Statement of Financial Accounting Standards No. 97

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Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments

December 1987

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments

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FAS 97: Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments

FAS 97 Summary

This Statement establishes standards of accounting for certain long-duration contracts issued by insurance enterprises, referred to in this Statement as universal life-type contracts, that were not addressed by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.* The Statement also establishes standards of accounting for limited-payment long-duration insurance contracts and investment contracts and amends Statement 60 to change the reporting of realized gains and losses on investments.

New life insurance contracts have evolved since the development of specialized insurance industry accounting principles and practices in the early 1970s. Many of those new life insurance contracts have different provisions than do the life insurance contracts to which Statement 60 applies. Those new life insurance contracts are characterized by flexibility and discretion granted to one or both parties to the contract. Statement 60 identifies but does not address those contracts, noting that the accounting was under study by the insurance industry and the accounting and actuarial professions.

This Statement requires that the retrospective deposit method be used to account for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder. Premium receipts are not reported as revenues when the retrospective deposit method is used. The Statement also requires that capitalized acquisition costs associated with universal life-type contracts be amortized based on a constant percentage of the present value of estimated gross profit amounts from the operation of a "book" of those contracts. Any gain or loss resulting from a policyholder's replacement of other life insurance contracts with universal life-type contracts is recognized in income of the period in which the replacement occurs.

This Statement requires that long-duration contracts issued by insurance enterprises that do not subject the enterprise to risks arising from policyholder mortality or morbidity (investment contracts) be accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments. Payments received on those contracts are not reported as revenue.

This Statement also addresses limited-payment contracts that subject the insurance enterprise to mortality or morbidity risk over a period that extends beyond the period or periods in which premiums are collected and that have terms that are fixed and guaranteed. This Statement requires that revenue and income from limited-payment contracts be recognized over the period that benefits are provided rather than on collection of premiums.

This Statement amends the reporting by insurance enterprises of realized gains and losses on investments. Statement 60 previously required that realized gains and losses be reported in the statement of earnings on a separate line below operating income and net of applicable income taxes. This Statement requires that realized gains and losses now be reported on a pretax basis as a component of other income and precludes the deferral of realized gains and losses to future periods.

This Statement is effective for financial statements for fiscal years beginning after December 15, 1988. Accounting changes to adopt the Statement should be applied retroactively through restatement of all previously issued financial statements presented, or if restatement of all years presented is not practicable, the cumulative effect of applying this Statement is to be included in net income of the year of adoption.

INTRODUCTION

1. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* issued in June 1982, contains specialized accounting principles and practices based on AICPA insurance Industry Audit Guides and Statements of Position. Statement 60 identifies but does not address a number of areas that were being studied by the insurance industry and the accounting and actuarial professions when that Statement was issued. One of those areas is the accounting for universal life insurance and similar products that were developed after the issuance of the AICPA Guides and Statements of Position.

2. Statement 60 describes two methods of premium revenue and contract liability recognition, referred to as long-duration and short-duration contract accounting. Each method is designed to reflect the insurance enterprise's obligations and policyholder rights under the provisions of the contract. The insurance contracts addressed in this Statement are generally considered long-duration insurance contracts.

3. Recognition of premiums as revenue when due from policyholders and measurement of a liability for policyholder benefits based on a uniform percentage of anticipated premiums are distinguishing features of the accounting for long-duration insurance contracts specified in Statement 60. Because no single function or service is predominant over the periods of most long-duration insurance contracts, recognition of premiums as revenue over the premium-paying periods was considered a reasonable measure of service performed.

4. The differences between universal life insurance and the long-duration contracts described

in Statement 60 led many to question the propriety of applying the accounting method described in Statement 60 to universal life insurance. Universal life insurance contracts lack the fixed and guaranteed terms that are typical for the contracts for which the accounting specified in Statement 60 was designed. Policyholders are frequently granted significant discretion over the amount and timing of premium payments. Insurers are frequently granted significant discretion over amounts that accrue to and that are assessed against policyholders.

5. Some long-duration insurance contracts that are addressed by Statement 60 have terms that are fixed and guaranteed but lack either the level premiums or the insurance protection characteristics contemplated in Statement 60. The increasing number of those contracts led the Board to reconsider the accounting for them at the same time it considered the accounting for universal life insurance.

APPLICABILITY AND SCOPE

6. This Statement applies to all insurance enterprises to which Statement 60 applies. The Statement establishes standards of financial accounting and reporting for three classes of long-duration contracts issued by those insurance enterprises and for reporting realized investment gains and losses. Those contracts are referred to in this Statement as *investment contracts, limited-payment contracts,* and *universal life-type contracts.* The accounting for long-duration contracts not otherwise addressed by this Statement is prescribed in Statement 60.

7. Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as investment contracts. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.

8. Annuity contracts may require the insurance enterprise to make a number of payments that are not contingent upon the survival of the beneficiary, followed by payments that are made if the beneficiary is alive when the payments are due (often referred to as *life-contingent payments*). Such contracts are considered insurance contracts under this Statement and Statement 60 unless (a) the probability that life-contingent payments will be made is remote [1] or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant.[2]

9. Long-duration insurance contracts with terms that are fixed and guaranteed, and for which

premiums are paid over a period shorter than the period over which benefits are provided, are referred to in this Statement as limited-payment contracts. The period over which benefits are provided, as used in this Statement, includes the periods during which the insurance enterprise is subject to risk from policyholder mortality and morbidity and during which the insurance enterprise is responsible for administration of the contract. The benefit period does not include the subsequent period over which the policyholder or beneficiary may elect to have settlement proceeds disbursed.

