Accounting & Auditing Update
What Lies Ahead

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David White, *AIG*

August 13, 2014
Agenda

• Accounting Standards Effective YE 2013 – 2014
  • GAAP
  • Statutory
• Items of Captive Interest
• Exposure Drafts
  • Leases
  • Recognition and Measurement of Financial Assets and Financial Liabilities
  • Financial Instruments-Credit Losses
  • Insurance Contracts
• Private Company Developments
Accounting Standards Effective YE 2013 - 2014
GAAP

Quick Summary – Limited Impact
• ASU 2013-07 – Liquidation Basis of Accounting

Covered in More Detail
• ASU 2013-02 – Comprehensive Income – Reclassification Adjustments
• ASU 2013-08 – Investment Companies
• ASU 2013-11 – Income Taxes – Unrecognized Tax Benefits
Comprehensive Income - Reporting of Amounts Reclassified Out of Accumulated OCI

- Effective:
  - YE 2013 – Subsidiaries of Public Entities
  - YE 2014 – Others

- Various components of OCI presented separately
- Significant items reclassified out of accumulated OCI presented by respective income statement line items
ASU 2013-08

Financial Services – Investment Companies

• Effective: Fiscal Years beginning after December 15, 2013

• Applies only to entities qualifying as Investment Companies under ASC 946

• Possibly impacts investment subsidiaries in holding company structure

• Changes reporting requirements for Investment Companies

• Requires measurement of certain investments at Fair Value

• Reorganizes characteristics of Investment Companies but doesn’t change key factors
ASU 2013-08, cont.

- Requires Investment Companies to disclose that they are Investment Companies

- ASC 820 – Defines when you can use “NAV” as a Practical Expedient to determine Fair Value
  - Investment is required to be an investment company to use NAV as a practical expedient (ASC 820-10-15-4)

- Hedge Funds, LLPs and Unregistered Mutual Funds
  - Typically have no readily determinable fair value
  - Would result in Equity Method or Cost Method of Accounting
ASU 2013-11

Income Taxes – Presentation of an Unrecognized Tax Benefit When Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists

- Effective Q4 2013 (Public), Q4 2014 (Captives). Early adoption permitted
- Applies to all entities with unrecognized tax benefits that also have a recognized tax loss or tax credit carryforwards
- Unrecognized tax benefit must be presented as a reduction to a deferred tax asset for an NOL carryforward, similar tax loss, or tax credit carryforward
- No impact on financial statement disclosures
Statutory

No significant statutory updates in 2014!

State of Vermont Update:

• 1/1/2014 – RRGs no longer required to include reconciliation back to SAP
QUESTIONS
Items of Captive Interest
Cell Captives

Presentation – Combined vs. Consolidated

• Cells under direct ownership of ultimate parent
  • Consolidated

• Cells are part of a “controlled group” with common control ownership
  • Combined
Cell Captives, cont.

- Presentation – Unaffiliated Cells
- Assets of cell shown as 1 line item on balance sheet for all cells
- Liabilities and equity of cell shown as 1 line item on balance sheet for all cells
- Supplemental schedule in the back of the statements added show detail of cell balances and activities
  - Similar to a “consolidating” or “combining” schedule for affiliate entities
• Extra note to financial statement should also be considered to disclose significant accounting policies of the cells
  • Divergence in practice can exist due primarily to materiality
    • Of each cell,
    • Of individual transactions and programs

• State Law may also dictate format of statements or require a separate audit for each cell (not required in VT)
**Company XXX**  
Combined Balance Sheet  
As of December 31, 2013

### Assets

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>$87,737,044</td>
</tr>
<tr>
<td>Program fee receivable</td>
<td>21,511</td>
</tr>
<tr>
<td>Premiums receivable</td>
<td>2,841,278</td>
</tr>
<tr>
<td>Reinsurance recoverable - unpaid losses</td>
<td>597,000</td>
</tr>
<tr>
<td>Segregated cell assets - Cell B</td>
<td>1,984,059</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>$93,180,892</strong></td>
</tr>
</tbody>
</table>

### Liabilities and Member's Capital

#### Liabilities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Losses and loss adjustment expenses</td>
<td>$16,658,927</td>
</tr>
<tr>
<td>Losses payable</td>
<td>3,360,612</td>
</tr>
<tr>
<td>Payable to affiliate</td>
<td>2,100,806</td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>59,387</td>
</tr>
<tr>
<td>Segregated cell liabilities and member's equity - Cell B</td>
<td>1,984,059</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>24,163,791</strong></td>
</tr>
</tbody>
</table>

