



Viva la captives!

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A Deep Dive into the 4 C's - Captives, Control, Consolidation, and Changes

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Learning Objectives

Learning Objective 1: An understanding of the impact on the insured/owner/affiliate financial statements depending on the legal structure, control, captive type, collateral, and ownership

Learning Objective 2: Understand conversation topics to have with prospective captive owners regarding the operating company financial statements and tax returns, consolidate, not to consolidate, discussion of Variable Interest Entities

Learning Objective 3: How the legal documents affect the financial statement treatment at the insured level

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Background

At conferences, we talk a lot about accounting, reinsurance, legal docs, collateral, at the captive level

Today we are focusing on the Parent/Affiliate/Insured

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Accounting Background

- Consolidation: ASC 810: This means you eliminate transactions between the Parent and the Subsidiary/Affiliate
 - Control can be exercised or there is common ownership, or a Parent/Subsidiary Relationship
 - Sometime even when the Parent owns less than 50%,
 - The tests for consolidation are very intense in determining whether the captive is a variable interest entity

Boring

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Accounting Background

- Equity Method: ASC 323: No eliminations
 - You record the investment as an investment and for the most part record the net income or loss pro-rata of the subsidiary/affiliate as a component of net income, and adjust to fair value
- Expedient Alternative: ASC 810-35-59
 - You record the pro-rata portion of Net Asset Value, which would differ from a fair value in most cases

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All about the Control

Segregated Account/Protected Cell: Many Domiciles

- The “owner” owns part of the captive sponsor, and “rents” for a fee capital, license and underwriting infrastructure
- Essentially there is an investment in the sponsor
- Two typical agreements
 - Operating/Series/Shareholder/Participation Agreement: outlines the rights of the captive sponsor and the “owner” to lay out terms and responsibilities of the parties when dividends may be paid and posting of collateral: what constitutes control over the cell?
 - Insurance Policy
 - Reinsurance Agreement/Pooling: business covered or assumed by the cell
- Can be virtually no control since the investment is in the captive sponsor, and entitlement to stuff can be limited, 20 equal participants = 5% ownership

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Scenario for Cat Videos R Us

- Invested asset \$25,000 into Captive Sponsor
- Results of the Captive Operations= \$100,000 profit
- Collateral posting direct to Fronting carrier or Flowing through the Captive: in this scenario we are assuming it is direct to the front



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Segregated
Cell No
Control

CAT VIDEOS ARE US				
Balance Sheets				
December 31, 2021				
	Operating Co.			Captive
	2021			2021
ASSETS				
Current assets:				
Cash	\$ 10,000,000			\$ 1,325,000
Accounts receivable (net)	5,000,000			-
Prepaid insurance	1,000,000			-
Total current assets	16,000,000			1,325,000
Property and equipment:				
Equipment	10,000,000			-
Leasehold improvements	1,000,000			-
	11,000,000			-
Less, accumulated depreciation	3,000,000			-
Total property and equipment	8,000,000			-
Other assets:				
Investment into captive sponsor	125,000			-
Collateral Posted	1,000,000			1,000,000
	1,125,000			1,000,000
Total assets	\$ 25,125,000			\$ 2,325,000

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Segregated
Cell No
Control

LIABILITIES AND STOCKHOLDER'S EQUITY			
Current liabilities:	Operating		Captive
Accounts payable	\$ 100,000		\$
Loss reserves	-		200,00
Unearned Premium	-		1,000,00
Collateral obligation			1,000,00
Total current liabilities	100,000		2,200,00
Stockholder's equity:			
Capital stock	1,000,000		25,00
Retained earnings	24,025,000		100,00
Total stockholder's equity	25,025,000		125,00
Total liabilities and stockholder's equity	\$ 25,125,000		2,325,00

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Segregated
Cell No
Control

CAT VIDEOS ARE US			
Statements of Income			
December 31, 2021			
	Operating Co.		Captive
Net sales/ Premiums Earned	\$ 30,000,000		\$ 1,000,000
Losses			800,000
Cost of sales and service	15,000,000		
Gross profit/Underwriting profit	15,000,000		200,000
Operating expenses:			
Insurance premiums	1,000,000		-
Captive Management			100,000
Kevin's shoe allowance	500,000		-
Nate's Flamingo outfits	200,000		-
Sandra's Travel	200,000		-
Leon's Flip Flops	100,000		-
Total operating expenses	2,000,000		100,000
Income from operations	13,000,000		100,000
Other income (expense):			
Change in NAV of Segregated Cell	100,000		-
	100,000		-
Net income for the year	\$ 13,100,000		\$ 100,000

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All about the Control

- Incorporated Cells, Series LLCs, and Single Parents: Many domiciles
- Variable Interest Entity?
- Collateral is still required, if there is a fronting carrier the structure can be different which changes items on the balance sheet
- Likely Consolidate!!

