

FASB Emerging Issues Task Force

Issue No. 06-5

Title: Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*

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Previously distributed EITF materials: None

References:

FASB Statement No. 5, *Accounting for Contingencies* (FAS 5)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance* (FTB 85-4)

International Accounting Standard 8, *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8)

AICPA Audit and Accounting Guide, *Life and Health Insurance Entities*

*** The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination.**

Background

1. FTB 85-4 requires that "the amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset." Subsequent to the issuance of FTB 85-4 there has been diversity in calculating "the amount that could be realized." For instance, some contracts provide the policyholder with an amount that upon surrender is greater if all individual policies are surrendered at the same time rather than if the individual policies are surrendered over a period of time. Generally, these types of contracts are either (a) multiple individual policies with a separate, group-level rider agreement, (b) multiple individual policies with a contractual stipulation in each individual policy referencing the other policies as a group, or (c) a group life policy that has multiple certificates (individual life insurance for multiple employees). The amount that can be realized (that is, converted into cash) is dependent on how the contract is assumed to be hypothetically settled and, if surrendered, whether the insurance policies are surrendered at the individual or group level. In evaluating the amount that could be realized under the insurance contract, the ability to consider management's intent was expressly rejected as discussed in paragraphs 9–10 of FTB 85-4. FTB 85-4 takes the view that the policyholder should only consider its current capacity to realize the contract benefits.

Definition of Key Terms

2. In order to facilitate Task Force discussion, the following terms are being defined. These definitions will not be consistent in each and every contract and care should be utilized before relying on any definition contained in this Issue Summary. These definitions will not be included in any final consensus reached by the Task Force.

3. *Interagency Statement*—Refers to the "Interagency Statement on the Purchase and Risk Management of Life Insurance" issued by the FDIC and the other federal bank regulatory agencies in December 2004.

4. *Insurance Policy*—The legal agreement between the policyholder and the insurance company that states the terms of the arrangement. The term *insurance policy* includes all riders, attachments, side agreements, and other related documents that are either directly or indirectly part of the contractual arrangement.

5. *Certificates*—An insurance company issues to each individual in a group contract a "certificate of insurance" for each person insured under the group contract. The certificate is merely a summary of the rights, duties, and benefits available under a group policy. If there is any conflict between the certificate and a group policy, the group policy is the controlling document.

6. *Cash Surrender Value ("CSV")*—The AICPA Audit and Accounting Guide, *Life and Health Insurance Entities*, defines cash surrender value as "The amount of cash that may be realized by the owner of a life insurance contract or annuity contract upon discontinuance and surrender of the contract prior to its maturity." The CSV may be different from the policy account balance due to outstanding loans (including accrued interest) and surrender charges (as defined below).

7. *Claims Stabilization Reserve ("CSR")*—The CSR is established through deductions from the Policy Account Balance (see below) through the cost of insurance charge and is sometimes held in a general account (that is, an account that is intermingled with the insurance company's assets) as opposed to a legally segregated account (sometimes referred to as a separate account). The amounts are accumulated in this account until a death benefit is paid. The death benefit represents a combination of the policy account balance and the CSR based on the contractual terms. The cost of insurance is recalculated periodically based on actual experience of the insured class. Annually the CSR is reviewed and an experience credit may be issued back to the policyholder if the experience has been favorable. The balance in the CSR will be reviewed annually and to the extent the balance is greater than the forecasted or expected amount, an experience refund would get credited to the entity's policy account balance. An entity's CSR will generally be realized through the collection of death benefits or an experience refund that gets credited to the policyholder's policy account balance or upon surrender of the group policy. A CSR is included in a policy as a mechanism for the policyholder and the insurance company to share in the mortality risk, which in this case is the risk that the deaths will occur sooner than originally expected. Absent a CSR, the policyholder's net cost of insurance would typically be higher than in a policy without a CSR. The CSR is sometimes referred to as a "mortality reserve" or a "mortality retention reserve."

