifications to SSAP No. 4 (illustrated in Exhibit A), reflect that for the purposes of statutory accounting, an asset shall be defined as: a present right of an entity to an economic benefit. An asset has two essential characteristics: (1) it is a present right, and (2) the right is to an economic benefit. The combination of these two characteristics allows an entity to obtain the economic benefit and control others’ access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others’ access to the benefit to which the entity is entitled. For clarity, an “economic benefit” represents services or other items of economic value and generally result in net cash inflows to the entity. Pursuant to current guidance, assets are then evaluated, as outlined in paragraph 3 below, to determine whether they are admitted for statutory accounting purposes.

3. 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, and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:

   a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or


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

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of assets but are specifically identified within the Accounting Practices and Procedures Manual as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.
Updates to the Definition of Assets

5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

DISCUSSION

6. In December 2021, FASB issued Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements, which introduced updated definitions of certain key elements used in financial reporting – most notably updating the fundamental definition of an asset. Through the FASB’s adoption of Concept Statement No. 8, the original Concept Statement No. 6 has been superseded. As statutory accounting currently reflects FASB’s historical definition, this issue paper is to review the prior concept definition (currently utilized by statutory accounting) and compare it to FASB’s updated concept definition and assess whether the revised concept definition shall be reflected in statutory accounting.

7. FASB concept statements do not reflect authoritative U.S. GAAP guidance. Rather concept statements are intended to set forth objectives and fundamental concepts that will be the basis for development of financial accounting and reporting guidance. The term “asset” is not captured or defined in the FASB Accounting Standards Codification (which is the source of authoritative U.S. GAAP.) Furthermore, although the concept statement is intended to be used as a guide in establishing authoritative U.S. GAAP, the FASB is not restricted to the concepts when developing guidance, and the FASB may issue U.S. GAAP which may be inconsistent with the objectives and fundamental concepts set forth in Concept Statements. A change in a FASB Concept Statement does not 1) require a change in existing U.S. GAAP, 2) amend, modify or interpret the Accounting Standards Codification, or 3) justify either changing existing generally accepted accounting and reporting practices or interpreting the Accounting Standards Codification based on personal interpretations of the objectives and concepts in the concepts statement.

8. Under the prior FASB concept statement, which was reflected in SSAP No. 4, an asset was defined as a probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events. In addition, the historical definition possessed three essential characteristics in that (1) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (2) a particular enterprise can obtain the benefit and control others’ access to it, and (3) the transaction or other event giving rise to the enterprise's right to or control of the benefit has already occurred.

9. Pursuant to the prior concept statement, and as incorporated in SSAP No. 4, probable, as referenced both in the definition and essential characters, was used in a usual general meaning, rather than in a specific accounting or technical sense and referred to which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

10. With the new FASB conceptual framework chapter, an asset is now defined as a present right of an entity to an economic benefit. In addition, the current definition only has two essential characteristics in that the asset is (1) a present right, and (2) the right is to an economic benefit. The combination of these two characteristics allows an entity to obtain the economic benefit and control others’ access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others’ access to the benefit to which the entity is entitled. For clarity, an “economic benefit” represents services or other items of economic value to the asset holder and generally result in net cash inflows to the entity.

11. The updated asset definition from Concept Statement No. 8 no longer includes the term probable or the phrases future economic benefit and as a result of past transactions or events. The FASB concluded that the term probable has historically been misunderstood as implying that a future benefit must be probable to a certain threshold before the definition of an asset was met. Thus, if the probability of a future benefit was low, an asset could not be recognized. The FASB also struck the phrase future economic benefit
as this phrase often was interpreted that the asset must represent a certain future economic benefit (such as eventual cash inflows), however with this action, the FASB clarified that the asset represents the rights to the benefit, not the actual benefit itself – nor the probability of realization. Finally, FASB struck the phrase *as the result of past transactions or events*. It was concluded that if the asset represents a *present right*, by default, the right must have occurred as the result of a past transaction or event and thus this phraseology was deemed redundant and unnecessary.

12. To meet the definition of an asset, the right must be a “present right,” that is the right must exist at the financial statement date, not a right that is expected to occur in the future. The existence of a present right at the financial statement date means that the right and therefore the reasons why that asset was obtained, must have arisen from a past transaction or event. A right entitles its holder to have or obtain something, or act in a certain manner. Rights can be obtained in various ways and are often obtained through legal ownership. Legal ownership gives the owner access to the economic benefits, including the ability to possess, use, and enjoy the right. However, legally enforceable rights to economic benefits can also be obtained without legal ownership of the underlying property. This occurs in cases where the underlying benefit itself, as is the example in the right of use or rights to specified cashflows in contract provisions, are possessed by an entity other than the legal title holder. One important aspect of the change in definition is the removal of the term “control.” The FASB clarified that while the term control has been removed, the notion of control has been maintained in the updated definition. In the prior definition, control was a required element and thus without control, an asset was not recognized. However, control often refers to the ability to direct, manage, or have power over something. The FASB stated that in many instances, constituents misunderstood the notion of control by 1) believing it represented a probable future economic benefit, or 2) failing to properly identify what was specifically controlled. An example provided was a trade receivable – the definition of control might be misapplied to mean the successful collection; however, the correct application should refer to the rights of collection – not the successful collection itself. Citing this as an example, the FASB concluded that while the notion of control was an important aspect, the explicit term did not sufficiently add to the definition – thus the term “control” was removed.

13. When reviewing the substance of the revisions, the FASB concluded that the updated definition resulted in a clearer and more precise definition and it did not fundamentally change the historical concept of an asset, nor should the revisions result in any material changes in instrument reclassification (e.g., items now being classified as an asset when previously they were not considered assets). For statutory accounting purposes, the updated definition should be viewed similarly, that is it does not change fundamental concepts, change current practices, or introduce a new, original or a modified accounting principle. The revisions to the definition of an asset clarify the definitional language and do not modify the original intent of SSAP No. 4 and thus the changes are deemed to be a statutory accounting principle clarification.

