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Accounting Standards Update for Captive Insurance Companies

April 2019

ASU 2016-01: Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities

Background

The new accounting pronouncement (ASU 2016-01) comes into effect for entities with annual reporting periods beginning after December 15, 2018 and brings forth a number of changes affecting entities that record their equity investments as 'available-for-sale'. The guidance is extensive, and this bulletin serves to highlight those pertinent matters applicable to the captive insurance sector.

Currently, captive insurance companies may classify their equity securities as 'available-for-sale' and changes to unrealized gains and losses are recorded in accumulated other comprehensive income ("AOCI") within Shareholders' Equity on the balance sheet. When an investment is sold, the realized gain or loss is then reclassified out of AOCI and into net income. The new guidance removes the 'available-for-sale' classification for equity securities and all unrealized and realized gains and losses are to be recognized through net income.

In addition to changes in presentation, the amendments could significantly increase earnings volatility for some captives, especially those that hold significant investments in available-for-sale equity securities. There may be other options available depending on the captive's circumstances and we encourage these discussions to be held now to remain proactive ahead of next year's audit.

Adoption requirements

The guidance in ASU 2016-01 should be applied as a 'cumulative effect' adjustment to the opening balance sheet of the fiscal year of adoption, with a corresponding adjustment to the opening balance of the retained earnings.

In addition, the following disclosures are required:

- The nature and reason for the change in accounting principle, including an explanation of the newly adopted accounting principle.
- The method of applying the change.
- The effect of the adoption on any line item in the balance sheet, if material, as of the beginning of the fiscal year; however, presentation of the effect on financial statement subtotals is not required.
- The cumulative effect of the change on retained earnings or other components of shareholders' equity in the balance sheet as of the beginning of the fiscal year.
- If the prior-year amounts disclosed for comparative purposes are no longer comparable because of measuring the fair value of financial instruments under ASC 820, the new guidance requires an entity to disclose this fact in conformity with the guidance in ASC 205-10.

Summary of main disclosures

- The guidance in ASU 2016-01 removes the requirement to classify equity securities into different categories (i.e. trading or available-for-sale).
- All equity securities are to be measured at fair value with changes in fair value (realized or unrealized) recognized through net income. There are a few exceptions to this rule, such as those accounted for under the equity method or equity investments that require the investor to consolidate the investee.
- The guidance introduces some changes in disclosures. Financial assets and liabilities are to be presented separately, grouped by measurement category (i.e. cost; fair value through net income; and fair value through OCI) and form (i.e. securities or loans and receivables) either on the balance sheet or in the accompanying notes to the financial statements.
- The guidance requires an entity to disaggregate the net gains and losses on equity securities recognized in the income statement into realized and unrealized gains and losses.
- There may be an impact to the statement of cash flows under the indirect method where the entity will need to adjust net income for changes in the fair value of equity securities reflected in net income to determine cash flows from operating activities.
- There are no changes to the previous classification and measurement guidance for debt securities and such may continue to be held-to-maturity, trading or available-for-sale. If they are to be classified as available-for-sale, unrealized gains and losses will continue to be recognized in other comprehensive income.
- For non-public entities, the guidance removes a past requirement for disclosing the fair value of financial instruments measured at amortized cost. Examples include debt securities, notes payables and receivables.

Where to find further disclosure guidance and examples

The complete update, as published by the Financial Accounting Standards Board (FASB), can be found by following the link below:

https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167762170&acceptedDisclaimer=true

Effective dates

Non-public entities: annual periods beginning after December 15, 2018.

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