Adding value to captives

David Liptz of Liptz & Associates explains the questions that businesses should be asking their auditors and considers the accounting standards they are up against to ensure compliance

Complying with regulatory measures, which are often complex and multi-faceted, can be a time-consuming and costly process. It can often be the case that beginning the compliance process throws up more questions than it answers, and if directors, CFOs and CPAs cannot find satisfactory responses they run the risk of experiencing problems later on. This article looks to resolve any issues involved in complying with three key pronouncements in the captives industry: FIN 46R, FAS 157 and FIN 48.

With businesses looking for captive arrangements to add value to their offerings, many are contemplating a Variable Interest Entity (VIE), formerly known as a 'special purpose entity'.

First, it is important to assess your captive's structure, looking over the entity as a whole, as a starting point to consider the following questions.

Is your captive insurance arrangement considered an off-balance sheet financing arrangement?
Captive arrangements are usually started when a business seeks an alternative insurance financing and risk arrangement, and could be considered an off-balance sheet financing arrangement.

Does your captive need to be consolidated into the financial statements of your parent or brother/ sister entity?
You may want your captive to be considered a VIE and consolidate it into your financial statements report as it will more than likely add value to your equity section.

What is a VIE, and does your captive qualify?
A VIE is an entity that is created via ownership interests other than through voting stock. It is an entity that is not self-supportive, in that it cannot finance its activities without financial support from another entity or individual. You and your accountant must perform both qualitative and quantitative procedures when determining if your captive is a VIE.

Is your captive thinly capitalised?
This is defined as a captive, which is not able to fund its activities without the financial support of another entity, for example, the payment of premiums, or if the reserves confidence level is too low to absorb a claim, the remaining funds will need to be sourced from the insured to pay for the loss (the parent).

It is also important to establish whether the total risk of the equity investment in the potential VIE is sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties. When addressing this issue it is essential to consider the following questions:

- Has the entity obtained debt financing without any guarantees?
- Was the original equity from sources outside of the reporting entity?
- Is all financing provided to the entity from unrelated parties?
- Is the equity investment at risk, measured on a fair value basis, more than 10%?

David B. Liptz, CPA, has over 20 years' experience working with captive insurance companies and over 15 years of auditing captive insurance companies. Mr Liptz regularly speaks, consults and discusses captive insurance tax and audit issues with other CPA's that specialise in the captive industry.

> "Banks and investors that invest or loan money to your company will be extremely interested if you have a Variable Interest Entity"

Investor interest

Banks and investors that invest or loan money to your company will be extremely interested if you have a VIE, and will need to include your captive in the consolidated financial statements. FIN 46R's provisions are particularly complex and require thorough analysis by your CPA. A company unable to obtain bank financing without

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an affiliate guaranteeing its bank loan for example qualifies as a VIE under FIN 46R, and must be consolidated. Alternatively, the shareholders and/or directors of the captive are related to the insureds.

Under Generally Accepted Accounting Principles (GAAP), a company must consolidate any entity in which it has a 'controlling interest', which is now defined as:

- The voting-interest model, where the investor owning more than 50% of an entity's voting interests consolidates the investee's operation; and
- The risk and reward model, where the party that participates in the majority of the entity's economic impact consolidates such operations. This party could be an equity investor, other capital provider, or a party with contractual arrangements. A VIE is subject to the risk and rewards model.

Many questions are being raised by directors, CFOs and CPAs, such as:

- Should you consolidate your captive into the financial statements of the parent or insured's?
- What happens if you don't consolidate your captive into your financial statements report?
- Will the readers of the financial statements understand the insurance/captive arrangement and structure?,
- Does your captive have independent management or employees?,
- Are administrative functions performed by any related parties?

The answers to these questions and the analysis of the above criteria will more than likely generate further questions and concerns for you, the directors, regulators and CPAs.

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FAS 157

Another accounting standard that is creating concern is FAS 157, 'Fair Value Measurements'. This standard defines fair value, ways to measure fair value and the expanded disclosures that you are required to comply with.

Fair value is defined as the price an asset or liability would be exchanged for in a transaction between market participants in the market in which the reporting entity would transact to sell the asset or transfer the liability. The definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an 'exit' price), not the price that would be paid to acquire the asset or received to assume the liability (an 'entry' price).

Where can you find entry and exit prices?

If the asset or liability is one that is listed on a publicly listed exchange, determining the exit price is relatively straight forward, and is referred to as a 'level 1' item. But, if the asset or liability is referred to as a 'level 2' or 'level 3' item, the Financial Accounting Standards Board (FASB) has provided a litany of regulations to be used to determine the exit price. "As you move through their procedures, you are required to include assumptions about inherent risk in the valuation technique used and the inherent risks in the inputs to the valuation technique." The statement continues to explain the expanded requirements regarding disclosure in the financial statement, the inputs utilised to measure the assets and liabilities in interim and annual financial statements periods subsequent to the initial recognition (exit) price.

FIN 48

The last accounting standard that we want to discuss is FIN 48, Accounting for Uncertainty in Income Taxes. The accounting and reporting requirements of FIN 48 involve a two-step process that may result in a larger income tax liability, a smaller deferred tax asset, or a smaller income tax refund. Also, to add to the increased compliance requirements, your CPA, who prepares the captive's income tax return, needs to be familiar with the new income tax form UTP that is now required to be attached to forms 1120PC and 1120L under several sets of circumstances. These include: first, if the corporation has assets in excess of $100m, and second if the corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year and the corporation has one or more tax positions that must be reported on Schedule UTP.

The FASB issued FIN 48 to bring consistency in the reporting of income tax assets and liabilities, and as a mechanism to provide greater transparency for uncertain tax positions to reform financial reporting of tax issues. Of course, the requirements as written are very difficult to understand and thus could have a significant impact on audited financial statements for large and small organisations.

These three pronouncements; FIN 46R, FAS 157 and FIN 48, are intended to assure the reader that financial statements are consistently reported and that the information on the reported entity is as transparent as possible. Businesses need to ensure that they keep up to date with the regulatory changes regarding captives as the requirements have a direct impact on their own arrangements. As shown in this article, the most important players in this market are the auditors, who need to be proactive in addressing these issues and flagging up potential problems.

LIPTZ & ASSOCIATES

Mr Liptz has extensive experience in the audit and review of businesses, preparation of audits, reviews and compilation of business financial records.

In October 1995, Mr Liptz began a private certified public accounting practice. He continued to audit captive insurance companies.

In addition to performing financial audits of captive insurance companies, he performed internal control reviews, collateral reviews, due diligence reviews and operational reviews.

Mr Liptz continued to audit captive insurance companies and prepare the compliance requirements that the companies have. His niche in the market became focused on the small captive insurance company.

Mr Liptz and Liptz & Associates are currently approved auditors in the following jurisdictions: British Virgin Islands, Bahamas, Nevis, Anguilla, Puerto Rico, Hawaii, Utah, Nevada, Arizona, Montana, Kentucky, District of Columbia and Delaware for over 200 captive insurance companies.