#### Member's Capital:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributed capital</td>
<td>32,148,691</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>36,868,410</td>
</tr>
<tr>
<td><strong>Total Member's Capital</strong></td>
<td><strong>69,017,101</strong></td>
</tr>
</tbody>
</table>

**Total Liabilities and Member's Capital**  
**$93,180,892**
## Company XXX
### Supplemental Combining Balance Sheet
#### As of December 31, 2013

**Assets**

<table>
<thead>
<tr>
<th></th>
<th>Core</th>
<th>Cell A</th>
<th>Eliminations</th>
<th>Combined</th>
<th>Cell B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>536,234</td>
<td>87,200,810</td>
<td>-</td>
<td>87,737,044</td>
<td>1,332,285</td>
<td>89,069,329</td>
</tr>
<tr>
<td>Program fee receivable</td>
<td>23,207</td>
<td>-</td>
<td>(1,696)</td>
<td>21,511</td>
<td>-</td>
<td>21,511</td>
</tr>
<tr>
<td>Premiums receivable</td>
<td>-</td>
<td>2,841,278</td>
<td>-</td>
<td>2,841,278</td>
<td>506,235</td>
<td>3,347,513</td>
</tr>
<tr>
<td>Reinsurance recoverable - unpaid losses</td>
<td>-</td>
<td>597,000</td>
<td>-</td>
<td>597,000</td>
<td>12,000</td>
<td>609,000</td>
</tr>
<tr>
<td>Prepaid reinsurance premiums</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>133,539</td>
<td>133,539</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>559,441</td>
<td>$ 90,639,088</td>
<td>$(1,696)</td>
<td>$ 91,196,833</td>
<td>$ 1,984,059</td>
<td>$ 93,180,892</td>
</tr>
</tbody>
</table>

**Liabilities and Member's Capital**

**Liabilities:**

<table>
<thead>
<tr>
<th></th>
<th>Core</th>
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<th>Combined</th>
<th>Cell B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Losses and loss adjustment expenses</td>
<td>-</td>
<td>16,658,927</td>
<td>-</td>
<td>16,658,927</td>
<td>87,000</td>
<td>16,745,927</td>
</tr>
<tr>
<td>Unearned premium</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>404,988</td>
<td>404,988</td>
</tr>
<tr>
<td>Losses payable</td>
<td>-</td>
<td>3,360,612</td>
<td>-</td>
<td>3,360,612</td>
<td>-</td>
<td>3,360,612</td>
</tr>
<tr>
<td>Payable to affiliate</td>
<td>-</td>
<td>2,100,806</td>
<td>-</td>
<td>2,100,806</td>
<td>-</td>
<td>2,100,806</td>
</tr>
<tr>
<td>Program fee payable</td>
<td>-</td>
<td>1,696</td>
<td>(1,696)</td>
<td>-</td>
<td>21,511</td>
<td>21,511</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>59,387</td>
<td>-</td>
<td>59,387</td>
<td>1,924</td>
<td>61,311</td>
<td></td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>59,387</td>
<td>22,122,041</td>
<td>$(1,696)</td>
<td>22,179,732</td>
<td>515,423</td>
<td>22,695,155</td>
</tr>
</tbody>
</table>

**Member's Capital:**

<table>
<thead>
<tr>
<th></th>
<th>Core</th>
<th>Cell A</th>
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<th>Combined</th>
<th>Cell B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributed capital</td>
<td>500,000</td>
<td>31,648,691</td>
<td>-</td>
<td>32,148,691</td>
<td>1,500,000</td>
<td>33,648,691</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>54</td>
<td>36,868,356</td>
<td>-</td>
<td>36,868,410</td>
<td>(31,364)</td>
<td>36,837,046</td>
</tr>
<tr>
<td><strong>Total Member's Capital</strong></td>
<td>500,054</td>
<td>68,517,047</td>
<td>-</td>
<td>69,017,101</td>
<td>1,468,636</td>
<td>70,485,737</td>
</tr>
</tbody>
</table>