14. One concept articulated in SSAP No. 4, and one that is not proposed for revision, is the concept of nonadmitted assets. As revisions are not proposed to this concept, further discussion is not included in this issue paper.

**Actions of the Statutory Accounting Principles (E) Working Group**

15. During the Spring 2022 National Meeting, the Working Group is exposed this issue paper for public comment.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

16. Relevant excerpts of SSAP No. 4, paragraphs 2-5 regarding the definition of an asset and a nonadmitted asset (nonadmitted asset as it is referenced in definition of an asset paragraph) utilized by statutory accounting is:

2. For purposes of statutory accounting, an asset shall be defined as: probable\(^1\) future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it\(^2\), and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.

3. As stated in the Statement of Concepts, "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," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:

a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or


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

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of assets, but are specifically identified within the Accounting Practices and Procedures Manual as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.

\(^1\) FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, states:

Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

\(^2\) If assets of an insurance entity are pledged or otherwise restricted by the action of a related party, the assets are not under the exclusive control of the insurance entity and are not available to satisfy policyholder obligations due to these encumbrances or other third-party interests. Thus, pursuant to paragraph 2(c), such assets shall not be recognized as an admitted asset on the balance sheet. Additional guidance for assets pledged as collateral is included in INT 01-31.
5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Generally Accepted Accounting Principles

17. Relevant paragraphs from Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements have been included below:

**Assets**

E16. An asset is a present right of an entity to an economic benefit.

**Characteristics of Assets**

E17. An asset has the following two essential characteristics: a. It is a present right. b. The right is to an economic benefit.

The combination of those two characteristics allows an entity to obtain the economic benefit and control others’ access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others’ access to the benefit to which the entity is entitled.

E19. Essential to the definition of an asset is a right to an “economic benefit”—the capacity to provide services or benefits to the entities that use them. Generally, in a business entity, that economic benefit eventually results in potential net cash inflows to the entity. In a not-for-profit entity, that economic benefit is used to provide desired or needed goods or services to beneficiaries or other constituents, which may or may not directly result in net cash inflows to the entity. Some not-for-profit entities rely significantly on contributions or donations of cash to supplement selling prices or to replace cash or other assets used in providing goods and services. The relationship between the economic benefit of an entity’s assets and net cash inflows to that entity can be indirect in both business entities and not-for-profit entities.

E22. A right entitles its holder to have or obtain something or to act in a certain manner. Rights can be obtained in various ways. Often, rights are obtained by legal ownership, for example, owning a building. Legal ownership gives the owner access to economic benefits, including the ability to possess, use, and enjoy the right; to sell, donate, or exchange the right; or to exploit the right’s value by, for example, pledging it as a security for borrowing.

E23. Legally enforceable rights to economic benefits can be obtained without legal ownership of the underlying benefit itself as is the case, for example, when property is leased or intellectual property is licensed or when an entity has the rights to specified certain cash flows, as in the case of a contract providing rights only to interest flows from a specified debt instrument. Other legally enforceable rights that give rise to assets include the right to require other parties to make payments or render services and the right to use a patent or a trademark. Legally enforceable rights include, among other rights, contractual rights (for example, rights from options held).

E31. Another essential characteristic of an asset is that the right of an entity must be to an economic benefit. An asset of an entity might be represented by rights to a particular property (such as the right to possess, use, and enjoy a parcel of land) or by rights to some or all the economic benefits derived from the property.

18. One of the most notable changes to the definitional change was the explicit removal of the term control, however the notion of control was retained. Chapter 4, Elements of Financial Statements included commentary regarding the FASB’s rationale of the change.
power over something to obtain or access benefits or to increase, maintain, or protect those benefits. Control goes beyond legal rights and includes the ability to obtain and control the benefit in other ways, including restricting, or otherwise prohibiting, the access of others to the economic benefit of the asset.

BC4.18. In applying the definition of an asset in Concepts Statement 6, however, many constituents misunderstood the notion of control. Some improperly viewed control of a probable future economic benefit in the same manner as described in business combinations or consolidation accounting. Additionally, in applying the term control, some failed to properly identify that which was controlled under the asset definition. For example, in the instance of trade receivables, the definition could be misunderstood to indicate that what is controlled is the successful collection of the receivable in the future. When applied appropriately, however, the definition in Concepts Statement 6 would conclude that the present right to collection is what is controlled. Similarly, if an entity has an option to acquire an asset, the present right of that entity is to the option itself, not the underlying asset that the option provides the right to acquire. Thus, control references the existing right that has the ability to generate economic benefits, or potential economic benefits, and to restrict others’ access to those benefits.

BC4.19. While the Board concluded that the notion of control was an important aspect of the asset definition, it was not clear to the Board whether the explicit term control added anything significant to the definition of an asset. Those considerations are addressed by including the term present right in the definition in this chapter. If an entity has a present right to an economic benefit, that would seem to be sufficient to establish the fact that the asset is an asset of that entity. Indeed, if an entity has exclusive rights, it presumably can deny or regulate access to that benefit by others, thereby implying control.