10. Except as provided in paragraph 11, long-duration insurance contracts with terms that are not fixed and guaranteed are referred to in this Statement as universal life-type contracts. Universal life-type contracts include contracts that provide either death or annuity benefits and are characterized by any one of the following features:

a. One or more of the amounts assessed by the insurer against the policyholder—including amounts assessed for mortality coverage, contract administration, initiation, or surrender—are not fixed and guaranteed by the terms of the contract.
b. Amounts that accrue to the benefit of the policyholder—including interest accrued to policyholder balances—are not fixed and guaranteed by the terms of the contract.
c. Premiums may be varied by the policyholder within contract limits and without consent of the insurer.

11. This Statement does not apply to conventional forms of participating and nonguaranteed-premium contracts. Those contracts are addressed by Statement 60. A participating or nonguaranteed-premium contract is covered by this Statement, however, if the terms of the contract suggest that it is, in substance, a universal life-type contract. The determination that a contract is in substance a universal life-type contract requires judgment and a careful examination of all contract terms. Paragraphs 12 and 13 describe some circumstances in which a participating or nonguaranteed-premium contract shall be accounted for as a universal life-type contract. The provisions of paragraphs 12 and 13 are not intended to be either all-inclusive or limiting.

12. A participating contract that includes any of the following features shall be considered a universal life-type contract:

a. The policyholder may vary premium payments within contract limits and without consent of the insurer.
b. The contract has a stated account balance that is credited with policyholder premiums and interest and against which assessments are made for contract administration, mortality coverage, initiation, or surrender, and any of the amounts assessed or credited are not fixed and guaranteed.
c. The insurer expects that changes in any contract element will be based primarily on changes in interest rates or other market conditions rather than on the experience of a group of similar contracts or the enterprise as a whole.

13. A nonguaranteed-premium contract that includes either of the following features shall be considered a universal life-type contract:

a. The contract has a stated account balance that is credited with policyholder premiums and interest and against which assessments are made for contract administration, mortality coverage, initiation, or surrender, and any of the amounts assessed or credited are not fixed and guaranteed.
b. The insurer expects that changes in any contract element will be based primarily on changes in interest rates or other market conditions rather than on the experience of a group of similar contracts or the enterprise as a whole.

14. This Statement does not apply to the following types of long-duration insurance contracts:

a. Contracts with terms that are fixed and guaranteed and for which premiums are collected over the same period that benefits are provided
b. Contracts that provide benefits related only to illness, physical injury, or disability.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Investment Contracts

15. Investment contracts issued by an insurance enterprise, as defined in this Statement, do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

Limited-Payment Contracts

16. Limited-payment contracts subject the insurer to risks arising from policyholder mortality and morbidity over a period that extends beyond the period or periods in which premiums are collected. For those contracts, the liability for policy benefits shall be established in accordance with the provisions of Statement 60. The collection of premium does not, however, represent the completion of an earnings process. Any gross premium received in excess of the net premium [3] shall be deferred and recognized in income in a constant relationship with insurance in force (when accounting for life insurance contracts) or with the amount of expected future benefit payments (when accounting for annuity contracts).

Universal Life-Type Contracts

17. The liability for policy benefits for universal life-type contracts shall be equal to the sum of:

a. The balance that accrues to the benefit of policyholders at the date of the financial statements [4]
b. Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (paragraph 20)
c. Any amounts previously assessed against policyholders that are refundable on termination of the contract
d. Any probable loss (premium deficiency) as described in paragraphs 35-37 of Statement 60.

18. Amounts that may be assessed against policyholders in future periods, including surrender charges, shall not be anticipated in determining the liability for policy benefits. In the absence of a stated account balance or similar explicit or implicit contract value, the cash value, measured at the date of the financial statements, that could be realized by a policyholder upon surrender shall represent the element of liability described in paragraph 17(a). Provisions for adverse deviation shall not be made.

19. Premiums collected on universal life-type contracts shall not be reported as revenue in the statement of earnings of the insurance enterprise. Revenue from those contracts shall represent amounts assessed against policyholders and shall be reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period.

20. Amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts shall be reported as unearned revenue and recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized acquisition costs. Amounts that are assessed against the policyholder balance as consideration for origination of the contract, often referred to as *initiation* or *front-end fees,* are unearned revenues.

21. Payments to policyholders that represent a return of policyholder balances are not expenses of the insurance enterprise and shall not be reported as such in the statement of earnings. Amounts reported as expenses shall include benefit claims in excess of the related policyholder balances, expenses of contract administration, interest accrued to policyholders, and amortization of capitalized acquisition costs.

22. Capitalized acquisition costs shall be amortized over the life of a book of universal life-type contracts at a constant rate based on the present value of the estimated gross profit amounts expected to be realized over the life of the book of contracts. The present value of

estimated gross profits shall be computed using the rate of interest that accrues to policyholder balances (sometimes referred to as the *contract rate*). If significant negative gross profits are expected in any period, the present value of estimated gross revenues, gross costs, or the balance of insurance in force shall be substituted as the base for computing amortization.

23. *Estimated gross profit,* as the term is used in paragraph 22, shall include estimates of the following elements, each of which shall be determined based on the best estimate of that individual element over the life of the book of contracts without provision for adverse deviation:

a. Amounts expected to be assessed for mortality (sometimes referred to as the *cost of insurance*) less benefit claims in excess of related policyholder balances
b. Amounts expected to be assessed for contract administration less costs incurred for contract administration (including acquisition costs not included in capitalized acquisition costs as described in paragraph 24)
c. Amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances
d. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as *surrender charges*)
e. Other expected assessments and credits, however characterized.

24. The amortization method based on the present value of estimated gross profits described in paragraphs 22 and 23 of this Statement differs from that provided in Statement 60, which is based on expected premium revenues. This Statement does not define the costs to be included in acquisition costs but does describe those that are not eligible to be capitalized under this Statement. Acquisition costs are addressed in paragraphs 28-31 of Statement 60. Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period shall be charged to expense in the period incurred.

