

Financial Services

Captive Accounting & Auditing Update — US GAAP Developments

Bermuda

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Alert number: 08-04

Statement of Financial Accounting Standards No. 157 – Fair Value Measurements

FAS 157 – Fair Value Measurement (“FAS 157”)

FAS 157 was created to standardise the definition of fair value under US GAAP which had previously been covered over several unrelated standards, none of which were particularly specific in the application of fair value principles.

The Standard not only covers the application of fair value but it also highlights the responsibility of management in its application for all financial assets and liabilities.

Depending upon the nature of the underlying investments and the availability of regular quoted market prices, the Standard will not necessarily result in the restatement of fair value amounts where management had previously taken values directly from statements provided by custodians, managers or pricing sources. It will, however, require disclosure of how management is comfortable with the fact that these sources and the values recorded are appropriate.

Further disclosure is also required with regard to the degree of certainty that management has over whether the carrying value is an appropriate representation of the exit price for that financial asset or liability. To differentiate between the varying degrees of certainty, the Standard identifies three Levels covering securities with a ready market (Level 1) to securities which may have a specific or illiquid market (Level 3).

Effective date:

- FAS 157 is effective for all fiscal years beginning on or after November 15, 2007, with prospective application.

Key changes:

- Definition of a fair value – change in focus from an “*entry*” price to an “*exit*” price i.e. how much would be received to sell the asset or paid to transfer the liability instead of how much would be paid to acquire an asset or received to assume a liability?
- Fair value measurement – the Standard prescribes the use of one or more of three acceptable valuation techniques (noted below).
- Hierarchy – assets and liabilities carried at fair value have to be classified and disclosed in one of three Levels (1, 2 or 3), with additional disclosure required for Level 3 (the most complex) items.
- Disclosures – move from generic fair value disclosures with little transparency of approach to an established hierarchy with required disclosures.

Captive context:

The key changes noted above will impact captive insurance companies reporting under US GAAP that hold financial assets and liabilities at fair value. Management will have to consider the inputs used to value the financial assets and liabilities and the disclosures made in the financial statements in respect of these, including position within the fair value hierarchy.

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Most likely the principal impact will be on the *valuation and disclosure around investments*. Depending on the complexity of the investment portfolio, the amount of work required by management to arrive at fair value may be substantially increased. Management will also need to provide support for the classification of financial assets and liabilities into the hierarchy noted on page 1 (under “Key Changes”).

However, since in most instances the value of financial assets and liabilities is unlikely to change upon adoption of the Standard and the disclosure requirement is specific to US GAAP, we expect that this standard will have little to no impact on the Statutory Financial Statements and Returns filed by Bermuda based captives.

Typical securities held by captive insurance companies:

- Cash only – no FAS 157 impact.
- Cash equivalents and short-term deposits at amortised cost:
 - if within the scope of FAS 115 (i.e. held at fair value), they are subject to FAS 157; and
 - if outside the scope of FAS 115 (i.e. not held at fair value), no FAS 157 impact.
- Fixed income securities, equities (quoted / unquoted) and funds (for example, liquid reserve funds, alternative investments, etc) – subject to FAS 157.

Fair value definition and basis for valuation:

Fair value is defined in the Standard as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.

The Standard sets out three accepted valuation methodologies:

1. Market approach – prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities i.e. observable prices.
2. Income approach – valuation techniques used to convert future amounts (e.g. cash flows or earnings) to a single present amount (discounted), based on values indicated by current market expectations.
3. Cost approach – current replacement cost, adjusted for obsolescence.

Fair value hierarchy:

The fair value hierarchy prioritises the inputs used to measure fair value into three broad Levels (Levels 1, 2 and 3), moving from quoted prices in active markets in Level 1 to unobservable inputs in Level 3.

Level 1 inputs – observable, quoted prices for identical assets or liabilities in active markets.

Examples include US government and agency securities, foreign government debt, listed equities and money market securities.

Level 2 inputs – quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets in markets that are not active; and inputs other than quoted prices e.g. interest rates and yield curves.

Examples include corporate bonds (investment grade, high yield), mortgage-backed securities, bank loans, loan commitments, less liquid listed equities, municipal bonds and certain OTC derivatives.