**Total Liabilities and Member's Capital**

<table>
<thead>
<tr>
<th></th>
<th>Core</th>
<th>Cell A</th>
<th>Eliminations</th>
<th>Combined</th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>$ 559,441</strong></td>
<td><strong>$ 90,639,088</strong></td>
<td></td>
<td><strong>$(1,696)</strong></td>
<td><strong>$ 91,196,833</strong></td>
<td><strong>$ 1,984,059</strong></td>
<td><strong>$ 93,180,892</strong></td>
</tr>
<tr>
<td><strong>Cell Company</strong></td>
<td><strong>ABC</strong></td>
<td><strong>DEF</strong></td>
<td><strong>GHI Year 1</strong></td>
<td><strong>GHI Year 2</strong></td>
<td><strong>JKL</strong></td>
<td></td>
</tr>
<tr>
<td>------------------</td>
<td>---------</td>
<td>---------</td>
<td>---------------</td>
<td>---------------</td>
<td>---------</td>
<td></td>
</tr>
<tr>
<td><strong>Opinion</strong></td>
<td>VT GAAP</td>
<td>Clean GAAP</td>
<td>Permitted practice to &quot;combine&quot; instead of &quot;consolidate&quot;</td>
<td>Permitted practice to &quot;combine&quot; instead of &quot;consolidate&quot;</td>
<td>NAIC Statutory with PP to combine cells with core</td>
<td></td>
</tr>
<tr>
<td><strong>Lead BS - Assets &amp; Liabilities of Cells</strong></td>
<td>Assets &amp; Liabilities held for participants with on <strong>1</strong> line for each</td>
<td>Assets &amp; Liabilities held for participants with <strong>multiple</strong> lines for each</td>
<td>Assets &amp; Liabilities held for participants with <strong>multiple</strong> lines for each</td>
<td>No assets or liabilities &quot;held for participants&quot;, looks like non cell company on face of balance sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Lead BS - Cell Equity</strong></td>
<td>Participant's equity in cell presented in <strong>liability</strong> section</td>
<td>Participant's equity in cell presented in <strong>liability</strong> section</td>
<td>Participant's equity in cell presented in <strong>equity</strong> section</td>
<td>Participant's equity are presented in total equity - same line as sponsor</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Lead IS</strong></td>
<td>Cell Rental Fee is only revenue - no premiums of cells' presented</td>
<td>Cell Rental Fee is only revenue - no premiums of cells' presented</td>
<td>Premiums and losses of cells on combined income statement with no reference to being cell activity.</td>
<td>Premiums and losses of cells on combined income statement with no reference to being cell activity.</td>
<td>Premiums and losses of cells on combined income statement with no reference to being cell activity.</td>
<td></td>
</tr>
<tr>
<td>Cell Company</td>
<td>ABC</td>
<td>DEF</td>
<td>GHI Year 1</td>
<td>GHI Year 2</td>
<td>JKL</td>
<td></td>
</tr>
<tr>
<td>--------------</td>
<td>-----</td>
<td>-----</td>
<td>------------</td>
<td>------------</td>
<td>-----</td>
<td></td>
</tr>
<tr>
<td>Disclosures / footnotes</td>
<td>No break out of individual cell activity in the notes</td>
<td>Full BS and IS of Cell</td>
<td>Full IS of Cell and Core - each with own column</td>
<td>Full IS of Cells together in one column and a 2nd column for Core</td>
<td>No break out of individual cell activity in the notes</td>
<td></td>
</tr>
<tr>
<td>Affiliation of cell(s) with core</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes and No</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Number of cells</td>
<td>20+</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>15+</td>
<td></td>
</tr>
<tr>
<td>Insurance business in the core</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Annual Statement Filing with Regulator</td>
<td>BS &amp; IS for each cell &amp; Combined</td>
<td>BS &amp; IS for each cell &amp; Combined</td>
<td>BS &amp; IS for each cell &amp; Combined</td>
<td>BS &amp; IS for each cell &amp; Combined</td>
<td>BS &amp; IS for each cell &amp; Combined</td>
<td></td>
</tr>
<tr>
<td>FIT for cells each separate or one combined return</td>
<td>Each cell on their own to determine status, file and pay. No FIT liability recorded</td>
<td>No return (disregarded entities), but accrual made</td>
<td>The Core and the Cells file separate income tax returns. For FIT purposes, some treated as insurance companies, some not</td>
<td>The Core and the Cells file separate income tax returns. For FIT purposes, some treated as insurance companies, some not</td>
<td>Combined return and then FIT accrual/expense allocated to each cell</td>
<td></td>
</tr>
</tbody>
</table>
Limited Distribution Opinion

- Typically used on financial statements presented using a statutory basis of accounting

- Restricts use of report as the basis and assumptions utilized in the financial statements are developed to comply with regulatory requirements departing from GAAP

- Unrestricted reports under GAAS are required to have a GAAP Adverse Opinion Paragraph – due to GAAP Departure
Internal Controls / Management Representation Letters

- Varying internal controls testing / documentation procedures among audit teams
- Highly subjective with no concrete audit steps in place
- Management Rep Letters
  - Who should be signing?
  - Detailed Parent company representations unknown by Management company signors
  - How much is “to the best of my knowledge” enough?
QUESTIONS
Exposure Drafts (ED)
Leases (Re-Exposure)

