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## Accounting by the issuer of surplus notes; Practice bulletin, 15

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

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**AICPA**

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

*January 1997*

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***Accounting  
by the Issuer  
of Surplus  
Notes***

*Prepared by the  
AICPA Insurance Companies Committee*

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## FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in Practice Bulletins issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document and (2) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project and issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

# Practice Bulletin 15

## Accounting by the Issuer of Surplus Notes

### Introduction and Background

1. Surplus notes<sup>1</sup> are financial instruments issued by insurance enterprises that are includable in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations.

2. The following are some general characteristics of surplus notes:

- Approval of the issuance by the domiciliary state insurance commissioner (commissioner)
- Stated maturity date in most but not all cases
- Scheduled interest payments
- Approval of the payment of principal and interest by the commissioner
- Nonvoting
- Subordinate to all claims except those of shareholders for stock companies
- Subordinate to all claims except policyholder residuals for mutual companies (after policyholder liabilities are settled)
- No or limited acceleration rights other than for rehabilitation, liquidation, or reorganization of the insurer by a governmental agency
- Proceeds from issuance in the form of cash, cash equivalent, or some other asset with a readily determinable fair value satisfactory to the commissioner

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<sup>1</sup>The term surplus notes is the most common term applied to these financial instruments. Some jurisdictions refer to these financial instruments as certificates of contribution, surplus debentures, or capital notes.

3. Mutual insurance enterprises are owned by their policyholders and cannot raise capital by issuing shares of common or preferred stock; thus, many mutual insurance enterprises have issued surplus notes. Early issuances of surplus notes were generally by financially troubled mutual insurance enterprises in need of raising capital with limited alternatives to do so. More recently, mutual life insurance enterprises which do not have access to traditional equity capital markets, have viewed these instruments as a viable method of raising capital and improving risk-based capital ratios.

4. Mutual life insurance enterprises currently account for surplus notes under statutory accounting practices almost universally as equity capital or surplus. Surplus treatment is allowed for statutory accounting purposes because of the regulatory control over an insurance enterprise's ability to repay interest and principal that is maintained through required approval of payment by the commissioner.

5. The accounting for and presentation of surplus notes under generally accepted accounting principles (GAAP) is a significant issue to mutual life insurance enterprises when implementing FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, and FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*. According to FASB Interpretation No. 40 as amended by FASB Statement No. 120, mutual life insurance enterprises that issue financial statements for fiscal years beginning after December 15, 1995, that are described as prepared "in conformity with generally accepted accounting principles" are required to apply all applicable authoritative accounting pronouncements in preparing those statements. Current authoritative accounting pronouncements are silent as to the accounting for surplus notes. Due to the prevalence and increasing use of these instruments by all kinds of insurance enterprises in the marketplace, GAAP guidance is necessary.

## Scope

6. This Practice Bulletin applies to life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies that issue surplus notes. It provides guidance on accounting, financial statement presentation, and disclosure by the issuers of surplus notes in their GAAP financial statements. This Practice Bulletin does not apply to investors in surplus notes.

## Conclusions

### ***Balance-Sheet Classification of Outstanding Surplus Notes***

7. Surplus notes should be accounted for as debt instruments and presented as liabilities in the financial statements of the issuer. Equity treatment for surplus notes is inappropriate. This Practice Bulletin does not establish new guidance for accounting for debt instruments by the issuer.

8. Consistent with paragraph 16 of FASB Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, a debtor shall derecognize a surplus note if and only if it has been extinguished. According to paragraph 16 of FASB Statement No. 125,<sup>2</sup> a liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

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<sup>2</sup>FASB Statement No. 125 supersedes FASB Statement No. 76, *Extinguishment of Debt*.

- b. The debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. *(Footnote omitted)*

### **Accrual of Interest**

9. Interest should be accrued over the life of the surplus note, irrespective of the approval of interest and principal payments by the insurance commissioner, and recognized as an expense in the same manner as other debt.

### **Disclosure**

10. Issuers of surplus notes should comply with existing disclosure requirements for debt instruments. In addition, disclosure is required regarding the commissioner's role and ability to approve or disapprove any interest and principal payments.

### **Effective Date and Transition**

11. This Practice Bulletin is effective for financial statements for fiscal years beginning after December 15, 1995. The effect of initially applying this Practice Bulletin shall be reported retroactively through restatement of all previously issued financial statements presented for comparative purposes. The cumulative effect of adopting this Practice Bulletin, including the accrual of interest, if any, shall be included in the earliest year restated.

**The provisions of this Practice Bulletin need not be applied to immaterial items.**

### **Basis for Conclusions**

12. This section discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this Practice Bulletin. It includes reasons for accepting certain views and rejecting others.



### ***Balance-Sheet Classification of Outstanding Surplus Notes***

13. AcSEC considered the characteristics of surplus notes and deemed them liabilities in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*.

14. FASB Concepts Statement No. 6 defines both liabilities and equity and describes their essential characteristics. Paragraph 35 of the Concepts Statement defines liabilities as “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.”

15. Paragraph 36 of FASB Concepts Statement No. 6 describes the following three essential characteristics of a liability.

(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.

16. Surplus notes represent a present duty to the holders of the notes that entails settlement by probable future transfers of cash. The future transfers of cash are normally on specified dates, subject to the approval of the commissioner. If the commissioner does not grant approval for payment on a specified date, the future transfer of cash takes place on occurrence of a specified event, which is the ultimate approval of the commissioner. Therefore, surplus notes meet the first characteristic of a liability. In addition, AcSEC observed that declaration of bankruptcy by an enterprise and the role of the court in determining when and in what amounts an obligation will be settled do not affect whether the debt instrument continues to qualify as a liability.