25. In computing amortization, interest shall accrue to the unamortized balance of capitalized acquisition costs and unearned revenues at the rate used to discount expected gross profits. Estimates of expected gross profit used as a basis for amortization shall be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised. The interest rate used to compute the present value of revised estimates of expected gross profits shall be either the rate in effect at the inception of the book of contracts or the latest revised rate applied to the remaining benefit period. The approach selected to compute the present value of revised estimates shall be applied consistently in subsequent revisions to computations of expected gross profits.

Internal Replacement Transactions

26. Policyholders often purchase universal life-type contracts as replacements for other

insurance contracts issued by the same enterprise (sometimes referred to as *internal replacement transactions*). In those cases, the policyholder often uses the cash surrender value of the previous contract to pay an initial lump-sum premium for the new contract. When surrender of a life insurance contract is associated with an internal replacement by a universal life-type contract, unamortized acquisition costs associated with the replaced contract and any difference between the cash surrender value and the previously recorded liability shall not be deferred in connection with the replacement contract.

Application of Statement 60

27. The provisions of Statement 60 dealing with loss recognition (premium deficiency), accounting for reinsurance, and financial statement disclosure shall apply to limited-payment and universal life-type contracts addressed by this Statement.

Reporting of Realized Investment Gains and Losses

28. Statement 60 required that insurance enterprises report realized gains and losses in the statement of earnings below operating earnings and net of applicable income taxes. This Statement precludes that practice. Realized gains and losses shall be reported in the statement of earnings as a component of other income, on a pretax basis, and shall not be deferred to future periods either directly or indirectly. The first sentence of paragraph 50 of Statement 60 is superseded by the following:

> Realized gains and losses on all investments (except those that are accounted for as hedges as described in FASB Statements No. 52, *Foreign Currency Translation,* and No. 80, *Accounting for Futures Contracts*) shall be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. Realized gains and losses shall not be deferred, either directly or indirectly.

Other Amendments to Statement 60

29. This Statement adds the following footnote to paragraph 6 of Statement 60:

> *The accounting for certain long-duration insurance contracts referred to as investment contracts, limited-payment contracts, and universal life-type contracts is established by FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.*

30. Paragraph 15 of Statement 60 is superseded by the following:

Premiums from long-duration contracts, such as whole-life contracts, guaranteed renewable term life contracts, and title insurance contracts, shall be recognized as revenue when due from policyholders.

Amendments to Other Pronouncements

31. Footnote 8 of APB 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,* as amended by Statement 60, is deleted.

Effective Date and Transition

32. This Statement shall be effective for fiscal years beginning after December 15, 1988, with earlier application encouraged. Except as provided in paragraph 33, accounting changes to adopt the provisions of this Statement shall be applied retroactively through restatement of all previously issued financial statements presented. In the year that the Statement is first applied, the financial statements shall disclose the nature of the restatement and its effect on income before extraordinary items, net income, and related per share amounts for each year presented.

33. If restatement of all years presented is not practicable, the cumulative effect of applying this Statement shall be included in net income in the year the Statement is adopted. (Refer to paragraph 20 of APB Opinion No. 20, *Accounting Changes.*) In the year of adoption, the financial statements shall disclose the nature of the cumulative adjustment and the effect of applying this Statement on income before extraordinary items, net income, and related per share amounts.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Lauver dissented.

Mr. Lauver dissents to the issuance of this Statement because of the manner in which capitalized acquisition costs related to universal life-type contracts are required to be amortized. That amortization method, described in paragraphs 22-25, introduces an interest factor by requiring periodic accruals to the balance of capitalized acquisition costs, a nonmonetary, nonearning deferred charge. The Board found sufficient, relevant distinctions between universal life-type contracts and other long-duration insurance contracts to cause it to reject the Statement 60 model and require use of the retrospective deposit method to account for universal life-type contracts. Mr. Lauver agrees that those distinctions are significant and believes that they should also have precluded introducing an interest factor into the amortization of capitalized acquisition costs related to universal life-type contracts. A similar notion has regularly been rejected by the

Board when advanced in the form of a sinking fund or annuity method of depreciating fixed assets.

Because the amortization of deferred costs is an area of accounting with pervasive application, Mr. Lauver believes it is inappropriate to have introduced an interest factor into the amortization method without first considering the broader implications of that action. The use of an interest factor as required herein is generally perceived as part of a general subject described as discounting. Although the Board has received many requests to consider that subject, it has not as yet evaluated those requests nor added the subject to its agenda. The precedent of the conclusion reached in this Statement can only complicate and make more difficult the inevitable evaluation of the appropriate circumstances in which interest factors should be introduced into accounting generally.

Members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Victor H. Brown
Raymond C. Lauver
James J. Leisenring
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Robert J. Swieringa

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix A: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

34. This appendix discusses factors deemed significant by members of the Board in reaching conclusions in this Statement. It includes descriptions of alternatives considered by the Board with reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others.

35. In the late 1970s, new insurance contracts were designed to address changing consumer needs. The accounting for one of those insurance contracts, universal life insurance, was identified in Statement 60 as an issue then being studied by the insurance industry and the accounting and actuarial professions. Statement 60 did not address the accounting for universal life insurance, pending the completion of that effort.

36. The American Academy of Actuaries released a Discussion Memorandum, *Accounting for Universal Life,* in September 1984. In November 1984, the AICPA released an Issues Paper, *Accounting by Stock Life Insurance Companies for Annuities, Universal Life Insurance, and Related Products and Accounting for Nonguaranteed-Premium Contracts.* The FASB added a project to its agenda in February 1985 to address the issues raised by those documents. In December 1986, the Board issued an Exposure Draft, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Insurance Contracts and for Realized Gains and Losses from the Sale of Investments.* The Board received comment letters from 111 individuals and organizations and in June 1987 conducted a public hearing at which representatives of 21 of those organizations appeared.

