GAAP and Statutory Accounting Updates including NAIC and FASB Topics

September 11, 2024

SIFM | Moderator and Panelists

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Agenda

1. National Association of Insurance Commissioners (“NAIC”) Statutory Accounting Update – Principles-Based Bond Project
2. Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures (ASU 2023-07)
3. Scope Application of Profits Interest Awards: Compensation – Stock Compensation (ASU 2024-01)
4. Income Taxes (Topic 740): Improvements to Income Tax Disclosures (ASU 2023-09)
5. Disaggregation – Income Statement Expenses – Board Redeliberations
6. FASB Technical Agenda timeline
7. Q&A

NAIC Statutory Accounting Principles-Based Bond Definition

NAIC Principles-Based Bond Project

Background

- Project originally focused on collateralized fund obligations (CFOs) and similar structures securitized from equity interests.
  - During 2008-2011, several concepts and clarifications were adopted into SSAP No. 43R- Loan-Backed and Structured Securities (Beneficial interests, Impairment, Securitized loans vs. securitized assets, Trust structure requirement, Mortgage-referenced securities, etc.)

- Working Group decided to focus on characteristics for investments to be reported as a bond on Schedule D – Part 1: Long-Term Bonds
  - Defined bonds as issuer credit obligations in *SSAP No. 26--Bonds*
  - Defined attributes for asset-backed securities in *SSAP No. 43—Asset-Backed Securities*