Timetable:
- 05/16/13 – Re-exposure draft issued
- 09/13/13 – Comments due
- 600+ comment letters
- Revisions to draft still under consideration
Lease Models

Type “A” Leases

Terms of lease > insignificant portion of the leased assets useful life

Amortization Expense (Lessee)

Interest Expense/Revenue

Type “B” Leases

Terms of lease < insignificant portion of the leased assets useful life

Lease Expense (Lessee)
Lease ED Comments

Considerable opposition for 2013 ED
  • Increased cost for preparers
  • Excessive disclosure requirements
  • Does not represent “economic” standpoint of leasing

FASB vote to propose ED split 4-3

Joint re-deliberations continued Spring 2014
  • Lessee accounting model
  • Lessor accounting model
  • Small-ticket leases
  • Lease terms
  • Sublease and Right-of-Use (ROU)

Timetable:

• 02/14/13 – Exposure draft issued
• 05/15/13 – Comments due
• 150+ comment letters
• Revisions to draft still under consideration
Recognition & Measurement

• Exposure draft proposed:
  • Contractual cash flow characteristics
  • Business model

• Comments conveyed the ED was too complex and amortized cost category was too restrictive

• Have abandoned provisions of initial ED
Recognition & Measurement Revisions

- Re-defined cash flow characteristics assessment
- Fair value option for hybrid financial instruments
- Final document expected by end of Q3 2014
Financial Instruments – Credit Losses

Timetable:

• 12/20/12 – Exposure draft issued
• 05/31/13 – Comments due
• 350+ comment letters
• Revisions to draft still under consideration
Credit Loss Model

Current impairment model

• Impairment recognized only after loss event has occurred or is “probable”

Current Expected Credit Loss (CECL) model

• Recorded at the end of each reporting period
• Recognized on the basis of “expected” credit losses (i.e. contractual cash flows not expected to be collected)
Credit Loss ED Comments

• Investors found to be in support of the ED
  • View the allowance as capital set aside as a reserve to offset future expected losses
  • Desire to see more detailed disclosures, such as a rollforward of expected credit losses

• Financial statement preparers not in favor of the ED
  • Will result in understating NAV of assets measured at amortized cost at inception
  • Prefer a model that recognizes only some of the expected credit loss or maintains a specified threshold before credit losses can be impaired
QUESTIONS
Insurance Contracts

• 06/27/13 – Exposure draft issued

• Two measurement approach:
  • Premium Allocation Approach (PAA)
    • Property, liability and short-term health contracts
  • Building Block Approach (BBA)
    • Life, annuity and long-term health contracts

• Negative comments on the proposed ED
  • Too complex
  • Costly
  • No comparability between companies
Insurance Contracts, cont.

- Initial exposure draft abandoned

- Key focus on disclosures & contract recognition and measurement

- Project split into two components
  - Short-term contracts (disclosures)
  - Long duration contracts (recognition & measurement)
Insurance Contract Areas of Focus

Short-term contracts
- Incurred and paid loss development
- Time bands of expected duration of claim reserves and relevant discount rates
- Severity and frequency of claims
- Assumptions used in Premium Deficiency Reserve calculation
- Amount of discounted reserves

Long-duration contracts
- Measurement of guarantees and options embedded in contracts not measured at fair value
- Amortization of deferred acquisition costs
- Whether assumptions used in the measurement of policyholder liability should be updated for current expectations
Tentative Decisions – Additional Disclosures

Short-term contracts
- Incurred and Paid Claim Development (Annual)
  - Applied prospectively
- Frequency and Severity of Claims (Annual)
  - Applied retrospectively
- Discounting (Annual)
  - Applied retrospectively
- Others (Interim and Annual)
  - Applied retrospectively
- Recommended effective date for periods ending after 12/31/2014 (Public) and 12/31/2015 (Non Public)
Private Company Developments
Private Company Council

Determining whether exceptions or modifications to existing U.S. Generally Accepted Accounting Principles (GAAP) are required to address the needs of users of private company financial statements

- Co-created framework with the FASB used as a basis for PCC developments
- Issued July 2013
Definition of a Non-Public Entity

**ASU 2013-12 Definition of a Public Business Entity**

- Required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements, with the SEC;
- Required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statement with a regulatory agency other than the SEC;
- Required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer;
- It 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;
- It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publically available on a periodic basis.
Private Co. Alternatives

- ASU 2014-02 *Intangibles – Accounting for Goodwill*
- ASU 2014-03 *Derivatives and Hedging*
- ASU 2014-07 *Consolidation – Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements*
QUESTIONS