Scope

37. After reviewing the nature of long-duration insurance contracts, the Board concluded that a general reconsideration of accounting by insurance enterprises is not necessary at this time. The Board concluded that the accounting for investment contracts, limited-payment contracts, and universal life-type contracts should be addressed. The Board concluded that consideration of those contracts separately from other long-duration contracts is justified because of the differences between each of those contracts and the traditional contracts to which Statement 60 applies.

38. The Board acknowledges that it is establishing accounting principles for three classes of long-duration contracts that differ from those applied to other long-duration insurance contracts.

The Board believes, however, that the differences in accounting are warranted by the differences in the contractual relationships involved. The Board rejected suggestions that it either broaden the scope of this project to include all long-duration contracts or that the principles of Statement 60 should be applied to the contracts addressed in this Statement.

Investment Contracts

39. The Board concluded that contracts issued by insurance enterprises that do not incorporate significant risk from the death or disability of policyholders (mortality or morbidity risk) are more comparable to financial or investment instruments issued by other financial institutions than to the insurance contracts contemplated by Statement 60. While many investment contracts are issued primarily by insurance enterprises, the Board believes that similar financial instruments should be accorded similar treatment regardless of the nature of the issuing enterprise. Therefore, the Board concluded that the accounting for investment contracts issued by insurance enterprises should be consistent with the accounting for interest-bearing and other financial instruments.

40. Several respondents suggested that the presence of an annuity purchase option constitutes a mortality risk and that some contracts designated as investment contracts by the Board were therefore subject to Statement 60. The Board concluded that the obligation to make payments that are contingent upon the death or continued survival of a specific individual or group is the essence of a mortality risk. The risk that the guaranteed price of an annuity may prove to be unfavorable to the guaranteeing enterprise when the annuity is purchased is a price risk not unlike a guaranteed price of any commodity and does not create a mortality risk. A mortality risk does not arise until the purchase provision is executed and the obligation to make life-contingent payments is present in an annuity contract. A nominal mortality risk—a risk of insignificant amount or of remote probability—is not sufficient to permit that a contract be accounted for as an insurance contract.

Limited-Payment Contracts

41. The accounting for single-premium and limited-payment contracts was addressed in Statement 60 and in the AICPA Industry Audit Guide, *Audits of Stock Life Insurance Companies* (the AICPA Guide), which was extracted in Statement 60. Statement 60 requires that premiums be recognized as revenue when due. The liability for policy benefits is computed on the same basis as for other long-duration contracts, and net income is recognized, in part, as a residual percentage of premium revenue. Measurement of income as a residual percentage of premium thus leads to income recognition before services have been performed.

42. The Board concluded that limited-payment contracts with terms that are fixed and guaranteed are similar to other contracts addressed by Statement 60 in all respects except for the pattern of premium payment. The Board also concluded that income from insurance contracts is earned through the performance of contract services. The collection of a single premium or a

limited number of premiums does not, in itself, represent the completion of an earnings process. The Board concluded that any amount of gross premium in excess of net premium, as those terms are defined in Statement 60, should be deferred and recognized over the period that services are provided.

43. The Board considered suggestions that it define a limited-payment contract in terms of a specified number of premiums or of a specific relationship between the present value of expected premiums and the present value of benefit and expense payments. The Board concluded that such a definition would necessarily be arbitrary and inconsistent with the proposition that contract services are provided over the entire benefit period.

Universal Life-Type Contracts

44. Most of the long-duration life insurance contracts to which Statement 60 applies have terms that are fixed and guaranteed. The purchaser of such a contract—having agreed to pay a fixed, usually level, premium in return for a guaranteed death benefit and schedule of cash value accumulations—cannot affect the individual elements of contract operation. Similarly, the insurer cannot unilaterally reduce the interest rate that is implicit in cash value increases or increase the amounts assessed for mortality, administration, and early termination that are inherent in the contract.

45. The purchaser of a universal life-type contract can often vary the amount and timing of premium payments, within limits set by the contract, without the approval of the insurer. Premium payments are credited to the policyholder balance, against which amounts are assessed for contract services and to which amounts are credited as income. The policyholder balance provides a base upon which interest accrues to the policyholder and, when compared with the death benefit amount, fixes the insurer's net amount at risk. The insurer can often adjust the schedule of amounts assessed for contract services and the rate at which interest is credited to the policyholder balance.

46. Some contracts may not possess all of the features described above. A contract might, for example, require payment of a fixed premium and provide a guaranteed death benefit while crediting interest to cash values at a rate established by reference to an external index. Several respondents suggested that the definition of universal life-type contracts should be based on only flexibility in premium payment or the presence of an explicit account balance. The Board concluded, however, that the elements of flexibility and discretion represent basic differences between universal life-type and other long-duration insurance contracts.

47. The Board acknowledges the view expressed by some respondents that the issuer of a universal life-type contract accepts many of the same risks that are present in other life insurance contracts. The Board also acknowledges that some enterprises employ the same aggregate pricing techniques for universal life-type contracts that are used for other life insurance contracts. The pooling of a large number of risks is essential to the life insurance industry, and

accounting has historically considered the portfolio or book of contracts as the unit of accounting. The Board concluded, however, that there is a fundamental difference between the relationship of insurer and policyholder when risks are assumed in connection with a contract that is fixed and guaranteed and the relationship that exists when risks are assumed in connection with a contract that is flexible or discretionary. The Board further concluded that this difference is relevant and should be reflected in different accounting for universal life-type contracts.