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CAT VIDEOS ARE US						
Balance Sheets						
December 31, 2021						
	Operating Co.	Captive	Combined	Eliminated	Consolidated	
	2021	2021	2021	2021	2021	
ASSETS						
Current assets:						
Cash	\$ 10,000,000	\$ 1,325,000	\$ 11,325,000			\$ 11,325,000
Accounts receivable (net)	5,000,000	-	5,000,000			5,000,000
Investment into Captive Insurer	125,000		125,000	(125,000)		-
Prepaid insurance	1,000,000		1,000,000	(1,000,000)		-
Total current assets	16,125,000	1,325,000	17,450,000			16,325,000
Property and equipment:						
Equipment	10,000,000	-	10,000,000			10,000,000
Leasehold improvements	1,000,000	-	1,000,000			1,000,000
	11,000,000	-	11,000,000			11,000,000
Less, accumulated depreciation	3,000,000	-	3,000,000			3,000,000
Total property and equipment	8,000,000	-	8,000,000			8,000,000
Other assets:						
			-			-
Collateral Posted	1,000,000	1,000,000	2,000,000	(1,000,000)		1,000,000
	1,000,000	1,000,000	2,000,000			1,000,000
Total assets	\$ 25,125,000	\$ 2,325,000	\$ 27,450,000			\$ 25,325,000

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LIABILITIES AND STOCKHOLDER'S EQUITY					
	Operating Co.	Captive	Combined	Eliminated	Consolidated
Current liabilities:					
Accounts payable	\$ 100,000	\$ -	\$ 100,000		\$ 100,000
Loss reserves	-	200,000	200,000		200,000
Unearned Premium	-	1,000,000	1,000,000	1,000,000	-
Collateral obligation	-	1,000,000	1,000,000	1,000,000	-
Total current liabilities	100,000	2,200,000	2,300,000		300,000
Stockholder's equity:					
Capital stock	1,000,000	25,000	1,025,000	25,000	1,000,000
Retained earnings	24,025,000	100,000	24,125,000	100,000	24,025,000
Total stockholder's equity	25,025,000	125,000	25,150,000		25,025,000
Total liabilities and stockholder's equity	\$ 25,125,000	\$ 2,325,000	27,450,000		25,325,000

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CAT VIDEOS ARE US					
Statements of Income					
December 31, 2021					
	Operating 2021	Captive 2021	Combined	Eliminated	Consolidated
Net sales/ Premiums Earned	\$ 30,000,000	\$ 1,000,000	\$ 31,000,000	\$ 1,000,000	\$ 30,000,000
Losses		800,000	800,000	(800,000)	-
Cost of sales and service	15,000,000	-	15,000,000		15,000,000
	15,000,000	800,000	15,800,000		15,000,000
Gross profit/Underwriting profit	15,000,000	200,000	15,200,000		15,000,000
Operating expenses:					
Insurance premiums	1,000,000	-	1,000,000	1,000,000	-
Insurance related losses				800,000	800,000
Captive Management		100,000	100,000		100,000
Kevin's Music allowance	500,000	-	500,000		500,000
Nate's Flamingo outfits	200,000		200,000		200,000
Sandra's Travel	200,000		200,000		200,000
Leon's Flip Flops	100,000		100,000		100,000
Total operating expenses	2,000,000	100,000	2,100,000		1,900,000
Income from operations	13,000,000	100,000	13,100,000		13,100,000
Other income (expense):					
Change in NAV of Segregated Cell	100,000	-	100,000	100,000	-
	100,000	-	100,000		-
Net income for the year	\$ 13,100,000	\$ 100,000	\$ 13,200,000		\$ 13,100,000

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Risk Retention Groups

- There is likely no element of control, but a RRG has multiple options, stock, mutual, or LLC Company basis
- In a RRG each “insurance payment” has a component of capital contribution and insurance premium?



- Depending on the Insurance and Capital Contribution Agreement and the ability to redeem shares and at what price determines how it is treated
- If redeemable, it could be at cost, or at the pro-rata share at exit time
- Many times in larger RRGs the capital contribution is not redeemable therefore it cannot be included as an asset

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Risk Retention Groups

- If the capital contribution and any accumulated earnings is redeemable at exit?
 - The capital contribution portion along with the pro-rata share of accumulated earnings would be considered an asset
 - If the capital contribution and share of accumulated earnings was paid out over time, the asset would likely need to be discounted using the insured cost of capital rate or incremental borrowing rate



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Group Captives

- You have some control: when dealing with the typical “A” Fund “B” Fund, where the “A” Fund is all of your captive’s risk and the “B” Fund is where you are sharing risks with a group, with Agg and Umbrella coverage above those layers.
- In a Group Captive you initial fund your captive’s capital, and fund collateral
- Depending on the Collateral/Capital Contribution Agreement and the ability to redeem shares and at what price determines how it is treated
 - Most likely it is redeemable, but over a period of time as the tail of the “B” Fund expires, so the carrying amount is typically discounted

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What Conversations Need to Be Had?

- What are the outside requirements?
 - Bonding for Construction?
 - Loan Covenants at the Bank?
- What is the financial reporting process?
- Plan, Plan, Plan



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Changes

- What happens if I move from a No Control Situation to a Controlled Situation?
 - You must begin to consolidate, this can illustrate a substantial change in working capital
 - Same for moving from participating in a RRG to a Single Parent
- If you move from a Group Captive to a Single Parent you will likely have an equity pick up as most groups require heavy reserving to protect members

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Questions or Comments?



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