8. *Deferred Acquisition Costs ("DAC") Tax*—Section 848 of the Internal Revenue Code requires insurance companies to capitalize certain policy acquisition costs and defer deducting them in determining the insurer's tax liability. This is known as the "DAC tax." The amount is a percentage of the premium received as specified by the Internal Revenue Code and the initial DAC tax is deducted from policyholders' policy account balance when the premium is paid. The DAC tax is credited back to the policyholder's policy account balance as the tax deduction is recognized in the insurer's tax return.

9. *Policy Account Balance*—At any point in time, this is the amount held by the insurance company on behalf of the policyholder. This balance may be held in a general account, separate account (a legally segregated account), or a combination of both on the insurance company's balance sheet. This account includes premiums received from the policyholder plus any credited income less any relevant charges (acquisition costs, cost of insurance, and so forth).

10. *Surrender Charge*—A contractual fee imposed by the insurance company when a policyholder surrenders the insurance policy that typically decreases over the life of the policy. The surrender charge represents a recovery of costs incurred by the insurance company in originating the policy. It may or may not be explicitly called a surrender charge and can be embedded in other agreements besides the insurance contract.

11. Life insurance policies are purchased by entities for a variety of purposes, including funding the cost of providing employee benefits and protecting against the loss of "key persons." These types of policies have generally been known as corporate-owned life insurance (COLI) or bank-owned life insurance (BOLI). One of the primary benefits to using an insurance policy as a funding mechanism is the ability for an entity to receive the death benefits tax free. Investment income is accumulated tax free through the internal build-up of the cash surrender value. In the event that a policy is surrendered early, the policyholder will be responsible for paying the tax on the previously unrecognized investment income. The tax on the cash surrender value can be significant if the policies have been held for a number of years. As a result, very few individual policies or certificates are surrendered and even fewer group policies (including multiple

individual policies with a group rider) are surrendered. In most situations in which an entity surrenders a significant number of individual policies or a group policy, the entity is facing financial hardship and liquidity is more important to the entity and its stakeholders than taxable income.

12. COLI/BOLI arrangements are established utilizing several different insurance products including universal life, variable life, and whole life policies. There are a few basic structures that are currently in the marketplace. However, these structures can be combined and modified in many different ways and, therefore, can be quite complex. The staff has not attempted to describe each type of structure or policy but, rather, has provided the Task Force with a general understanding of the structures in order to make an informed decision. For the purpose of this Issue, consider the following insurance policy structures:

- a. *Individual-Life Policy*—The individual-life policy generally has one contract value component and a surrender charge. The amount that could be realized for this policy is the amount reported by the insurance company as the cash surrender value.
- b. *Multiple Individual-Life Policies*—Many entities purchase separate individual-life policies for each employee. Similar to the individual-life policy, each policy has only one contract value component and in some cases a surrender charge. If one or more, but not all, policies are surrendered, the policyholder will incur the surrender charges on those policies surrendered. This will result in a permanent loss of asset value to the extent of the surrender charge. However, a rider (or simply a contractual stipulation) can be obtained for the insurance policy that will waive the surrender charges on each individual policy if all of the policies are surrendered at the same time. The cost of the rider will vary depending on the individual facts and circumstances.
- c. *Group Life Policy*—The group life policy constitutes the legal contract with the insurance company that covers individual-life insurance for multiple employees. Each individual in the group policy is issued a certificate. If the group policy is cancelled, each of the individual certificates is terminated. While certificates are issued pursuant to the policy

and form part of the policy, the group life policy contract is the controlling document. It should be noted that under the group life policy, individual life insurance certificates can be surrendered separately. In that situation, the cash surrender value for the certificate is received by the policyholder for the full surrender amount of that certificate.