NAIC Principles-Based Bond Project

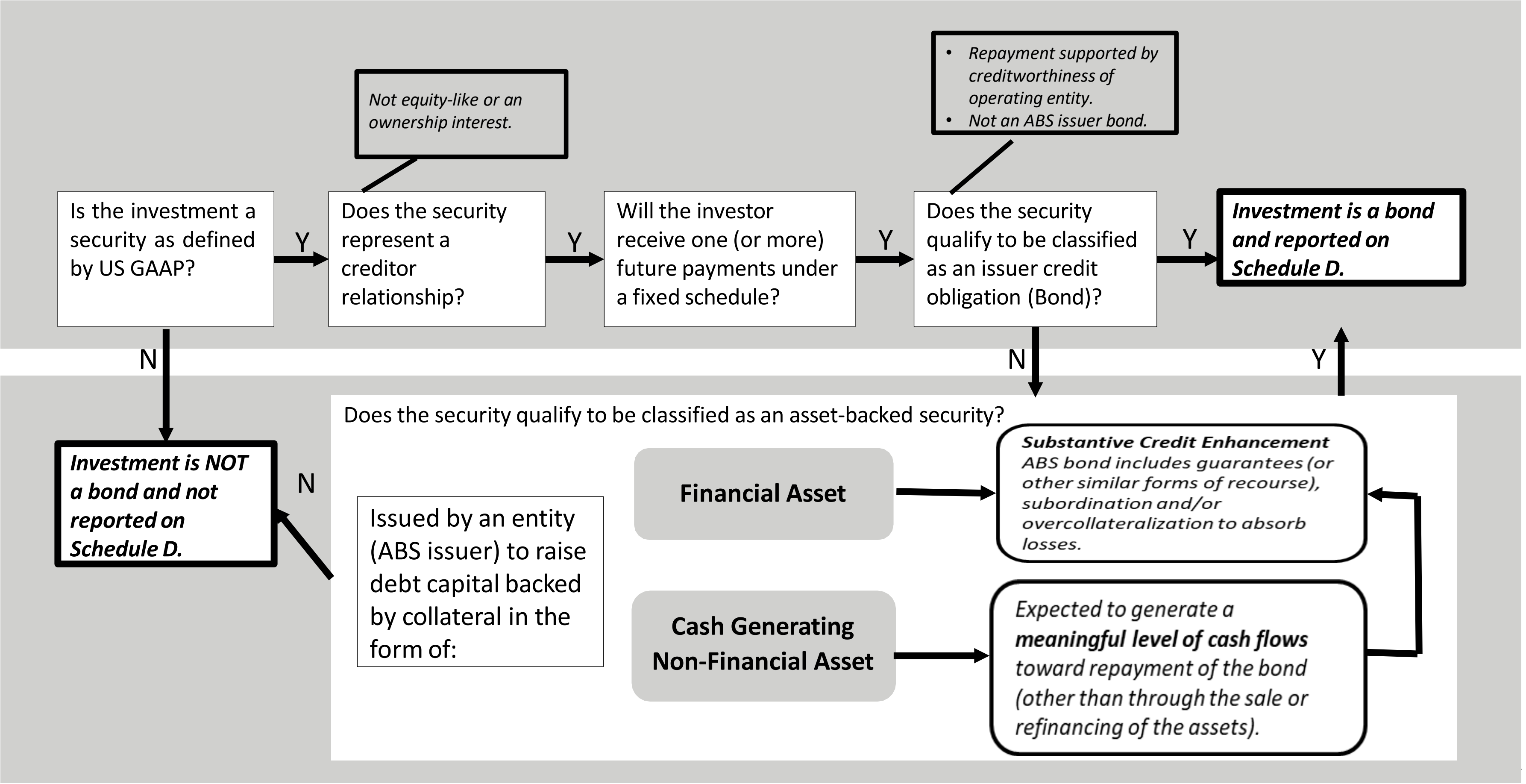
Adopted New SAP Concepts

SSAP No. 26R—Bonds; SSAP No. 43R—Asset-Backed Securities; and Various SSAPs

- On August 13, 2023, during the 2023 Summer National Meeting, the Working Group adopted revisions to *SSAP No. 26—Bonds* and *SSAP No. 43—Asset Backed Securities*, for the new principles-based definition, as well as various SSAPs to reflect the revised definition.
- Effective date of January 1, 2025

*A bond shall be defined as any **security** representing a **creditor relationship**, whereby there is a **fixed schedule** for one or more future payments, and which qualifies as **either an issuer credit obligation or an asset backed security**.*

NAIC Bond Definition Decision Tree



NAIC Principles-Based Bond Project

Does the security represent a creditor relationship? Will the investor receive one (or more) future payments under a fixed schedule?

For a debt instrument to represent a creditor relationship, the instrument/security must have pre-determined principal and interest payments (fixed or variable) with contractual amounts that do not vary based on performance of any underlying collateral value or other non-debt variable.

- Does not, in substance, possess equity-like characteristics or represents an ownership interest.
- Does not exclude debt instruments with common variable interest adjustments:
  - Plain-vanilla inflation or benchmark interest rate adjustments
  - Schedule interest rate step-ups
  - Credit-quality related interest rate adjustments
  - Nominal interest rate adjustments
- All returns in excess of principal are required to be considered as interest.
- Examples of other securities excluded from the bond definition:
  - Structured Notes
  - Principal-Protected Securities

An issued security that has varying principal and interest payments based on the ***appreciation of referenced equity, real estate or other non-debt variables*** is ***precluded*** *from bond treatment.*

NAIC Principles-Based Bond Project

Does the security qualify to be classified as an issuer credit obligation because repayment is supported by the creditworthiness of the issuer?

An issuer credit obligation is a bond, for which the general creditworthiness of an operating entity or entities , through direct or indirect recourse, is the primary source of repayment.

- Operating entity or entities includes holding companies with operating entity subsidiaries where the holding company can access the subsidiaries' cash flows due to its ownership rights.
  - Cannot be a natural person or asset-backed security issuer.
- Examples of issuer credit obligations (SSAP No. 26, paragraph 6):
  - U.S. Treasury securities
  - U.S. government agency securities
  - Most municipal securities
  - Corporate bonds
  - Project finance bonds
  - Credit-Tenant Loans, Equipment trust certificates, Funding Agreement Backed Notes
  - Bonds issued by real estate investment trusts (REITs) or similar property trusts
  - Bonds issued by business development corporations, closed-end funds, or similar operating entities
  - Convertible bonds

*Note the importance of the issuer being an **operating entity** and direct or indirect recourse to the operating entity as the primary source of repayment.*

NAIC Principles-Based Bond Project

Does the security represent a creditor relationship?