48. Some respondents pointed out that participating life insurance and nonguaranteed-premium life insurance contracts provide a measure of discretion to the insurance enterprise that is similar to that found in universal life-type contracts. Participating life insurance contracts usually contemplate the sharing of favorable experience relative to contract guarantees rather than the market-related adjustments that are characteristic of universal life-type contracts. The policyholder is thus granted a right that is not present in universal life-type contracts. The operation of universal life-type contracts usually centers on an account or policy balance that is credited with interest and against which amounts are assessed for contract services. Participating and nonguaranteed-premium contracts usually lack this feature. The Board considered incorporating participating and nonguaranteed-premium contracts in the scope of this Statement but decided that the differences between the traditional forms of those contracts and universal life-type contracts justify their exclusion. However, the Board concluded that some participating and nonguaranteed-premium contracts may be, in substance, universal life-type contracts. The Board concluded that this Statement should apply to all contracts that have similar provisions, regardless of the name given to the contract.

49. Life insurance enterprises developed a number of approaches to the accounting for universal life-type contracts following the introduction of those contracts in the late 1970s. Some enterprises accounted for the new generation of contracts in a manner similar to that specified for other long-duration contracts in Statement 60. Others adopted accounting methods that measure the liability for policy benefits based on the balances that accrue to policyholders. The Board concluded that users of financial statements would be better served if insurance enterprises applied a single accounting method for universal life-type contracts.

50. An insurance enterprise agrees to provide two basic services to the policyholder when it enters into a long-duration life insurance contract. The first is to provide contract services, including assumption of mortality risk. The second is to manage the investment of the funds deposited by the policyholder. Statement 60 concluded that no predominant function or service was representative of the pooling or aggregation of services in a life insurance contract. In view of that conclusion and the usual level pattern of premium payments over the life of the contract, premiums were considered an appropriate measure of revenue. Under that approach, the liability for policy benefits accrues at a constant percentage of premiums received.

51. The variable terms of universal life-type contracts and the increased importance of the investment element led to a reexamination of the view that an insurance contract is a pool or aggregation of indistinguishable parts. The presence of a policyholder account balance in many

universal life-type contracts and of separate amounts assessed for contract services that can change from time to time suggests that the advance funding and contract service functions can be measured and accounted for separately. In addition, the discretion in premium payment that is often granted to individual policyholders suggests that a liability based on the accounting method specified in Statement 60 may not be representationally faithful.

52. Paragraphs 35 and 36 of FASB Concepts Statement No. 6, *Elements of Financial Statements,* describe a liability in the following terms:

> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
>
> A liability has three essential characteristics:(a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. [Footnote references omitted.]

53. After examining the characteristics of various long-duration insurance contracts, the Board concluded that the balance that accrues to the benefit of individual policyholders represents the minimum measure of an insurance enterprise's liability that is consistent with the definition above. For many universal life-type contracts, this amount takes the form of an account balance that, absent future action by the policyholder, will continue to fund operation of the contract until exhausted or reduced to a contract minimum. The insurer has a present obligation, arising from past transactions, to continue to maintain the contract and provide mortality protection as long as an adequate account balance exists. Other universal life-type contracts do not have an explicit policyholder account but do have a policyholder balance to which interest is accrued at a variable rate. In either case, future events and transactions will change the amount of the enterprise's obligation as policyholders make additional premium deposits and realize contract benefits. The present obligation, however, is fixed by the amount that has accrued to the benefit of the policyholder.

54. Some respondents suggested that the information provided by the insurer to individual policyholders does not represent the substance of the services provided under the contract. They maintained that services are provided ratably over the life of a contract and that amounts should be deferred or anticipated to produce a pattern of reported earnings that reflects a level pattern of service. The Board rejected that view. Accounting typically presumes that the terms and conditions of a contract entered into between two parties dealing at arm's length are representative of their agreement. This presumption can be overcome if evidence indicates that the substance of the agreement is not captured in the contract—for example, if the terms of contract financing differed from performance of contract services. The Board recognized that

amounts assessed against policyholders might compensate the insurer for services to be provided in future periods. In those cases, this Statement requires that amounts be deferred and recognized over the period that service is provided.

55. Papers prepared by the AICPA and the American Academy of Actuaries suggested an accounting method for universal life-type contracts that has been termed the composite or balanced method. The composite method, which is an extension of the basic methods employed in Statement 60, requires that additional provisions for adverse deviation, beyond the amount that would otherwise be included under Statement 60, be incorporated into the measurement of universal life-type contracts. A portion of income would then be recognized in amounts that reflect release from management's estimate of the various risks assumed under the contract, with the balance recognized as a residual percentage of premiums collected.

56. The provision for adverse deviation is a convention unique to the accounting for long-duration insurance contracts. Adverse deviation is fundamentally a notion of subjective conservatism and requires an increase in the reported liability for policy benefits beyond management's best estimate of the enterprise's ultimate obligation to policyholders. Companies other than life insurers are proscribed from making similar provisions by FASB Statement No. 5, *Accounting for Contingencies.* While the Board concluded that the accounting for traditional long-duration insurance contracts should not be reconsidered at this time, it did not adopt accounting approaches that would incorporate provisions for adverse deviation in accounting for universal life-type contracts.

57. The Board rejected the view that the application of adverse deviation to universal life-type contracts represents an appropriately conservative approach to income recognition for flexible insurance contracts. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* indicates that accounting conservatism is "a prudent reaction to uncertainty." Concepts Statement 2 articulates the principle that, while conservatism may suggest that the more conservative of two equally likely alternatives should be used in an accounting measurement, conservatism does not suggest that a less likely outcome should be used simply because it is less favorable to the enterprise.