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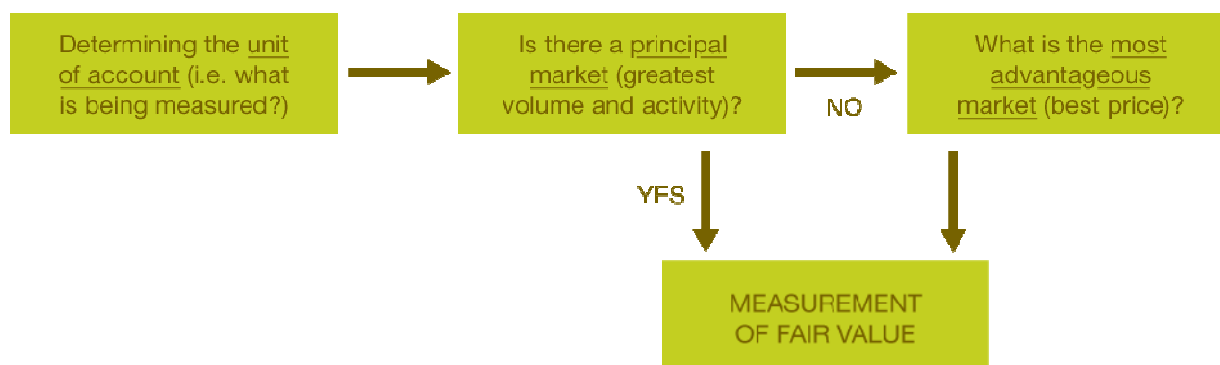
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Level 3 inputs – unobservable inputs for the asset or liability. These should be based on the best information available. The company should utilise all reasonably available information, but need not incur excessive cost or effort to do so. However, it should not ignore information that can be obtained without undue cost and effort. As such, the reporting entity's own data should be adjusted if information is reasonably available without undue cost and effort.

Examples include distressed debt, private equity, exotic or non-standard derivatives.

How are the new fair value requirements applied?



Principal market – the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability.

Most advantageous market – the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective markets.

All fair value measurements assume the **highest and best use** of the asset by market participants.

The Standard also makes specific reference to the use of **blockage factors** (use prohibited for Level 1 inputs, but not for Level 2 or 3 inputs) and **bid-ask prices** (the price within the spread that is most representative of fair value in the circumstances should be used to measure fair value).

Disclosure requirements:

For assets and liabilities measured at a fair value on a recurring basis, the reporting entity must disclose the following information:

- The fair value measurement at the reporting date.
- The Level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair Level 1, Level 2 and Level 3 (see below).
- For Level 3 measurements, a reconciliation (see example below) of the beginning and ending balances, separately presenting changes during the period attributable to the following –
 - Total gains or losses for the period (realised and unrealised), segregating those gains or losses included in earnings (or changes in net assets) and a description of where those gain or losses included in earnings are reported in the Standard of income;
 - Purchases, sales, issuances and settlements (net); and
 - Transfers in and / or out of Level 3 (e.g. transfers due to changes in the observability of significant inputs).

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- The amount of the total unrealised gains or losses in the Level 3 roll-forward that were included in earnings relating to assets and liabilities still held at the reporting date and a description of the amounts.
- The valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques, if any, during the period.

Illustrative disclosures:

Example analysis of the Company's investments – disclosure by Level of input

	Level 1 \$	Level 2 \$	Level 3 \$	Total \$
Fixed maturities	100	500	1,000	1,600
Equities	100	1,000	250	1,350
Mutual funds	200	750	100	1,050
Cash equivalents	500	100	0	600
Total investments at fair value	900	2,350	1,350	4,600

Example of the Company's Level 3 Roll-Forward –

	Level 3		
	Derivatives	Venture Capital Investments	Total
Beginning balance	\$ 14	\$ 11	\$ 25
Total gains or losses (realised / unrealised)			
- Included in earnings	11	(3)	8
- Included in other comprehensive income	4	-	4
Purchases, issuances and settlements	(7)	2	(5)
Transfers in and / or out of Level 3	(2)	-	(2)
Ending balance	20	10	30

The amount of total gains or losses for the period included in earnings attributable to the change in unrealised gains or losses relating to assets still held at the reporting date

\$ 7	\$ 2	\$ 9
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(Note - for liabilities, a similar table should be presented)

Total gains or losses included in earnings for the period (above)
Change in unrealised gains or losses relating to assets still held at reporting date

Trading Revenues	Other Revenues
\$ 11	\$ (3)
\$ 7	\$ 2

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