The Rebuttable Presumption - Factors to consider in making this determination include but are not limited to:

- Number and diversification of the underlying equity interests
- Characteristics of the underlying equity interests (vintage, asset-types, etc.)
- Liquidity facilities
- Overcollateralization
- Waiting period for distributions/paydowns to begin
- Capitalization of interest
- Covenants (e.g., loan-to-value trigger provisions)
- Reliance on ongoing sponsor commitments

Reliance of the debt instrument on sale of underlying equity interests or refinancing at maturity - ***As reliance on sale or refinancing increases, the more compelling the other factors needed to overcome the rebuttable presumption become.***

Analysis must be conducted and documented at the time such an investment is acquired.

NOTE ON REPORTING REQUIREMENTS: For reporting purposes, capture the group of debt securities that do not reflect a creditor relationship, by NAIC designation and whether or not affiliated.

*There is a **rebuttable presumption** that a debt instrument collateralized by equity interests does not represent a creditor relationship in substance.*

*The presumption can be rebutted if the characteristics of the underlying equity interests lend themselves to the **production of predictable cash flows** and the **underlying equity risks have been sufficiently redistributed through the capital structure of the issuer**.*

NAIC Principles-Based Bond Project

What are the criteria for a security to be classified as an asset-backed security?

An asset-backed security is a bond issued by an entity (an ABS Issuer) created for the primary purpose of raising debt capital BACKED by financial assets or cash generating non-financial assets OWNED by the ABS Issuer. The primary source of REPAYMENT IS DERIVED FROM THE CASH FLOWS ASSOCIATED WITH THE UNDERLYING COLLATERAL rather than the cash flows of an operating entity.

- ABS Issuer:
  - Not expected to continue function beyond maturity.
  - Generally, in the form of a trust or special purpose vehicle (SPV) but not a requirement.
- Cash-generating non-financial assets – assets expected to generate a meaningful level of cash flows toward repayment through use, licensing, leasing, servicing or management fees, and other similar cash flow generation.
- Meaningful level of cash flows from non-financial assets other than through the sale or refinancing of the underlying assets held by the ABS Issuer is determined by considering the following factors:
  - Price volatility
  - Liquidity
  - Diversification characteristics
  - Overcollateralization
  - Variability of cash flows

NOTE: The requirement to assess "meaningful cash flows" only applies to cash-generating non-financial assets and not to financial assets.

Practical Expedient For Determining If Cash Flows From Non-Financial Assets are meaningful:

May consider an asset for which ***less than 50% of the original principal relies on sale or refinancing*** to meet the meaningful cash-flow generating criteria[1].

[1]SSAP No. 26R, paragraph 8b

NAIC Principles-Based Bond Project

What are the criteria for a security to be classified as an asset-backed security?

Holder of the debt instrument issued by an ABS Issuer is in a DIFFERENT ECONOMIC POSITION than if the holder owned the ABS Issuer's assets directly.

Different economic position achieved by the debt instrument through substantive credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization.

- Differentiate bonds from instruments with equity-like characteristics
- Differentiate bonds from investment in the underlying collateral
- Structure required to absorb losses debt instrument being evaluated would absorb losses
- Evaluation:
  - Specific to each transaction
  - Determined at origination
  - Refers to the level of credit enhancement a market participant would conclude is substantive.

NOTE ON REPORTING REQUIREMENTS: *Capture and group debt securities without substantive credit enhancement and debt securities that do not qualify solely because of lack of meaningful cash flows, by NAIC designation and whether affiliated.*

Two defining characteristics for a security to meet the definition of an asset-backed security:

- ***Meaningful level of cash flows*** *toward repayment from cash generating non-financial assets*
- *Holder of the ABS must be in a* ***different economic position*** *than holding the ABS Issuer's underlying assets.*

NAIC Principles-Based Bond Project

Examples of Analysis for Determining Meaningful Cash Flows

Financial Assets versus Non-financial Assets:

- Mortgage-backed securities – backed by financial assets
  - Mortgage receivables are unconditional promises to pay without additional performance obligations associated.
- Securitization of rental car leases – backed by cash generating non-financial assets
  - Lessor must provide a car before the lessee is required to pay on the lease.

- *Meaningful cash flows to service the debt throughout the duration.*
- *Intent is to exclude transactions that require sale or refinancing of collateral to service debt.*

NAIC Principles-Based Bond Project

Effective: January 1, 2025

What is the transition guidance?

Best efforts to assess whether investments meet the new bond definition.