BC4.22. The Board redeliberated the issue and decided that the term control should not be used in the definition of an asset for the following reasons:

a. It eliminates redundancy. If an entity has a present right, that would seem to be sufficient to establish the fact that the asset is an asset of that entity. In fact, the Board used the phrase of the entity in the definition of an asset to clarify that point. Indeed, if an entity has exclusive rights, it presumably can deny or regulate access to that benefit by others.

b. It eliminates misunderstanding of the term. The term control has two issues in the existing definition of an asset. First, many have a different definition of the term control. Second, many associate the term control with whether one has control of the economic benefit. The Board notes that what is controlled is the existing right that gives rise to economic benefits, or potential economic benefits, rather than the economic benefits themselves. The Board’s reasoning for removing the term control is the same as removing other terms, such as future and probable, from the definition of an asset.

c. It avoids confusion with the IASB’s Conceptual Framework use and meaning of the term. The IASB defines an asset as “a present economic resource controlled by the entity as a result of past events.” In the basis for conclusions to the IASB’s Conceptual Framework’s discussion on control, footnote 19 references both IFRS 10, Consolidated Financial Statements, and IFRS 15, Revenue from Contracts with Customers. The Board is concerned about the references to IFRS 10 and IFRS 15 because those standards refer to control of an economic benefit, not control of the right. The Board notes that convergence with the IASB’s asset definition on this point is not critical because it could perpetuate the misunderstanding discussed above.

19. Other changes regarding the definition of an asset included removal of the term probable and the phrases future economic benefit and past transactions of events. Rationale for these changes were documented in Chapter 4, Elements of Financial Statements commentary as follows:
BC4.11. The definitions of both an asset and a liability in Concepts Statement 6 include the term probable and the phrases future economic benefit and past transactions or events. The term probable in the definitions in Concepts Statement 6 has been misunderstood as implying that a future economic benefit or a future sacrifice of economic benefit must be probable to a certain threshold before the definition of an asset or a liability is met. In other words, if the probability of future economic benefit is low, the asset definition is not met under that interpretation. A similar interpretation could be made for liabilities. The footnotes to the Concepts Statement 6 definition of assets and liabilities also were not helpful in clarifying the application of the term probable as used in the definitions of assets and liabilities. Accordingly, the Board decided to eliminate that term from the definitions of both assets and liabilities.

BC4.12. The term future in the definitions in Concepts Statement 6 focused on identifying a future flow of economic benefits to demonstrate that an asset exists or identifying a future transfer of economic benefits to demonstrate that a liability exists. The definitions in Concepts Statement 6 were often misunderstood as meaning that the asset (liability) is the ultimate future inflow (outflow). For example, in the instance of trade receivables, the definition in Concepts Statement 6 could be misunderstood to indicate that the asset is the successful collection of the receivable in the future. When applied appropriately, however, the definition would conclude that the asset is the present right to collection. Similar misunderstandings occurred in applying the liability definition. As a result, the Board concluded that a focus on the term present would appropriately shift the focus from identifying a future occurrence. Therefore, the Board decided to include the term present right to demonstrate that an asset exists and emphasize the term present obligation to demonstrate that a liability exists.

BC4.13. The definitions of assets and liabilities in Concepts Statement 6 both include the phrase past transactions or events. The Board concluded that if an entity has a present right or a present obligation, one can reasonably assume that it was obtained from some past transaction or event. Therefore, that phrase is considered redundant and has been eliminated from the definitions.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

Generally Accepted Accounting Principles

Effective Date

20. As issue papers are not authoritative and are not represented in the Statutory Hierarchy (see Section V of the Preamble), the consideration and adoption of this issue paper will not have any impact on the SAP clarifications adopted to SSAP No. 4 by the Working Group on TBD.
EXHIBIT A – SAP Clarification Revisions to SSAP No. 4—Assets and Nonadmitted Assets

Statement of Statutory Accounting Principles No. 4

Assets and Nonadmitted Assets

SCOPE OF STATEMENT

1. This statement establishes the definition of an “asset” for use in statutory accounting and establishes the criteria for consistent treatment of nonadmitted assets.

SUMMARY CONCLUSION

2. For purposes of statutory accounting, an asset shall be defined as: a present right of an entity to an economic benefit probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it is a present right that embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, and (b) the right is to an economic benefit, a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.

3. As stated in the Statement of Concepts, “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,” and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:

   a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or


\footnote{FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.}

\footnote{FASB Statement of Financial Accounting Concepts No. 8, Elements of Financial Statements, states that the combination of these two characteristics allows an entry to obtain the economic benefit and control others’ access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefits and the ability to restrict other’s access to the benefit which the entity is entitled.}

\footnote{If assets of an insurance entity are pledged or otherwise restricted by the action of a related party, the assets are not under the exclusive control of the insurance entity and are not available to satisfy policyholder obligations due to these encumbrances or other third party interests. Thus, pursuant to paragraph 2(c), such assets shall not be recognized as an admitted asset on the balance sheet. Additional guidance for assets pledged as collateral is included in INT 01-31.}
If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of assets, but are specifically identified within the Accounting Practices and Procedures Manual as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.

5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Assets Pledged as Collateral or Otherwise Restricted

6. Assets that are pledged to others as collateral or otherwise restricted (not under the exclusive control of the insurer, subject to a put option contract, etc.) shall be identified in the investment schedules pursuant to the codes in the annual statement instructions, disclosed in accordance with SSAP No. 1—Accounting Policies, Risks & Uncertainties, and Other Disclosures, reported in the general interrogatories, and included in any other statutory schedules or disclosure requirements requesting information for assets pledged as collateral or otherwise restricted. Restricted assets should be reviewed to determine admitted or nonadmitted assets status in the statutory financial statements per the terms of their respective SSAPs. Asset restrictions may be a factor in determining the admissibility of an asset under a respective SSAP. However, determining that a restricted asset is an admitted asset does not eliminate the statutory requirements to document and identify the asset as one that is pledged as collateral or otherwise restricted.

7. Assets pledged as collateral are one example of assets that are not under the exclusive control of the insurer, and are therefore restricted, even if the assets are admitted under statutory accounting guidelines (e.g., the asset is substitutable and/or other related SSAP conditions are met). As such, the asset shall be coded as pledged in the investment schedules pursuant to the annual statement instructions, disclosed in accordance with SSAP No. 1, reported in the general interrogatories, and included in any other statutory schedules or disclosure requirements requesting information for assets pledged as collateral or otherwise restricted.