Statement of Earnings Presentation

58. Statement 60 continued the industry practice of recognizing premiums from long-duration insurance contracts as revenue when due. This convention is based on the view that no single contract function is predominant over the periods of a long-duration contract and that individual functions are not readily measurable. Universal life-type contracts typically provide separate measures of the attributes of the contract that are communicated regularly to the policyholder. In addition, respondents indicated that separate measurements of the advance funding and contract services functions are inherent in the provisions of long-duration contracts, even when those individual measurements are not communicated as such to policyholders.

59. The Board concluded that it is inappropriate to report total cash inflows (premiums) as revenues from universal life-type contracts. Concepts Statement 6 defines revenues as "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" (paragraph 78). The portion of a premium that accrues directly to the policyholder balance—the advance funding function—does not satisfy that definition of revenue. Similarly, the Board concluded that payments that represent a return of policyholder balances are not expenses. The Board considered requiring separate disclosure of the total premiums received on universal life-type contracts. The Board concluded that an enterprise may voluntarily make such disclosure in footnotes or in the statement of cash flows but that requiring a disclosure would not be appropriate. Having concluded that premiums on certain contracts do not constitute revenues, the Board decided that requiring a disclosure of those premiums as if they were revenues would be confusing. Information about premiums may be useful to some financial statement users in evaluating volume or growth, just as is similar information about capacity or order backlog in other industries, but that information is not typically required in general-purpose financial statements.

60. The Board considered whether this Statement should provide additional guidance about circumstances in which amounts assessed against policyholders should be considered to have been collected in advance of having been earned. Some respondents suggested, for example, that amounts assessed for mortality protection often produce a much larger gross profit margin in early years than is produced from those same amounts assessed in later years. They maintained, therefore, that a portion of early mortality assessments represents compensation for services to be provided in future periods. The profit attributed to mortality assessments in early years, however, is usually the result of the recently completed underwriting process rather than of the collection of amounts assessed before they are earned.

61. The Board considered a number of circumstances that might suggest that an amount assessed against policyholders was collected before being earned. An amount assessed might be considered unearned, for example, if it is assessed only in certain contract periods or in a manner that is expected to result in current profits and future losses from a specific contract function. The Board concluded that those circumstances and others might lead to the determination that a particular amount assessed is unearned but that the determination must be based on the facts and circumstances of individual cases. The Board also concluded that amounts assessed against policyholder balances that are refundable and amounts that are assessed for initiation of a universal life-type contract are unearned revenues.

Capitalized Acquisition Costs

62. Statement 60 requires that capitalized acquisition costs be charged to expense in proportion to premium revenue recognized using methods that include the same assumptions used in estimating the liability for future policy benefits. The Board concluded that in accounting for universal life-type contracts it is appropriate to continue the practice of

amortizing capitalized acquisition costs in a manner consistent with the accounting for performance under the contract. The retrospective deposit method adopted in this Statement, however, recognizes as revenue the amounts assessed against the policyholder accounts. Accordingly, capitalized policy acquisition costs are amortized based on the present value of the gross profit expected to be generated by the book of insurance.

63. Although capitalized acquisition costs are not, in themselves, monetary items, the requirements of Statement 60 link such costs to monetary liabilities and result in amortization methods that incorporate the same concepts of discounting and accrual of interest that are used in liability measurement. The Board has in the past also concluded that, in other limited situations, capitalized acquisition costs should be accounted for as if they were monetary because of their relationship to the measurement of the liability for future policy benefits in Statement 60.[5]

64. The Exposure Draft reflected the Board's conclusion that the retrospective deposit method breaks the linkage that exists in Statement 60 between the measurement of capitalized acquisition costs and the measurement of the liability for future policy benefits. The Board believed that the rationale for measuring and reporting capitalized acquisition costs as if they were monetary items was not appropriate when the retrospective deposit method is used to account for universal life-type contracts. The Board initially concluded, therefore, that interest should not accrue to the unamortized balance of capitalized acquisition costs associated with universal life-type contracts. A majority of respondents disagreed with that conclusion.

65. After considering the comments received, the Board concluded that the Exposure Draft provision should be changed. The assenting Board members hold two views of the basis for incorporating discounting techniques in the amortization of capitalized acquisition costs.

66. The first view is that the essential character of a long-duration insurance contract is that of a complex financial instrument incorporating both financial and service functions. The cash flows that arise from a book of universal life-type contracts are not as closely linked to the contract as are the cash flows from many other financial instruments. However, those cash flows are reasonably predictable and are sufficiently linked to capitalized acquisition costs to justify accounting that is appropriate for financial assets and liabilities.

67. The second view emphasizes the character of capitalized acquisition costs and existing industry practice. The commissions and other costs incurred to acquire universal life-type contracts are essentially the same as those incurred to acquire traditional long-duration contracts. The amortization of capitalized acquisition costs under Statement 60 is based on the present values of capitalized acquisition costs and accrual of interest to the unamortized balance of those costs. Insurance enterprises that adopted retrospective deposit methods carried forward this industry practice in the amortization of capitalized acquisition costs of universal life-type contracts. The Board members who hold this view acknowledge the similarity in costs and the established use of interest methods in amortizing costs on a variety of long-duration insurance contracts and concluded that the use of interest methods in amortizing capitalized acquisition

costs should not be altered in this project.

Initiation Fees and Surrender Charges

68. Universal life-type contracts typically include an amount assessed against policyholders on inception of contracts (initiation fee) or an amount assessed against policyholders when contracts are terminated (surrender charge), or both. The Exposure Draft reflected the Board's conclusion that both initiation fees and surrender charges are assessed primarily to recover capitalized acquisition costs. Insurance enterprises that adopted retrospective deposit methods before the Exposure Draft was issued typically accounted for initiation fees as recoveries of capitalized acquisition costs. However, they accounted for surrender charges as revenues when realized. Most respondents supported that approach.