- Investments previously reported on as a bond but no longer qualify:
  - Disposal and a reacquisition on the appropriate reporting schedule.
  - Disposal at amortized cost with consideration reported at amortized cost (no gain/loss reported, and investment schedules roll appropriately) on Schedule D-4.
    - If held at amortized cost at 12/31/2024:
      - Initial Measurement – Book Adjusted Carrying Value (BACV) EQUALS Amortized Cost
      - Step 2 – If new SSAP requires valuation at amortized cost – No Change. If new SSAP requires valuation at lower of amortized cost or fair value – recognized an unrealized loss if fair value is less than amortized cost.
    - If held at fair value at 12/31/2024:
      - Initial Measurement – Reverse previously reported unrealized losses PRIOR TO DISPOSAL (reported value equals amortized cost). Then record disposal on Schedule D- 4.
      - Step 2 – Recognize an unrealized loss to match the previously reported BACV to continue reporting at lower of amortized cost or fair value.

New Schedule BA Categories:

- *Debt Securities That Do Not Reflect a Creditor Relationship in Substance*
- *Debt Securities That Lack Substantive Credit Enhancement*
- *Debt Securities That Do Not Qualify as Bonds Solely to a Lack of Meaningful Cash Flows*

NAIC Principles-Based Bond Project

Effective: January 1, 2025

What are some important things to remember regarding the transition guidance?

- ***After application of the transition guidance, all securities should either reflect the same reported value as of December 31, 2024, or a lower reported value if the security is now subject to the lower of amortized cost or fair value.***

- ***There should be no instances that result with a security having a greater reported value that what was presented on December 31, 2024.***

- ***Securities reported at fair value may incur unrealized gains or losses due to fair value fluctuations but should never have unrealized gains that result with a book adjusted carrying value that exceeds amortized cost.***

NAIC Principles-Based Bond Project

Possible Take Aways

1. Begin now - scope your portfolio

2. Work with the appropriate/relevant departments within your organization (i.e. trading, front office, etc.)

3. If applicable, work with Annual Statement Software Provider

ASU 2023-07: SEGMENT REPORTING (TOPIC 280)

Improvements To Reportable Segment Disclosures

FAST FACTS, IMPACTS, ACTIONS

All amendments in ASU 2023-07 are effective for fiscal years beginning after December 15, 2023, and interim periods within fiscal years beginning after December 15, 2024. Early adoption is permitted.

ITEMS TO DISCLOSE

- **Significant segment expenses** regularly provided to the CODM and included within the reported measure(s) of a segment's profit/loss.
- The amount and composition of **other segment items**. This amount reconciles segment revenue, less significant expenses, to the reported measure(s) of a segment's profit or loss.
- The **CODM's title and position**.
- How the **CODM uses the reported measure(s) of a segment's profit or loss** to assess segment performance and decide how to allocate resources.
- On an **interim basis**, all segment profit or loss of assets disclosures currently required annually by Topic 280, as well as those introduced by the ASU.
- **Multiple measures of a segment's profit or loss** may be reported, under certain conditions.
- **Single reportable segment entities** must apply Topic 280 in its entirety.

NOTE: The ASU does not change how a public entity identifies its operating segments, aggregates those operating segments or applies the quantitative thresholds to determine its reportable segments.

SEC CLARIFICATION POINTS ON NEW SEGMENT GUIDANCE

FREQUENTLY ASKED QUESTIONS

- Would an entity managed on a consolidated basis be permitted to disclose a measure of segment profit or loss other than consolidated net income? **YES**
- Would the SEC staff's views of the previous question differ if the CODM is not the CEO or CFO certifying the Form 10-K or 10-Q? **Not necessarily**
- Could there be circumstances where an entity is organized as a single operating (and reportable) segment but not managed on a consolidated basis? **It depends on facts and circumstances**
  - **Note:** It can be viewed that an entity that aggregates multiple operating segments into a single reportable segment **is not managed** on a consolidated basis
- Is it acceptable for an entity to disclose an expense that is not calculated in accordance with GAAP as a significant segment expense under Topic 280? **Yes**
- Would the SEC staff object to a different measure of segment profit or loss being used for different reportable segments? **No**