Disclosure

8. The financial statements shall disclose if the written capitalization policy and the resultant predefined thresholds changed from the prior period and the reason(s) for such change.

Relevant Literature


Effective Date and Transition

10. 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. Guidance reflected in paragraphs 3, 5 and 8,

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6 An example of such a situation is detailed in footnote 2 pertaining to assets restricted by the action of a related party. This is only a single example and each restricted asset would need to be reviewed to ensure it qualifies as an admitted asset.
incorporated from SSAP No. 87, was originally effective for years beginning on and after January 1, 2004. The guidance in footnote 2 to paragraph 2 was originally contained within INT 01-03: Assets Pledged as Collateral or Restricted for the Benefit of a Related Party and was effective June 11, 2001.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 119—Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82*
- *Issue Paper No. 16X—Updates to the Definition of an Asset*
Exposure Draft

ISSUE PAPER NO. 16X – UPDATES TO THE DEFINITION OF A LIABILITY

Hearing Date: 2022 Summer National Meeting or TBD  Location: 2022 Summer National Meeting or TBD

Deadline for Written Notice of Intent to speak: June 3, 2022  Deadline for Receipt of Written Comments: June 3, 2022

Notice of Public Hearing and Request for Written Comments

Basis for hearings. The Statutory Accounting Principles (E) Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) Policy Statement on Open Meetings. An individual or organization desiring to speak must notify the NAIC in writing by June 3, 2022. Speakers will be notified as to the date, location and other details of the hearings.

Oral presentation requirements. The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in this Exposure Draft by June 3, 2022. Individuals or organizations whose submission is not received by this date will only be granted permission to present at the discretion of the Working Group chair. All submissions should be addressed to NAIC staff at the address listed below.

Format of hearings. Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

Copies. Exposure drafts can be obtained on the Working Group’s Web page at (http://www.naic.org). The documents can be downloaded using Microsoft Word.

Written comments. Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to only measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the SAPWG. Comments should register agreement or disagreement with a detailed explanation, a description of the impact of the proposed guidelines, and possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments addressed to the SAPWG to the attention of Julie Gann at igann@naic.org, Robin Marcotte at rmarcotte@naic.org, Jim Pinegar at jpinegar@naic.org, Jason Farr at jfarr@naic.org and Jake Stultz at jstultz@naic.org no later than June 3, 2022. Electronic submission is preferred. Jim Pinegar is the NAIC staff that is the project lead for this topic.

National Association of Insurance Commissioners

1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197
Statutory Issue Paper No. 16X

Updates to the Definition of a Liability

STATUS
April 4, 2022 – Exposure Draft

Original and Current Authoritative Guidance: SSAP No. 5R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper documents the SAP clarification revisions to SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets. The intent of the revisions is to align current statutory accounting guidance, specifically the definition of a “liability,” with the term utilized by the Financial Accounting Standards Board (FASB).

SUMMARY CONCLUSION

2. The statutory accounting principle clarifications to SSAP No. 5R (illustrated in Exhibit A), reflect that for the purposes of statutory accounting, a liability shall be defined as: a present obligation of an entity to transfer an economic benefit. A liability has two essential characteristics: (1) it is a present obligation, and (2) the obligation requires an entity to transfer or otherwise provide economic benefit to others. For the purposes of these characteristics, transfer is typically used to describe obligations to pay cash or convey assets, while the term provide is used to describe obligations to provide services or stand by to do so. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity’s financial statements when incurred.

3. Estimates (e.g., loss reserves) are required in financial statements for many ongoing and recurring activities of a reporting entity. The mere fact that an estimate is involved does not of itself constitute a loss contingency. For example, estimates of losses utilizing appropriate actuarial methodologies meet the definition of liabilities as outlined above and are not loss contingencies. (The definition and recognition requirements of loss contingencies under SSAP No. 5R are not proposed to be revised and will continue as statutory accounting guidance.)

DISCUSSION

4. In December 2021, FASB issued Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements, which introduced updated definitions of certain key elements used in financial reporting – most notably updating the fundamental definition of a liability. Through the FASB’s adoption of Concept Statement No. 8, the original Concept Statement No. 6 has been superseded. As statutory accounting currently reflects FASB’s historical definition, this issue paper is to review the prior concept definition (currently utilized by statutory accounting) and compare it to FASB’s updated concept definition and assess whether the revised concept definition shall be reflected in statutory accounting.

5. FASB concept statements do not reflect authoritative U.S. GAAP guidance. Rather concept statements are intended to set forth objectives and fundamental concepts that will be the basis for development of financial accounting and reporting guidance. The term “liability” is not captured or defined in the FASB Accounting Standards Codification (which is the source of authoritative U.S. GAAP.)
Updates to the Definition of a Liability

Furthermore, although the concept statement is intended to be used as a guide in establishing authoritative U.S. GAAP, the FASB is not restricted to the concepts when developing guidance, and the FASB may issue U.S. GAAP which may be inconsistent with the objectives and fundamental concepts set forth in Concept Statements. A change in a FASB Concept Statement does not 1) require a change in existing U.S. GAAP, 2) amend, modify or interpret the Accounting Standards Codification, or 3) justify either changing existing generally accepted accounting and reporting practices or interpreting the Accounting Standards Codification based on personal interpretations of the objectives and concepts in the concepts statement.

6. Under the prior FASB concept statement, which was reflected in SSAP No. 5R, a liability was defined as a probable future sacrifice of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transactions or events. In addition, the historical definition possessed three essential characteristics in that (1) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (2) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (3) the transaction or other event obligating the entity has already happened.