69. After considering the nature of amounts assessed against policyholders under universal life-type contracts, the Board concluded that all such amounts contribute proportionately to the profitability of a book of contracts. The fact that a particular event, for example, surrender of a contract, may trigger realization of an amount assessed does not alter that conclusion. The Board also concluded that some amounts are collected before being earned and that an initiation fee is one such amount. A surrender charge, on the other hand, is collected when the relationship between policyholder and insurer has been severed. The insurance enterprise has no remaining obligation, and, therefore, the surrender charge is earned when realized.

Internal Replacement Transactions

70. Universal life-type contracts are often purchased as replacements for traditional life insurance contracts issued by the same enterprise. In such cases, the policyholder often uses the cash surrender value of the previous contract to make an initial premium deposit for the new, universal life-type contract. This transaction is commonly referred to as an internal replacement. Insurance enterprises often conduct marketing programs aimed at retaining policyholders who might otherwise replace traditional contracts with universal life-type contracts issued by other insurance enterprises.

71. The replacement of a traditional life insurance contract with a universal life-type contract typically results in the need to account for an amount equal to the sum of (a) the unamortized acquisition costs associated with the replaced contract and (b) the difference between the cash surrender value and the previously recorded liability for policy benefits related to the replaced contract. The AICPA Issues Paper suggested that this net amount should be deferred and amortized as part of the capitalized acquisition costs of the new book of universal life-type contracts. The Issues Paper took the position that the universal life-type replacement contract represented a continuing relationship between the insurer and the policyholder, and maintained that the new contract represented only a change in the form of insurance protection. Some respondents also suggested that the incremental costs of replacement transactions are usually less than the costs of sales to new policyholders. In their view, the continued deferral of net amounts

related to replaced contracts more nearly equates the costs of contracts issued to different classes of policyholders.

72. The Board rejected those proposals. The Board recognizes that an insurance enterprise that conducts an internal replacement program may be motivated by a desire to retain its customer base and that the alternative to replacement may be loss of that base. That objective is not, however, different from the objectives of similar transactions undertaken by insurance enterprises and other enterprises for which continued deferral of costs is not permitted, including the refunding of debt. Paragraphs 19 and 20 of APB Opinion No. 26, *Early Extinguishment of Debt,* as amended by FASB Statement No. 76, *Extinguishment of Debt,* describe the accounting for extinguishment of debt, including extinguishments in which the old and new liability are to the same party:

> *Reduction of alternatives.* The [Accounting Principles] Board concludes that all extinguishments of debt are fundamentally alike. The accounting for such transactions should be the same regardless of the means used to achieve the extinguishment.
>
> *Disposition of amounts.* A difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. . . . Gains and losses should not be amortized to future periods. [Footnote reference omitted.]

Reporting of Realized Investment Gains and Losses

73. Statement 60 continued the insurance industry practice of reporting realized gains and losses from all investments on a separate line in the statement of earnings, below operating income and net of applicable income taxes. At the time Statement 60 was issued, banks reported realized gains and losses in a similar fashion. In 1983, the AICPA issued Statement of Position (SOP) 83-1, *Reporting by Banks Of Investment Securities Gains or Losses.* That Statement of Position amended the AICPA Industry Audit Guide, *Audits of Banks,* to require the presentation of realized gains or losses on investments on a pretax basis in the "other income" section of a bank's statement of earnings. As a result, only insurance enterprises and certain investment companies continued to report realized gains and losses separately from operating income.

74. The Board concluded that investment activities, including realized gains and losses, are an integral part of an insurance enterprise's operations and that operating income should include the results of all investment operations. The Board could find no compelling reason to continue the exception granted to the insurance industry from financial reporting practices that apply to most other financial institutions.

75. Some respondents, including many users of financial statements, suggested that presentation of realized gains and losses with operations provides an opportunity to manage

reported income because the selection of securities sold and the timing of sales are at the discretion of management. The Board noted, however, that the ability to manage reported income through the selection and timing of sales is inherent in transaction-based historical-cost accounting because gains and losses are reported in income only when realized. The Board also noted instances in which the two-step statement of earnings presentation permits enterprises to enter into transactions designed to increase operating income with offsetting nonoperating realized losses.

76. Some respondents maintained that there is no reason to change because the present format has been in use for years and is well understood by users. The Board concluded, however, that realized gains and losses from investments are an integral part of the operating results of an insurance enterprise and cannot be considered incidental. The Board also noted that the two-step statement of earnings has been eliminated from financial reporting by most other financial institutions. The Board believes that financial reporting is enhanced when enterprises report similar transactions in a similar fashion.

77. Some respondents suggested that certain realized gains and losses should be deferred and recognized over the remaining life of the insurance contracts to which they maintain the gains are related. Some suggested that the deferral should be reflected directly—by excluding realized transactions from the statement of earnings—while others suggested that additional liabilities should be recorded. The objective of this practice, in their view, is the presentation of an appropriate investment yield over the life of the book of contracts. The Board notes that generally accepted accounting principles require that realized investment gains and losses be reflected in the period in which they occur. The Board acknowledges that some contracts with policyholders may entitle policyholders to an amount equal to a portion of specific investment performance. The recording of liabilities to reflect amounts to which those policyholders are entitled is appropriate, but the deferral of realized gains and losses is not justified.