Scope Application of Profits Interest Awards: Compensation - Stock Compensation (ASU 2024-01)

Scope Application of Profits Interest Awards: Compensation – Stock Compensation

Final ASU

Background

- In October 2018, the FASB received an agenda request related to providing specific guidance on whether a profits interest award should be accounted for as a share-based payment arrangement under ASC 718 or in a manner similar to a cash bonus or profit-sharing arrangement under ASC 710 or other ASC topics. The agenda request noted that the absence of such guidance has resulted in diverse accounting for these awards.
- At the December 14, 2022, FASB meeting, the FASB added a project to its technical agenda to address the diversity in practice in applying the scope guidance in Topic 718 to profits interest awards.

Main Provisions

- The amendments in this Update provide an illustrative example that includes four fact patterns to demonstrate how an entity should apply the scope guidance in paragraph 718-10-15-3 to determine whether a profits interest or similar award should be accounted for in scope of Topic 718. This Update also includes amendments that improve the understandability of paragraph 718- 10-15-3.
- The FASB believes the clarifications provided through the proposed update will result in more profits interest awards being accounted for in accordance with Topic 718.

Scope Application of Profits Interest Awards: Compensation – Stock Compensation

Final ASU

Illustrative Examples

Profits Interest Awards

Case A: The Class B units cliff vest at the end of three years of service or fully vest upon an exit event if the grantee is still providing services to Entity X. Upon an exit event, the grantee would retain the vested Class B units or, if the Class B units are settled through an exit event, Entity X would distribute proceeds to the Class B unit holders on a pro rata basis along with the Class A units once the Class A unit holders have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.

Case B: The Class B units vest only upon an exit event. When such exit event occurs, the grantee would retain the vested Class B units. Alternatively, if the Class B units are settled through an exit event, Entity X would distribute proceeds to the Class B unit holders on a pro rata basis with the Class A units once the Class A unit holders have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units. In addition, the Class B units are eligible to participate in nonforfeitable operating distributions on the grant date.

Key Considerations

Case A: Within scope of ASC 718

- The Class B units "vest upon three years of service or an exit event."
- Holding the vested Class B units gives the grantee "the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units of Entity X in accordance with the distribution waterfall described in [ASC] 718-10-55-140(a)."

Case B: Within scope of ASC 718

- The Class B units vest upon an exit event.
- Holding the vested Class B units gives the grantee "the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units of Entity X in accordance with the distribution waterfall described in [ASC] 718-10-55-142(a)."

Scope Application of Profits Interest Awards: Compensation – Stock Compensation

Final ASU

Illustrative Examples

Phantom Share Units

Case C: The grantee of the Class B phantom share units is only eligible to receive cash upon an exit event. If such an event occurs, the Class B phantom share units are cash-settled on the basis of their fair value, which is calculated by reference to the price of the Class A units of Entity X as determined on the date of the exit event. Further, to receive any proceeds, the grantee must be providing services when the exit event occurs.

Case D: The grantee of the Class B phantom share units is only eligible to participate in Entity X's operating distributions equal to 1 percent of the preceding fiscal year's net income after the grantee provides three years of services. Further, the grantee is not eligible to participate in any proceeds upon an exit event, and the Class B phantom share units are forfeitable upon the grantee's termination for any reason at any time.

Key Considerations

Case C: Within scope of ASC 718

- ASC 718-10-55-146 states that in the evaluation of whether the condition in ASC 718-10-15-3(b)(1) is met, Entity X has incurred a liability to the grantee that is based, at least in part, on the price of Entity X's shares and that the Class B phantom share units are therefore within the scope of ASC 718.

Case D: Not within scope of ASC 718

- The proceeds received by the grantee related to operating distributions are based on an operating metric (1 percent of the preceding fiscal year's net income) of Entity X and are not based, at least in part, on the price of Entity X's shares.
- There is no circumstance in which Entity X would be required to issue its equity shares or other equity instruments

Scope Application of Profits Interest Awards: Compensation – Stock Compensation

Final ASU

Transition

- An entity shall apply the guidance either (1) retrospectively to all prior periods presented in the financial statements or (2) prospectively to awards granted or modified on or after the effective date with qualitative disclosure about the nature of and reason for the change in accounting principle.