7. Pursuant to the prior concept statement, and as incorporated in SSAP No. 5R, probable, as referenced both in the definition and essential characters, was used in a usual general meaning, rather than in a specific accounting or technical sense and referred to which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

8. With the new FASB conceptual framework chapter, a liability is now defined as a present obligation of an entity to transfer an economic benefit. In addition, the current definition has two essential characteristics in that the liability is (1) a present obligation, and (2) the obligation requires an entity to transfer or otherwise provide economic benefits to others.

9. The updated liability definition from Concept Statement No. 8 no longer includes the term probable or the phrase in the future and as a result of past transactions or events. The FASB concluded that the term probable has historically been misunderstood as implying that a future obligation must meet a probability to a certain threshold before the definition of a liability was met. Thus, if the probability of a future transfer of an asset (or the requirement to provide a service) was low, a liability would likely not be recognized. In removing the term probable (and replacing it with “present obligation”), FASB concluded that in almost all situations, the presence of an obligation will be apparent. It stated that most present obligations are legally enforceable, including obligations arising from binding contracts, agreements, statutes, or other legal or contractual means. Chapter 4 also discusses the prevalence of certain business risks and how to assess if they result in the recognition of a liability. The FASB concluded that while certain businesses have a risk that a future event will cause them to transfer an economic benefit (an asset), the risk itself does not represent a present obligation because exposure to a potential negative consequence does not constitute a present obligation.

10. However, the FASB also stated that situations lacking clear legal or contractual evidence of a present obligation may pose particular challenges that may make it difficult to discern whether a present obligation exists. In these settings, the FASB stated that constructive obligations or other noncontractual obligations are created by circumstance rather than by explicit agreement. In the absence of an explicit agreement, sufficient information to distinguish a present obligation is likely only available at the specific standards level. Thus, the FASB concluded that the specific facts and circumstances at the standards level (or in the case of statutory accounting, at the SSAP level) must be utilized to determine whether the entity has created a constructive obligation and must recognize a liability.

11. The FASB also struck the phrase as the result of past transactions or events. With this action, the FASB clarified that if the liability represents a present obligation, by default, the obligation must have
occurred as the result of a past transaction or event and thus this phraseology was deemed redundant and unnecessary.

12. When reviewing the substance of the revisions, the FASB concluded that the updated definition resulted in a clearer and more precise definition. Furthermore, while it did not fundamentally change the historical concept of a liability, the revised definition potentially expands the population of liabilities to include certain obligations to issue or potentially issue an entity’s own shares rather than settle an obligation exclusively with assets. In essence, clarifying that instruments with characteristics of both liabilities and equity may in fact be classified as liabilities in certain situations.

13. In general, the FASB did not anticipate that the liability definition revisions would result in any material changes in instrument reclassification (e.g., items now being classified as a liability when previously they were not considered liabilities). Again, FASB Concept Statements are not authoritative and thus the guidance in any specific standard will still be utilized for instrument measurement and classification. For statutory accounting purposes, the updated definition should be viewed similarly, that is it does not change fundamental concepts, change current practices, or introduce a new, original or a modified accounting principle. The revisions to the definition of a liability clarify the definitional language and do not modify the original intent of SSAP No. 5R and thus the changes are deemed to be a statutory accounting principle clarification.

14. The remaining concepts and guidance articulated in SSAP No. 5R (e.g., contingencies, impairments, guarantees, etc.) were not proposed for revision and thus are not further discussed in this issue paper.

Actions of the Statutory Accounting Principles (E) Working Group

15. During the Spring 2022 National Meeting, the Working Group is exposed this issue paper for public comment.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

16. Relevant excerpts of SSAP No. 5R, paragraphs 2-3 regarding the definition of a liability accounting are as follows:

2. A liability is defined as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).

3. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, 

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1 FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement 5, Accounting for Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.
Updates to the Definition of a Liability

Attachment 14
IP No. 16X

reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity’s financial statements when incurred.

Generally Accepted Accounting Principles

17. Relevant paragraphs from Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements have been included below:

Liabilities

E37. A liability is a present obligation of an entity to transfer an economic benefit

Characteristics of Liabilities

E38. A liability has the following two essential characteristics: a. It is a present obligation. b. The obligation requires an entity to transfer or otherwise provide economic benefits to others.2

E39. Liabilities commonly have features that help identify them. For example, many liabilities require the obligated entity to pay cash to one or more identified other entities. Liabilities may not require an entity to pay cash but may require the entity to convey other assets, provide services, or transfer other economic benefits or to be ready to do so. Liabilities are based on a foundation of legal rights and duties.

E40. Entities routinely incur liabilities in exchange transactions to acquire the funds, goods, and services they need to operate. For example, borrowing cash (acquiring funds) obligates an entity to repay the amount borrowed, acquiring assets on credit obligates an entity to pay for the assets, and selling products with a warranty or guarantee obligates an entity to either pay cash or repair or replace any products that prove defective. Often, obligations incurred in exchange transactions are contractual based on written or oral agreements to pay cash or to provide goods or services to specified or determinable entities on demand at specified or determinable dates or on the occurrence of specified events.

Present obligation

E41. A liability requires that an entity be obligated to perform or act in a certain manner. In most cases it is apparent that liabilities are legally enforceable. Legally enforceable obligations include those arising from binding contracts, agreements, rules, statutes, or other requirements that would be upheld by a judicial system or government. Judicial systems vary in type and form, and the term judicial systems includes any such system that would enforce laws, statutes, and regulations. In the context most relevant to financial reporting, an obligation is any condition that binds an entity to some performance or action. In a financial reporting context, something is binding on an entity if it requires performance. Performance is what the entity is required to do to satisfy the obligation.