Additional Contractual Provisions

13. A number of policies include certain provisions that can make them more attractive to the policyholder. For example, a provision may allow for the recovery of deferred acquisition costs (see the definition of DAC tax above) or the unused balance of the CSR (see definition above). However, many of the provisions limit the amount that is realized (either a reduction of the CSV or not distributing other amounts, that is, CSR or DAC Tax) and may necessitate meeting certain criteria in order to recover any of these amounts. These limitations should be considered when determining the amounts that could be realized in accordance with the insurance contract. Some of the more typical examples of limitations that exist are the prohibition against having a change of control or restructuring occurring within the last 24 months; a planned restructuring within the next 12 months; or the extent to which the policyholder is in a net NOL carryforward position. Generally, current practice has been for entities to conclude that these limitations have to be remote, otherwise the limitations should be considered in determining the amount realizable under the insurance contract. Amounts that are recoverable by the policyholder at the discretion of the insurance company should not be considered in the amount that could be realized. The amount associated with the termination of the policy may be received over an extended period of time subsequent to the surrender of the insurance policy or certificate. The expected payment pattern should be considered in measuring the amount that will be realized.

14. The two issues in this Issue Summary are intended to provide clarifying guidance on determining the amount that could be realized by the policyholder under FTB 85-4. In the first Issue, the FASB staff is asking the Task Force to determine the type of contractual provisions that should be considered in determining the amount that could be realized. In the second Issue, the FASB staff is asking the Task Force to determine whether a policyholder should consider the surrender of all of the individual policies at the same time or the surrender of individual policies

independent of one another, for purposes of determining the amount that could be realized under FTB 85-4.

Accounting Issues and Alternatives

Issue 1: Whether a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the "amount that could be realized under the insurance contract" in accordance with FTB 85-4.

View A: A policyholder should consider only the cash surrender value when determining the amount that could be realized under the insurance contract.

15. Proponents of View A believe that a policyholder should only consider the cash surrender value as defined in the insurance policy when determining the amount that could be realized under the insurance contract. These proponents believe that FTB 85-4 should be interpreted narrowly. They believe that since the FTB 85-4 only discusses cash surrender value, the ability to recognize an asset related to the insurance contract should be limited to the cash surrender value.

16. Proponents of View A note that while the Interagency Statement is not authoritative U.S. GAAP guidance, View A's interpretation is consistent with the interpretation provided in the Interagency Statement. The Interagency Statement only addresses cash surrender value and does not consider any additional amounts in the insurance contract for purposes of determining the amount that is realizable under the insurance contract.

View B: A policyholder should consider any additional amounts included in the contractual terms of the policy in determining the "amount that could be realized under the insurance contract."

17. Proponents of View B believe that a policyholder should consider any additional amounts that are included in the contractual terms of the policy. These proponents believe that those

additional amounts represent assets of the policyholder that are realizable under the contractual provisions of the insurance policy. For example, in situations in which the DAC tax will be credited to the policyholder's Policy Account Balance over time regardless of whether the policyholder surrenders an individual policy, the DAC tax is a realizable asset of the policyholder.

18. Proponents of View B believe that it is not appropriate to narrowly interpret FTB 85-4 as proponents of View A. FTB 85-4 states that the policyholder should recognize the amount that could be realized but does not provide prescriptive guidance about what to include in that amount. These proponents note that the reference to cash surrender value in paragraph 2 of FTB 85-4 is only to provide clarification on how to classify the investment income from the cash surrender value in the income statement.

Issue 2: Whether a policyholder should consider the contractual ability to surrender all of the individual-life policies (or certificates in a group policy) at the same time in determining the "amount that could be realized under the insurance contract" in accordance with FTB 85-4.

View A: The amount that could be realized should be determined on the individual policy (or certificate) level.

19. Proponents of View A believe that FTB 85-4 intended for the unit of account to be an individual-life insurance policy (or certificate) and that the valuation of that policy (or certificate) must be based only on the hypothetical surrender of that individual policy (or certificate) at the balance sheet date.

20. Proponents of View A believe that assuming surrender of all of the policies (or certificates) at the same time results in the recognition of a gain contingency because the amounts to be received are dependant on future events. Under FAS 5, that gain contingency would not be recognized until the contingency (that is, the surrender of all of the individual policies (or certificates)) is satisfied.

21. Proponents of View A also believe that assuming surrender of all of the policies (or certificates) is inconsistent with current practice regarding how often policies (or certificates) are actually surrendered. Generally, companies do not surrender individual policies (or certificates) and the surrender rate is even lower on a group policy. As a result, they believe that it is inappropriate to recognize the amount that could be realized based on an assumption that all of the policies will be surrendered, when it occurs infrequently. Opponents to View A do not believe FTB 85-4 allows for an evaluation of intentions or current practice in determining the amount that could be realized but, rather, requires a strict interpretation of the contractual terms of the policy.