17. Should the commissioner not grant approval for an interest or principal payment, the issuer cannot make the payment and the holders of the notes have no recourse. The commissioner will grant approval only if it is consistent with his or her responsibility and objective to maintain the solvency and financial stability of the insurer. Although the commissioner has discretion, AcSEC concluded that the commissioner is not part of the organization. The discretion described in FASB Concepts Statement No. 6 is not delegable outside the enterprise. The entity has little or no discretion to avoid the future sacrifice and thus surplus notes do meet the second characteristic of a liability.

18. AcSEC concluded that the previous transfer of cash to enterprises from the noteholder in return for the issuance of the surplus note is the event needed to obligate the entity and therefore surplus notes meet the third characteristic of a liability.

19. Equity of a business enterprise is defined in paragraph 60 of FASB Concepts Statement No. 6 simply as a residual interest — the difference between an enterprise's assets and its liabilities. Equity of a business enterprise stems from ownership rights or the equivalent, and it involves a relationship between an enterprise and its owners as owners rather than as employees, suppliers, lenders, or in other nonowner roles.

20. FASB Concepts Statement No. 6 explains that the essential characteristics of equity center on the conditions for transferring enterprise assets to the holders of equity interests. Distributions to owners are at the discretion and volition of the owners or their representatives after satisfying restrictions imposed by law, regulation, or agreements with other entities. In most circumstances, an enterprise is not obligated to transfer assets to owners except in the event of the enterprise's liquidation unless it formally acts to do so, such as by declaring a dividend. An enterprise's liabilities and equity are mutually exclusive claims to or

interests in its assets by other entities, and liabilities take precedence over ownership interests.

21. Surplus note payments require the approval of the commissioner. The commissioner's responsibilities and objectives include maintaining the solvency and financial stability of the insurer. AcSEC concluded that although the commissioner has the ability to restrict payments of interest and principal, the issuer continues to have the obligation even though the timing may be uncertain. Actions by the commissioner do not formally discharge the issuer's obligation to pay the principal or interest. Therefore, the characteristics of surplus notes are not consistent with the characteristics of equity as described in FASB Concepts Statement No. 6.

### ***Surplus Notes — Statutory Basis***

22. Statutory accounting practices for surplus notes generally are consistent among all the states. Once approved by the commissioner, these instruments are classified as surplus on the balance sheet. Interest is reported as an expense and a liability only after payment has been approved by the commissioner. Interest that has not yet been approved for payment is not accrued as an expense and liability but rather disclosed in the notes to the financial statements. AcSEC observed that the objectives of regulatory accounting requirements are not always consistent with GAAP, and differences in accounting for other transactions currently exist.

### ***Other Instruments With Similar Characteristics***

23. AcSEC considered other instruments with similar characteristics to surplus notes. Subordinated liabilities of broker/dealers, mandatorily redeemable preferred stock, and hybrid preferred securities such as monthly/quarterly income preferred stock (MIPS/QUIPS) have characteristics of both liabilities and equity and are generally presented on the balance sheet as a separate component between liabilities and equity.

### *Subordinated Liabilities of Broker/Dealers*

24. Insurance enterprise surplus notes have many of the same characteristics as subordinated liabilities of brokers and dealers in securities. Both kinds of instruments qualify as capital for regulatory purposes, are subordinated to all other claims except those of owners, and require regulatory approval or meeting of prescribed regulatory conditions before repayment. The revised AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* does not permit reporting combined subordinated liabilities with stockholders' equity in the statement of financial condition, which was acceptable under the superseded guide. The superseded presentation was believed to be misleading because it implied that subordinated liabilities are a component of stockholders' equity, unencumbered by the right of the creditor to be repaid. Liabilities frequently have repayment limitations of one sort or another, but nevertheless remain liabilities. AcSEC concluded that accounting for surplus notes as a liability is consistent with the accounting for subordinated liabilities of brokers and dealers.

### *Mandatorily Redeemable Preferred Stocks and Hybrid Preferred Securities*

25. Surplus notes and mandatorily redeemable preferred stocks are similar in that both are subordinated to other claims and because of the terms of the redemption as prescribed by the instrument; once issued, redemption is outside the control of the issuer. AcSEC concluded that although practice is to show mandatorily redeemable preferred stock in a separate category between liabilities and equity, to treat surplus notes in the same manner would be inappropriate. AcSEC was not persuaded that surplus notes, an instrument that meets all the characteristics of a liability, should be required or permitted to be displayed other than as a liability.

26. Hybrid preferred securities such as monthly and quarterly income preferred securities (MIPS/QUIPS) are securities issued by a special-purpose entity that lends the proceeds to its controlling company. AcSEC concluded

that although the practice is to show hybrid preferred securities in a separate category between liabilities and equity, to treat surplus notes in the same manner would be inappropriate. AcSEC concluded that surplus notes meet all of the characteristics of a liability and to record surplus notes in a separate category between liabilities and equity outside of liabilities would not provide users with as relevant information.

### ***Income Statement Presentation***

27. Because surplus notes are presented on the balance sheet as liabilities, interest payments on surplus notes should be recorded as interest expense through operations. This treatment is consistent with current accounting practice for interest expense on debt.

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