

Statutory Issue Paper No. 20

Gain Contingencies

STATUS

Finalized March 16, 1998

Original SSAP: SSAP No. 5; Current Authoritative Guidance: SSAP No. 5R

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not address accounting for gain contingencies. GAAP requires contingencies that may result in gains to be disclosed but not recorded in current year income.
2. This issue paper establishes the statutory accounting for gain contingencies that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For purposes of applying this statutory accounting principle, a “gain” shall be defined as an increase in surplus (net assets) which results from peripheral or incidental transactions of a reporting entity and from all other transactions and other events and circumstances affecting the reporting entity except those that result from revenues or investments by owners. If, on or before the balance sheet date, (a) the transaction or event has been fully completed, and (b) the amount of the gain is determinable, then the transaction or event is considered a gain, and is recognized in the financial statements. This definition excludes increases in surplus that result from activities that constitute a reporting entity’s ongoing major or central operations or activities. Because investment activities are central to an insurer’s operations, increases in surplus that result from such investment activities are excluded from the definition of gains. Revenues are inflows or other enhancements of assets of a reporting entity or settlements of its liabilities (or a combination of both) from providing products, rendering services, or other activities that constitute the reporting entity’s ongoing major or central operations. Investments by owners include any type of capital infused into the surplus of the reporting entity.
4. A “gain contingency” shall be defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible “gain” (as defined in the preceding paragraph) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur (e.g., a plaintiff has filed suit for damages associated with an event occurring prior to the balance sheet, but the outcome of the suit is not known as of the balance sheet date). Gain contingencies shall not be recognized in a reporting entity’s financial statements. However, if subsequent to the balance sheet date but prior to the issuance of the financial statements, the gain contingency is realized, the gain shall be disclosed in the notes to financial statements and the unissued financial statements should not be adjusted to record the gain. A gain is generally considered realizable when noncash resources or rights are readily convertible to known amounts of cash or claims to cash.
5. Gain contingencies shall not be recorded in a reporting entity’s financial statements. The notes to the financial statements shall contain adequate disclosure about the nature of the gain contingency. However, care should be exercised to avoid misleading implications as to the likelihood of realization.

DISCUSSION

6. This issue paper adopts paragraph 17 of *FASB Statement No. 5, Accounting for Contingencies* (FAS 5), which provides guidance with respect to the accounting and reporting of gain contingencies.

7. The definition of a “gain,” as stated in paragraph 3 above, is consistent with that of *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements* (CON 6). This definition of gains excludes investment activities of insurance companies.

8. Disclosure in a note to the financial statements but not recording a gain contingency is consistent with the conservatism and recognition concepts included in the Statement of Concepts. In addition, it prevents the recognition of transactions before the earnings process is completed (as prescribed in the recognition concept in the Statement of Concepts).

Drafting Notes/Comments

- Accounting for loss contingencies is addressed in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Revenue recognition issues are addressed in separate issue papers
- Income taxes are addressed in a separate issue paper
- Reinsurance agreements are addressed in a separate issue paper

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

9. As noted above, current statutory guidance does not address gain contingencies. However, the conservatism and recognition concepts of the Statement of Concepts provide guidance which can be applied to the accounting treatment of gain contingencies. The conservatism concept of the Statement of Concepts states the following:

To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting. Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results.

10. The recognition concept of the Statement of Concepts states that “*Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed.*”

Generally Accepted Accounting Principles

11. *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements* (CON 6), paragraphs 78 and 82, defines revenues and gains as follows:

Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

12. Additionally, paragraph 88 states the following:

Items that are revenues for one kind of entity may be gains for another, and items that are expenses for one kind of entity may be losses for another. For example, investments in securities

that may be sources of revenues and expenses for insurance or investment companies may be sources of gains and losses in manufacturing or merchandising companies.

13. GAAP literature addresses accounting for gain contingencies in both general terms and in the event of gain contingencies which result from specific accounting treatments required by GAAP. FAS 5 provides general guidance for the treatment of gain contingencies. FAS 5, paragraph 17, states the following:

Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

14. Examples of GAAP literature which require a conservative treatment of gain recognition in specific accounting situations include:

1. *FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, paragraph 14, which requires gains due to the curtailment of all or a portion of a defined benefit pension plan to be recognized in income only when the related employee terminations occur, as opposed to curtailment losses which must be recognized in income when it is probable that the curtailment will occur and the effects are reasonably estimable.
2. *Accounting Principles Board Opinion No. 30, Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, paragraph 15, which requires gains from the disposal of a segment of a business to be recognized in income at the actual disposal date, as opposed to losses from the disposal of a segment of a business which must be recognized in income at the measurement date (i.e. the date at which management commits to a formal plan to dispose the segment).

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

Generally Accepted Accounting Principles

- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*
- *Accounting Principles Board Opinion No. 30, Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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