22. Proponents of View A believe that if you assume surrender of all of the individual policies or the group policy, the entity will recognize a loss in the event that an individual policy (or certificate) is surrendered. These proponents believe that because FTB 85-4 concluded that the capacity to realize the benefits is limited to settlement amounts specified in the contract, this should preclude the recognition of an amount that potentially may not be realized.

View B: The amount that could be realized shall be determined based on surrender of all of the individual-life policies (or certificates) at the same time.

23. Proponents of View B believe that because the determination of the realizable amount is based on the hypothetical surrender of the policies (or certificates) at the balance sheet date, assuming they are surrendered on that date, it is appropriate to calculate the value based on the contractual provisions for the surrender of all policies (or certificates) together.

24. Proponents of View B observe that the controlling document is not the individual policy (or certificate) but, rather, the group rider or the group policy. These proponents believe that an entity should evaluate the contractual terms of the controlling document in order to determine the amount that could be realized. Therefore, they believe a policyholder should assume that all of the policies (or certificates) are surrendered.

25. Proponents of View B believe that the phrase "could be" from FTB 85-4 implies a concept of maximization of the amount to be realized. These proponents believe that a policyholder will always act in a rational manner and surrender the policies in a manner that will provide the maximum payout. Therefore, they believe a policyholder should assume that all of the policies (or certificates) are surrendered.

26. In Multiple Individual-Life Policies, proponents of View B believe that the determination of the amount that could be realized should include the additional contracts or riders that provide for the waiver of the surrender charges as these would be considered part of the "agreed provisions" considered by the buyer and seller in determining the settlement options. Likewise, under a group life policy, the determination of the amount should include the cash surrender value associated with the individual certificates as well as the value associated with the termination of the group life policy as the group life policy is the controlling document that provides for the "agreed provisions."

Board Action

27. The Task Force may conclude that FTB 85-4 no longer provides the most appropriate measurement attribute for the purchase of life insurance in the current environment and therefore formally recommend that the Board undertake a project to reconsider FTB 85-4.

28. Proponents of this position believe that these life insurance contracts have changed significantly since FTB 85-4 was issued and that other methodologies would better reflect the economics of the arrangements. These proponents believe that either a fair value method or recording death benefits on an actuarially expected basis over the course of time are measurement attributes that would better reflect the economics of the contracts. They believe that using cash surrender value is inappropriate because the life insurance contracts are not insurance contracts but, rather, investments and should be accounted for like other investments. Opponents note that variable life products are currently marked to market and reported at fair value through the cash surrender value. Proponents believe that the amount that could be realized is essentially a liquidation basis of accounting and is not consistent with the intent of the policyholder and the objectives of reporting under a going concern assumption. These

proponents also note that the Board recently approved a fair value election for the accounting for the purchase of a life settlement contract and the continued use of "the amount that could be realized" is inconsistent with that decision.

29. Opponents of this position believe FTB 85-4 appropriately concludes that the only capacity to realize the amounts is through the settlement of the contract through the contract provisions. They believe that it is inappropriate to reconsider the policyholder's accounting unless the insurer's accounting is also reconsidered. These opponents believe that in the life settlements project, the Board was asked to deal with a very specific class of life insurance policies that have a unique set of characteristics and concluded that this was one of reasons for the different accounting treatment. These opponents also note that the exposure draft of the Fair Value Option project permits an entity to elect to account for life insurance at fair value if an entity believes that "the amount that could be realized" is not the appropriate measurement attribute for its insurance contracts. The Board previously considered undertaking this project and rejected adding a project to reconsider the accounting in the FTB 85-4.

International Convergence

30. IAS 8 currently does not address policyholder accounting. The IASB has a project to address insurance accounting and in the second phase of that project, policyholder accounting is expected to be addressed. As a result, management would use paragraphs 10–12 in IAS 8, which provide general guidance on the selection of an accounting policy when an issue is not specifically addressed in the literature, to determine how to develop and apply an accounting policy for the insurance contracts. Because different models are used to account for the policyholder's life insurance under IAS and US GAAP, the Task Force's consensus on this Issue does not impact international convergence.