E42. Many obligations that qualify as liabilities stem from contracts and other agreements that are enforceable by courts or from governmental actions that have the force of law. Agreements, contracts, or statutory requirements often will specify or imply how an obligation was incurred and when and how the obligation is to be settled. For example, borrowing and lease agreements specify the amount of charges and the dates when the payments are due. The absence of a specified maturity date or event to require settlement may cast doubt that an obligation exists.

E43. Liabilities necessarily involve other parties, society, or law. The identity of the other party or recipient need not be known to the obligated entity before the time of settlement. An obligation of an entity to itself cannot be a liability. For example, in the absence of external requirements an

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2 This chapter continues the practice of describing liabilities as an obligation either to transfer or to provide economic benefits. For example, the term transfer has typically been used to describe obligations to pay cash or convey assets, and the term provide has typically been used to describe obligations to perform services or stand ready to do so.
entity is not obligated to repair the roof of its building or maintain its plant and equipment. Although those actions may be wise business moves, the entity may forgo or defer such activities because there is no present obligation to perform the activity.

E44. Certain obligations require nonreciprocal transfers from an entity to one or more other entities. Such obligations include taxes imposed by governments, donations pledged to charitable entities, and cash dividends declared but not yet paid.

E45. To have a liability, an entity must have a present obligation, that is, the obligation exists at the financial statement date. The settlement date of the liability may occur in the future, but the obligation must be present at the financial statement date. Transactions or other events or circumstances expected to occur in the future do not in and of themselves give rise to obligations today.

E46. An intention to purchase an item, for example, an asset, does not in and of itself create a liability. However, a contractual obligation that requires an entity to pay more than the fair value of the asset at the transaction date may create a liability before the asset is received, reflecting what the entity might have to pay to undo the unfavorable contract.

E47. Business risks result from the conduct of an entity’s business activities. A business risk is not a present obligation, though at some point in the future an event may occur that creates a present obligation. Some businesses have the potential of carrying out activities and creating present obligations as a result of those activities. However, no present obligation exists even if it is virtually certain that an obligating event will occur, though at present no such event has occurred. The essence of distinguishing business risks from liabilities is determining the point in time when an entity has a present obligation.

E48. Some business risks result from an entity’s transactions, for example, selling goods in overseas markets might expose an entity to the risk of future cash flow fluctuations because of changes in foreign exchange rates. Other business risks result from an entity’s operating environment, for example, operating in a highly specialized industry might expose an entity to the risk that it will be unable to attract sufficient skilled staff to sustain its operating activities. Those risks are not liabilities.

E49. To be presently obligated, an entity must be bound, either legally or in some other way, to perform or act in a certain way. Most liabilities are legally enforceable, including those arising from contracts, agreements, rules, and statutes. An entity also can become obligated by other means that would be expected to be upheld by a judicial process. However, the existence of a present obligation may be less clear in those circumstances.

E50. Some liabilities rest on constructive obligations, including some that arise in exchange transactions. A constructive obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. An entity may become constructively obligated through customary business practice. In the normal course of business, an entity conducting certain activities may not create a clear contractual obligation but may nonetheless cause the entity to become presently obligated. For example, policies and practices for sales returns and those for warranties in the absence of a contract may create a present obligation because the pattern of behavior may create an enforceable claim for performance that would be upheld in the ultimate conclusion of a judiciary process.

E51. An entity’s past behavior also may give rise to a present obligation. Repeated engagement in a certain behavior may obligate the entity to perform or act in a certain way on the basis of that pattern of behavior. For example, the entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so.
18. The most notable changes regarding the definition of a liability included removal of the term probable and the phrase as a result of past transactions or events. Rationale for these changes were documented in Chapter 4, Elements of Financial Statements commentary as follows:

BC4.11. The definitions of both an asset and a liability in Concepts Statement 6 include the term probable and the phrases future economic benefit and past transactions or events. The term probable in the definitions in Concepts Statement 6 has been misunderstood as implying that a future economic benefit or a future sacrifice of economic benefit must be probable to a certain threshold before the definition of an asset or a liability is met. In other words, if the probability of future economic benefit is low, the asset definition is not met under that interpretation. A similar interpretation could be made for liabilities. The footnotes to the Concepts Statement 6 definition of assets and liabilities also were not helpful in clarifying the application of the term probable as used in the definitions of assets and liabilities. Accordingly, the Board decided to eliminate that term from the definitions of both assets and liabilities.

BC4.12. The term future in the definitions in Concepts Statement 6 focused on identifying a future flow of economic benefits to demonstrate that an asset exists or identifying a future transfer of economic benefits to demonstrate that a liability exists. The definitions in Concepts Statement 6 were often misunderstood as meaning that the asset (liability) is the ultimate future inflow (outflow). For example, in the instance of trade receivables, the definition in Concepts Statement 6 could be misunderstood to indicate that the asset is the successful collection of the receivable in the future. When applied appropriately, however, the definition would conclude that the asset is the present right to collection. Similar misunderstandings occurred in applying the liability definition. As a result, the Board concluded that a focus on the term present would appropriately shift the focus from identifying a future occurrence. Therefore, the Board decided to include the term present right to demonstrate that an asset exists and emphasize the term present obligation to demonstrate that a liability exists.

BC4.13. The definitions of assets and liabilities in Concepts Statement 6 both include the phrase past transactions or events. The Board concluded that if an entity has a present right or a present obligation, one can reasonably assume that it was obtained from some past transaction or event. Therefore, that phrase is considered redundant and has been eliminated from the definitions.

19. The other significant change to the definition of a liability included changing future sacrifices to a present obligation. Rationale for these changes were documented in Chapter 4, Elements of Financial Statements commentary as follows:

BC4.25. The term present obligation is included in the definition of a liability, both in this chapter and in Concepts Statement 6. Because the application of the liability definition under Concepts Statement 6 did not give sufficient emphasis to the term present obligation, the definition in this chapter more appropriately emphasizes that term. Assessing whether a present obligation exists is the primary criterion in the definition of a liability in this chapter. The primacy of the term present obligation is made more evident through the removal of many of the problematic terms in the definition of a liability in Concepts Statement 6, as discussed in paragraphs BC4.11–BC4.13.