Effective Date and Transition

78. The Board considered a solely prospective application of the accounting required by this Statement. The Board believes, however, that restatement of all financial statements presented for prior years will provide useful information about the relative importance of the various contracts addressed by this Statement. The Board concluded that restatement will provide useful information for comparing financial data for periods before and after the effective date of this Statement. Further, the provisions of this Statement establish a fundamentally different basis of liability measurement for universal life-type insurance contracts than for traditional long-duration insurance contracts. Continued recognition of the liability for policy benefits using other methods for some books of universal life-type contracts while applying the provisions of this Statement to newly issued contracts would result in inconsistent recognition of liabilities, revenues, and capitalized acquisition costs. The Board concluded, therefore, that restatement of only some financial statements presented while not restating others is not appropriate in this circumstance.

Appendix B: ILLUSTRATION OF ACCOUNTING FOR CAPITALIZED ACQUISITION COSTS

79. The accompanying schedules illustrate the accounting for capitalized acquisition costs incurred in connection with a portfolio or book of universal life-type contracts, projected over a 20-year period. The illustration displays the computations involved in (a) amortizing that amount as gross profits and surrender charges are realized, and (b) revising estimates of gross profit expected to be realized (refer to paragraphs 22-25). During year one, actual experience is assumed to be the same as management's estimate. During year two, 20 percent of policyholders surrender their contracts. Management's original estimate was that 12 percent of policyholders would surrender their contracts in year two. Interest is credited to policyholder balances at 9 percent.

80. **Schedule One—Computation of Estimated Gross Profit**

Year	Surrender Charges (a)	Mortality Assessments (b)	Mortality Cost Incurred (c)	Expense Assessments (d)	Recurring Expenses Incurred (e)	Investment Income Related to Policy Balances (f)	Interest Credited to Policy Balances (g)	Estimated Gross Profit	Revised Gross Profit at Year 2
1	$13,298	$ 17,300	$ (3,685)	$ 11,700	$ (12,176)	$ 6,405	$ (5,490)	$ 27,352	$ 27,352
2	13,169	15,099	(3,541)	9,356	(9,669)	10,571	(9,061)	25,924	34,637
3	7,314	14,104	(3,627)	8,229	(8,476)	14,436	(12,374)	19,606	17,822
4	4,656	13,604	(3,866)	7,566	(7,781)	18,356	(15,734)	16,801	15,273
5	3,645	13,199	(4,107)	7,108	(7,309)	22,405	(19,204)	15,737	14,304
6	2,739	12,791	(4,330)	6,676	(6,866)	26,286	(22,531)	14,765	13,422
7	1,929	12,950	(4,513)	6,270	(6,449)	29,957	(25,677)	14,467	13,151
8	1,208	12,905	(4,690)	5,888	(6,057)	33,447	(28,669)	14,032	12,756
9	567	12,755	(4,865)	5,529	(5,688)	36,779	(31,525)	13,552	12,320
10	0	12,593	(5,003)	5,191	(5,340)	39,965	(34,256)	13,150	11,954
11-20	0	108,164	(55,512)	37,183	(38,270)	551,879	(473,039)	130,405	118,543
21-50	0	140,607	(88,833)	32,577	(33,712)	2,618,726	(2,244,622)	424,743	386,112
Total	$48,525	$386,071	$(186,572)	$143,273	$(147,793)	$3,409,212	$(2,922,182)	$730,534	$677,646
Present Value								$180,944	$176,087

Explanation of columns:

(a) Surrender charges realized on termination of contracts.
(b) Amounts assessed against policyholder balances for mortality coverage.
(c) Benefit claims, less the amount in the related policyholder balances.
(d) Amounts assessed against policyholder balances for contract administration on either a percentage or a fixed amount per contract basis.
(e) Recurring expenses not included in capitalized acquisition costs.
(f) Investment income earned on policyholder deposits, computed by multiplying policyholder balances by the expected asset earning rate of 10.5 percent.
(g) Interest that is accrued to policyholder account balances at the expected crediting rate of 9 percent.

81. **Schedule Two—Computation of Amortization Rate**

		Original Estimate	Revised Estimate
Present value of estimated gross profit, years one to fifty (from Schedule One)	(x)	$180,944	$176,087
Present value of capitalized acquisition costs	(y)	$ 90,986	$ 90,986
Amortization rate = (y) / (x)	(z)	50.284 %	51.671 %

82. **Schedule Three—Illustration of Amortization**

	Original Estimate	Revised Estimate
Capitalized costs, year one	$ 77,780	$ 77,780
Interest accrual at 9 percent	7,000	7,000
Amortization, year one		
Gross profit of $27,352(from Schedule One) at rate (z) above	(13,754)	(14,133)
Balance, end of year one	71,026	70,647
Additional capitalized costs, year two	14,394	14,394
	85,420	85,041
Interest accrual at 9 percent	7,688	7,654
Amortization, year two		
Gross profit of $34,637 (from Schedule One) at 51.671% (revised rate from Schedule Two)	(17,897)	(17,897)
	$ 75,211	$ 74,798
Balance based on Original Estimate	$ 75,211	
Balance based on Revised Estimate	74,798	
Adjustment required	$ (413)	
Net amortization recognized		
In year one	$ 6,754	
In year two	$ 10,622	

Footnotes

FAS97, Footnote 1--The term *remote* is defined in paragraph 3 of FASB Statement No. 5, *Accounting for Contingencies,* as "the chance of the future event or events occurring is slight."

FAS97, Footnote 2--*Webster's New World Dictionary,* Second College Edition, defines the term *insignificant* as "having little or no importance; trivial."

FAS97, Footnote 3--Statement 60 defines *gross premium* as "the premium charged to a policyholder for an insurance contract." That Statement defines *net premium* as "the portion of the gross premium required to provide for all benefits and expenses."

FAS97, Footnote 4--Accounting methods that measure the liability for policy benefits based on policyholder balances are known as retrospective deposit methods.

FAS97, Appendix A, Footnote 5--FASB Statements No. 33, *Financial Reporting and Changing Prices,* and No. 52, *Foreign Currency Translation.*