Effective Date

- For public business entities, the amendments in this Update are effective for annual periods beginning after December 15, 2024, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2025, and interim periods within those annual periods.
- Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance. If an entity adopts the amendments in an interim period, it should adopt them as of the beginning of the annual period that includes that interim period.

ASU 2023-09: INCOME TAXES (TOPIC 740)

Improvements To Income Tax Disclosures

FAST FACTS, IMPACTS, ACTIONS

Public business entities (PBEs) must apply the ASU's guidance to annual periods beginning after **December 15, 2024** (2025 for calendar-year-end PBEs).

Entities other than PBEs have an **additional year** to adopt it.

KEY PROVISIONS OF THE ASU

- Rate Reconciliation
- State and Local Income Taxes
- Foreign Tax Effects
- Impacts of Federal (National Income Taxes)
- Tax Credits
- Changes in Valuation Allowances
- Nontaxable or Nondeductible Items
- Changes in Unrecognized Tax Benefits
- Statutory Tax Rate
- Materiality
- Income Taxes Paid
- Disaggregation of Pretax Income and Expense
- Indefinitely Reinvested Foreign Earnings
- Unrecognized Tax Benefits

RATE RECONCILIATION

The ASU amends ASC 740-10-50-12 to require a PBE to disclose a reconciliation “between the amount of reported income tax expense (or benefit) from continuing operations and the amount computed by multiplying the income (or loss) from continuing operations before income taxes by the applicable statutory federal (national) income tax rate of the jurisdiction (country) of domicile.”

If the PBE “is not domiciled in the United States, the federal (national) income tax rate in such entity’s jurisdiction (country) of domicile shall normally be used in the rate reconciliation.”

The amendments prohibit the use of different income tax rates for subsidiaries or segments.

Further, PBEs that use an income tax rate in the rate reconciliation that is other than the U.S. income tax rate must disclose the rate used and the basis for using it.

RATE RECONCILIATION

The ASU also adds ASC 740-10-50-12A, which requires entities to annually disaggregate the income tax rate reconciliation between the following eight categories by both percentages and reporting currency amounts:

1. State and local income tax, net of federal (national) income tax effect
2. Foreign tax effects
3. Effect of changes in tax laws or rates enacted in the current period
4. Effect of cross-border tax laws
5. Tax credits
6. Changes in valuation allowances
7. Nontaxable or nondeductible items
8. Changes in unrecognized tax benefits.

Categories 2, 4, 5, and 7 must be further disaggregated on the basis of a quantitative threshold of 5 percent “of the amount computed by multiplying the income (or loss) from continuing operations before income taxes by the applicable statutory federal (national) income tax rate.” If a reconciling item is not within any of the eight categories but meets the conditions for disaggregation on the basis of the 5 percent threshold, it must be “disaggregated by nature.”

Disaggregation – Income Statement Expenses – Board Redeliberations

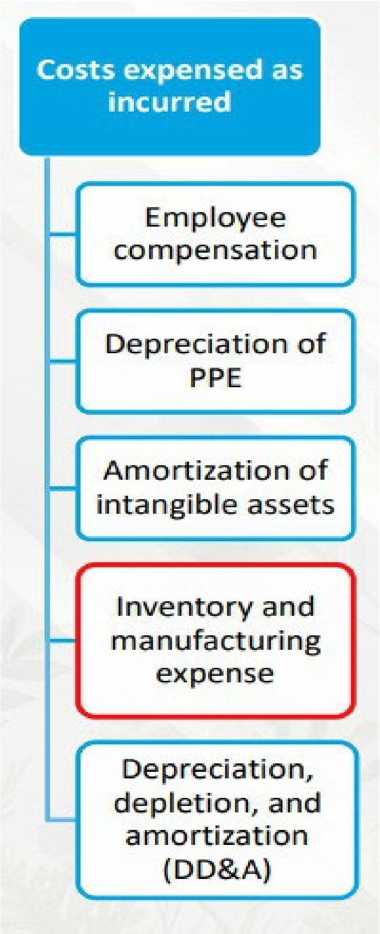
Disaggregation—Income Statement Expenses

Board Redeliberations

Background

- Exposure draft issued July 31, 2023; requires the following on an interim and annual basis for public business entities:
  - Disclose details of the expense categories listed in the income statement captions in a disaggregated tabular format, with additional breakdowns required for inventory and manufacturing expenses.
  - Provide a qualitative description of any amounts within relevant expense captions or in inventory and manufacturing expenses not further quantitatively disaggregated.
  - Annually, disclose total selling expenses, the internal definition of selling expenses, and the criteria distinguishing them from other expenses. Apply a similar annual disclosure requirement for other manufacturing expenses.