BC4.26. Almost always, the existence of a present obligation will be apparent. Most present obligations are legally enforceable, including obligations arising from binding contracts, agreements, statutes, or other legal or contractual means. However, situations lacking clear legal or contractual evidence of a present obligation pose particular challenges that may make it difficult to discern whether a present obligation exists.

BC4.27. Determining when a present obligation exists has caused confusion with the existence of business risks. Business risks result from the nature of the business and where, when, and how an entity conducts its business. While certain businesses pose risks of future events occurring that will cause a transfer of economic benefits, the Board decided that the risks themselves are not present obligations because exposure to a potential negative consequence does not constitute a present obligation. Rather than viewing all business risks as liabilities, the Board decided that an entity has
a present obligation only after an event occurs that demonstrates that the inherent business risk has created a present obligation. Thus, distinguishing when a business risk makes an entity presently obligated requires analysis of the facts and circumstances at the standards level.

BC4.28. Determining the existence of a present obligation is particularly challenging in evaluating constructive obligations. Interpreting constructive obligations too narrowly will tend to exclude significant actual obligations of an entity, while interpreting them too broadly will effectively nullify the definition by including items that lack an essential characteristic of liabilities.

BC4.29. Given that constructive obligations and other noncontractual obligations are created by circumstance rather than explicit agreement, it can be unclear whether a present obligation exists. In the absence of an explicit agreement, sufficient information to distinguish a present obligation is likely only available at the specific standards level. Thus, the Board decided that specific facts and circumstances at the standards level must be assessed to determine whether an entity has created a constructive obligation.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

Generally Accepted Accounting Principles

Effective Date

20. As issue papers are not authoritative and are not represented in the Statutory Hierarchy (see Section V of the Preamble), the consideration and adoption of this issue paper will not have any impact on the SAP clarifications adopted to SSAP No. 5R by the Working Group on TBD.
EXHIBIT A – SAP Clarification Revisions to SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets

Statement of Statutory Accounting Principles No. 5 - Revised

Liabilities, Contingencies and Impairments of Assets

SCOPE OF STATEMENT

1. This statement defines and establishes statutory accounting principles for liabilities, contingencies and impairments of assets.

SUMMARY CONCLUSION

Liabilities

2. A liability is defined as a present obligation of an entity to transfer an economic benefit certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).

3. A liability has three essential characteristics: (a) it is a present obligation—embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, and (b) the obligation required an entity to transfer or otherwise provide economic benefit to others duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity’s financial statements when incurred.

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

FN1—FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement 5, Accounting for Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

Relevant Literature

39. This statement adopts FASB Statement No. 5, Accounting for Contingencies (FAS 5), FASB Statement 114, Accounting by Creditors for Impairment of a Loan only as it amends in part FAS 5 and paragraphs 35 and 36 of FASB Statement of Financial Accounting Concepts No. 6—Elements of Financial Statements. FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5 (FIN No. 14) is adopted with the modification to accrue the loss amount as the midpoint of the range rather than the minimum as discussed in paragraph 3 of FIN No. 14. This statement adopts with modification ASU 2013-04, Obligations Resulting from Joint and Several Liability
Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date with the same statutory modification adopted for FIN 14. This statement incorporates the definition of a liability from FASB Statement of Financial Accounting Concepts No. 8, Chapter 4, Elements of Financial Statements, paragraphs E37 and E38.

REFERENCES

Relevant Issue Papers

- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 20—Gain Contingencies
- Issue Paper No. 135—Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others
- Issue Paper No. 16X – Updates to the Definition of a Liability
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June 3, 2022

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Items Exposed for Comment by the Statutory Accounting Principles Working Group on April 4, 2022, with Comments due June 3

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the exposure drafts released for comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working Group).

We offer the following comments:

**Ref #2021-20: Effective Derivatives – ASU 2017-12**

The Working Group exposed two documents for public comment. The first document (labeled 21-20 SSAP No. 86 – Exhibit A 3-2-22), proposes revisions in the form of a new Exhibit A (which will replace both Exhibit A and Exhibit B of SSAP No. 86 that adopts with modification U.S. GAAP guidance in determining hedge effectiveness. The second document (labeled 21-20 SSAP No. 86 – Excluded Components - 3-17-22), proposes measurement methods for excluded components in hedging Ref # 2021-20. The Working Group also directed staff to continue to work with industry representatives on other elements within ASU 2017-12: Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities.

Interested parties support the changes and we look forward to working with the staff on the further updates.

**Ref #2022-01: Conceptual Framework – Updates**

The Working Group moved this agenda item to the active listing, categorized as a SAP
clarification, and exposed revisions to the Preamble, SSAP No. 4—*Assets and Nonadmitted Assets* and SSAP No. 5R—*Liabilities, Contingencies and Impairment of Assets* to incorporate 1) updates from FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*—Chapter 7, Presentation which identifies factors to consider when deciding how items should be displayed on the financial statements, and 2) Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*—Chapter 4, *Elements of Financial Statements*, which updates the definitions of an asset and a liability. The Working Group also exposed two draft issue papers for historical documentation of these SAP clarifications.

Interested parties request an additional 30 days to review this item.

**Ref #2022-02: SSAP No. 48 – Alternative Valuation of Minority Ownership Interests**

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed two possible options for the U.S. GAAP audit exception in SSAP No. 48—*Joint Ventures, Partnerships and Limited Liability Companies*. The options are described below:

Option #1 proposes to delete the audited U.S. tax basis equity as a permissible valuation method as this method does not appear to be utilized by insurers.