Transition and Disclosure

31. The FASB staff's recommendation is that the consensus on these Issues should be effective for periods beginning after December 15, 2006. Early application of this guidance is permitted in periods for which any interim or annual financial statements have not yet been issued. Accordingly, the FASB staff believes that the Task Force should consider transition alternatives

for any consensus reached on these Issues. The staff has identified the following transition alternatives for Task Force consideration:

View A: The proposed consensus should be applied retrospectively to all life insurance contracts in accordance with the requirements of FAS 154. This should include the recognition of:

- a. *The cumulative effect of the change to the new accounting principle on periods prior to those presented reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented*
- b. *An offsetting adjustment, if any, made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period*
- c. *Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle.*

The following would be disclosed:

- a. *A description of the prior-period information that has been retrospectively adjusted, if any*
- b. *The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for any prior periods retrospectively adjusted*
- c. *The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.*

32. Proponents of View A believe that retrospective application would provide more useful information because prior-period balance sheet amounts and prior-period income and cash flow statement amounts would be restated to reflect the consensus in these Issues.

View B: *The proposed consensus should be applied prospectively to all life insurance contracts with a cumulative effect recognized at the date of adoption of the proposed consensus for all existing life insurance contracts currently held. An investor shall disclose the following in the fiscal period of adoption in which a change in accounting principle is made:*

- a. The nature of and reason for the change in accounting principle*
- b. The cumulative effect of the change on retained earnings in the statement of financial position as of the date of adoption.*

33. Proponents of View B believe that the time and effort required to apply the transition guidance in View A would outweigh the benefits.

Exhibit 06-5

EXAMPLE OF THE APPLICATION OF ISSUE 06-5

The following example illustrates the application of the different views presented in this Issue.

On January 1, 1997, TKO Incorporated (TKO) purchases a group variable life policy on 20 executives of TKO. The insurance company issued an individual certificate for each executive when the policy was purchased. The entire policy was funded with an initial single premium of \$10,000,000. TKO is paid the face amount of the certificate when the insured dies. The policy contains a surrender charge of \$50,000 per certificate assessed if a certificate is surrendered. The policy includes a CSR account, and includes a provision that allows for the recovery of the upfront DAC tax over 11 years. The CSR is paid out in cash to TKO only if the certificates are surrendered at the same time. The DAC tax is recovered on a certificate by certificate basis even when an individual certificate is surrendered. If all of the certificates are surrendered at once (the group policy is surrendered) the surrender charge is waived. At December 31, 2005, the individual components of TKO's policy have the following values:

CSV = \$8,700,000 (Policy Account Balance less surrender charges)

CSR = \$500,000

DAC tax (on a discounted basis) = \$250,000

The following is an evaluation of the fact pattern to illustrate the amount to be included in TKO's financial statements at December 31, 2005 for each of the views:

	Issue 1 View A Issue 2 View A	Issue 1 View B Issue 2 View A	Issue 1 View A Issue 2 View B	Issue 1 View B Issue 2 View B
Cash Surrender Value	\$ 8,700,000	\$ 8,700,000	\$ 8,700,000	\$ 8,700,000
CSR				500,000
DAC Tax		250,000		250,000
Add Back				
Surrender Charges (calculated as 20 policies at \$50,000 surrender charge per certificate)			1,000,000	1,000,000
	<u>\$ 8,700,000</u>	<u>\$ 8,950,000</u>	<u>\$ 9,700,000</u>	<u>\$ 10,450,000</u>

Issue 1

View A: A policyholder should consider only the cash surrender value when determining the amount that could be realized under the insurance contract.

View B: A policyholder should consider any additional amounts included in the contractual terms of the policy in determining the "amount that could be realized under the insurance contract."

Issue 2

View A: The amount that could be realized should be determined on the individual policy (or certificate) level.

View B: The amount that could be realized shall be determined based on surrendering all of the individual-life policies (or certificates) at the same time.