- A roundtable was held on Wednesday, December 13, 2023. The purpose of the roundtable was to provide an opportunity for those who had submitted a comment letter or provided feedback on the proposed Update (which would apply to public business entities) to discuss their feedback with the FASB.



Disaggregation—Income Statement Expenses

Board Redeliberations

Affirmed

- Scope of entities subject to the provisions and the framework used to disaggregate relevant expense categories, including employee compensation, depreciation, and intangible asset amortization
- Qualitative description of “Other” items
- Quantitative and qualitative disclosure of selling expenses
- Integration of existing disclosures with mapping requirement
- Declined to address specific application of materiality to the proposed standard
- Declined to provide any practical expedients and directed the staff not to perform any further research about industry-specific guidance.

Continued Discussion

- Inventory and manufacturing expense disaggregation – single-level disaggregation approach
- Interim reporting, transition, effective date, etc.

Disaggregation—Income Statement Expenses

Board Redeliberations

Effective Date and Transition

- The Board will determine the effective date of the guidance after it considers feedback on the proposed ASU. The proposal would require PBEs to adopt the new guidance prospectively while also providing an optional retrospective application.

Next Steps

- The Board will continue deliberations at a future Board meeting.

Potential impact for insurers

- For PBE's, increased Income statement line disclosures. For example, if the company has an "Operating Expenses" or "Other Underwriting Expenses" as a financial statement line item, they will be required to disaggregate the line items in their disclosure between employee compensation, depreciation, intangible asset amortization and other expenses.
- Therefore, users of the financials will have more visibility into the trends of major categories within the aggregated financial statement line item.

FASB Technical Agenda Timeline

FASB Technical Agenda – Current Projects

As of June 5, 2024

NOTE: Changes since January 2024 in red.

Topic - Recognition and Measurement Projects	Next Milestone	Expected Date
Accounting for and Disclosure of Software Costs	Board Deliberations	Ongoing
Accounting for Environmental Credit Programs	Board Deliberations	Ongoing
Accounting for Government Grants	~~Board Deliberations~~ Exposure Draft	~~Ongoing~~ 3Q 2024
Codification Improvements (next phase)	Board Deliberations	Ongoing
~~Codification Improvements – Amendments to Remove References to the Concepts Statements~~	~~Final ASU~~	~~1Q 2024~~
Financial Instruments – Credit Losses (Topic 326) – Purchased Financial Assets	Board Deliberations	Ongoing
Induced Conversions of Convertible Debt Instruments (EITF Issue No. 23-A)	~~Exposure Draft~~ Final ASU	~~4Q 2023~~ 3Q 2024
~~Scope Application of Profits Interest Awards: Compensation – Stock Compensation (Topic 718)~~	~~Final ASU~~	~~1Q 2024~~
Topic 815 – Hedge Accounting Improvements	~~Board Deliberations~~ Exposure Draft	~~Ongoing~~ 3Q 2024
Topic 815 – Derivatives Scope Refinements	~~Board Deliberations~~ Exposure Draft	~~Ongoing~~ 3Q 2024

FASB Technical Agenda – Current Projects (cont.)
As of June 5, 2024

Topic – Presentation and Disclosure Projects	Next Milestone	Expected Date
Disaggregation – Income Statement Expenses	Board redeliberations	Ongoing
Interim Reporting – Narrow-Scope Improvements	Exposure Draft	~~2Q 2024~~ 3Q 2024
Statement of Cash Flows Targeted Improvements	Board deliberations	Ongoing

Topic – Framework Projects	Next Milestone	Expected Date
Conceptual Framework: Measurement	~~Exposure Draft~~ Final Concepts Statement	~~4Q 2023~~ 2Q 2024

Questions

Deloitte.

THANK YOU

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