Option #2 proposes to retain the audited U.S. tax basis equity valuation method but clarifies that the audit must reside at the investee level.

Interested parties recommend that Option #2 be adopted as there are insurers who use this approach for investments in some partnerships.

**Ref #2022-04: ASU 2021-10, Government Assistance**

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 24—*Discontinued Operations and Unusual or Infrequent Items* which incorporate certain disclosures from ASU 2021-10 to supplement existing disclosures regarding unusual or infrequent items.

Interested parties have no comment on this item.

**Ref #2022-05: ASU 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities**

The Working Group moved this item to the active listing, categorized as a SAP clarification, and exposed revisions to reject ASU 2021-05 in SSAP No. 22R—*Leases*.

Interested parties have no comment on this item.
Ref :2022-06: ASU 2021-07, Compensation – Stock Compensation

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 104R—Share-Based Payments to incorporate a practical expedient for the current price input, a required component for option-pricing models which are utilized in the determination of fair value for share-based payments.

Interested parties have no comment on this item.

Ref #2022-07: ASU 2021-08, Business Combinations

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 47—Uninsured Plans and SSAP No. 68—Business Combinations and Goodwill to reject ASU 2021-08 for statutory accounting. In addition, the proposed revisions to SSAP No. 68 include notations that the rejection of ASU 2021-08 does not impact the determination of U.S. GAAP book value in an acquired entity.

Interested parties have no comment on this item.

*   *   *

Thank you for considering interested parties’ comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell             Rose Albrizio

cc: NAIC staff
    Interested parties
July 19, 2022

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Ref# 2022-01: Conceptual Framework – Updates

Dear Mr. Bruggeman:

Interested parties appreciate the extension of the comment deadline and the opportunity to comment on Ref# 2022-01 that was released for comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working Group) during its meeting on April 4 in Kansas City.

We offer the following comments:

Ref #2022-01: Conceptual Framework – Updates

Liability

Interested parties are concerned with the change for the liability definition as the FASB notes it will change the definition of a liability, expanding the population of liabilities and it will need to be reviewed on a standard basis. On expanding the population of liabilities, paragraph 12 states that the FASB recognized “the revised definition potentially expands the population of liabilities to include certain obligations to issue or potentially issue an entity’s own shares rather than settle an obligation exclusively with assets. In essence, clarifying that instruments with characteristics of both liabilities and equity may in fact be classified as liabilities in certain situations.”

We noted that there is not an analysis by the SAPWG of the impact on the various SSAP’s of incorporating the guidance. The FASB states that needs to be done “Thus, the FASB concluded that the specific facts and circumstances at the standards level (or in the case of statutory accounting, at the SSAP level) must be utilized to determine whether the entity has created a constructive obligation and must recognize a liability.” Please see the shaded text from the FASB
From the Liability Paper:

9. The updated liability definition from Concept Statement No. 8 no longer includes the term *probable* or the phrase *in the future* and *as a result of past transactions or events*. The FASB concluded that the term *probable* has historically been misunderstood as implying that a future obligation must meet a probability to a certain threshold before the definition of a liability was met. Thus, if the probability of a future transfer of an asset (or the requirement to provide a service) was low, a liability would likely not be recognized. In removing the term *probable* (and replacing it with “present obligation”), FASB concluded that in almost all situations, the presence of an obligation will be apparent. It stated that most present obligations are legally enforceable, including obligations arising from binding contracts, agreements, statutes, or other legal or contractual means. Chapter 4 also discusses the prevalence of certain business risks and how to assess if they result in the recognition of a liability. The FASB concluded that while certain businesses have a risk that a future event will cause them to transfer an economic benefit (an asset), the risk itself does not represent a present obligation because exposure to a potential negative consequence does not constitute a present obligation.

10. However, the FASB also stated that situations lacking clear legal or contractual evidence of a present obligation may pose particular challenges that may make it difficult to discern whether a present obligation exists. In these settings, the FASB stated that constructive obligations or other noncontractual obligations are created by circumstance rather than by explicit agreement. In the absence of an explicit agreement, sufficient information to distinguish a present obligation is likely only available at the specific standards level. Thus, the FASB concluded that the specific facts and circumstances at the standards level (or in the case of statutory accounting, at the SSAP level) must be utilized to determine whether the entity has created a constructive obligation and must recognize a liability.

12. When reviewing the substance of the revisions, the FASB concluded that the updated definition resulted in a clearer and more precise definition. Furthermore, while it did not fundamentally change the historical concept of a liability, the revised definition potentially expands the population of liabilities to include certain obligations to issue or potentially issue an entity’s own shares rather than settle an obligation exclusively with assets. In essence, clarifying that instruments with characteristics of both liabilities and equity may in fact be classified as liabilities in certain situations.

13. In general, the FASB did not anticipate that the liability definition revisions would result in any material changes in instrument reclassification (e.g., items now being classified as a liability when previously they were not considered liabilities). Again, FASB Concept Statements are not authoritative and thus the guidance in any specific standard will still be utilized for instrument measurement and classification. For statutory accounting purposes, the updated definition should be viewed similarly, that is it does not change fundamental concepts, change current practices, or introduce a new, original or a
modified accounting principle. The revisions to the definition of a liability clarify the definitional language and do not modify the original intent of SSAP No. 5R and thus the changes are deemed to be a statutory accounting principle clarification.

Consistent with the FASB approach that an evaluation needs to be done at the standards level, interested parties recommend that for the case of statutory accounting the Working Group complete an SSAP-by-SSAP analysis to identify potential effects prior to amending the definition of liability to avoid unintended consequences.

* * *

Thank you for considering interested parties’ comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell                         Rose Albrizio

cc: NAIC staff
    Interested parties