EITF ABSTRACTS

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

Dates Discussed: June 15, 2006; September 7, 2006

References: FASB Statement No. 5, *Accounting for Contingencies*
FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*
APB Opinion No. 21, *Interest on Receivables and Payables*
AICPA Audit and Accounting Guide, *Life and Health Insurance Entities*

ISSUE

1. 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.

2. 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 currently used as a framework for most policies in the marketplace. However, these structures can be combined and modified in many different ways and,

therefore, can be quite complex. For purposes of this Issue, consider the following insurance policy structures:

a. *Individual-Life Policy*—The individual-life policy generally has one contract value component and, in some cases, a surrender charge. The amount that could be realized for this policy upon surrender 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 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. Under the group-life policy, individual-life insurance certificates can be surrendered separately and the cash surrender value for the certificate is received by the policyholder for the full surrender amount of that certificate.

3. Additionally, a number of policies include certain provisions that can make them more attractive to the policyholder (for example, a provision allowing for the recovery of certain costs). However, many provisions limit the amount that is realized and may necessitate the meeting of certain criteria in order to recover any of those amounts. Some of the more typical examples of limitations that exist are the prohibition against having a change of control or a 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 operating loss (NOL) carryforward position. 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.

4. Technical Bulletin 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 Technical Bulletin 85-4 there has been diversity in the calculation of *the amount that could be realized under the insurance contract*. 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). These contracts may 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. The amount that can be realized under the insurance contract (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.

5. The issues are:

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 Technical Bulletin 85-4

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 Technical Bulletin 85-4

Issue 3—Whether the cash surrender value component of the amount that could be realized under the insurance contract in accordance with Technical Bulletin 85-4 should be discounted in accordance with Opinion 21, when contractual limitations on the ability to surrender a policy exist.

EITF DISCUSSION

6. The Task Force reached a consensus on Issue 1 that 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. When it is probable[1] that contractual terms would limit the amount that could be realized under the insurance contract, the Task Force agreed that these contractual limitations should be considered when determining the realizable amounts. Those amounts that are recoverable by the policyholder at the discretion of the insurance company should be excluded from the amount that could be realized under the insurance contract. The Task Force observed that amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy should be discounted in accordance with Opinion 21.

7. The Task Force also reached a consensus on Issue 2 that a policyholder should determine the amount that could be realized under the insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). The Task Force also noted that any amount that ultimately would be realized by the policyholder upon the assumed surrender of the final policy (or final

[1]As defined in Statement 5.

certificate in a group policy) shall be included in the amount that could be realized under the insurance contract. Refer to the illustration in Exhibit 06-5A.

8. The Task Force reached a consensus on Issue 3 that a policyholder should not discount the cash surrender value component of the amount that could be realized under the insurance contract when contractual restrictions on the ability to surrender a policy exist, as long as the holder of the policy continues to participate in the changes in the cash surrender value as it had done prior to the surrender request. The Task Force observed that if, however, the contractual restrictions prevent the policyholder from participating in changes to the cash surrender value component, then the amount that could be realized under the insurance contract at a future date should be discounted in accordance with Opinion 21. The Task Force noted that Internal Revenue Code Section 1035 exchanges do not constitute a "cash" surrender as contemplated by Technical Bulletin 85-4.

9. Finally, the Task Force noted that if a group of individual-life policies or a group policy only allows for the surrender of all of the individual-life policies or certificates as a group, then the policyholder shall determine the amount that could be realized under the insurance contract on a group basis.

10. Exhibit 06-5A illustrates the above consensus. Exhibit 06-5B contains definitions of key terms used in this Issue.

Disclosure

11. The Task Force reached a consensus that a policyholder should disclose when contractual restrictions on the ability to surrender a policy exist.

Transition

12. The consensus in this Issue is effective for fiscal years beginning after December 15, 2006. Earlier application is permitted as of the beginning of a fiscal year for periods in which interim or annual financial statements have not yet been issued. The consensus in this Issue should be adopted through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods.

13. If a policyholder chooses to apply the consensus in this Issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings, a policyholder should disclose the cumulative effect of the change on retained earnings or on other components of equity or net assets in the statement of financial position.

14. If a policyholder chooses to apply the consensus in this Issue as a change in accounting principle through retrospective application to all periods, a policyholder should include the recognition of:

a. The cumulative effect of the change in 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. The cumulative effect of the change in accounting principle on retained earnings or on other components of equity or net assets in the statement of financial position
c. Adjustments to financial statements for each individual prior period presented to reflect the period-specific effects of applying the new accounting principle.

15. If a policyholder chooses to apply the consensus in this Issue as a change in accounting principle through retrospective application to all prior periods, the following should be disclosed:

a. A description of the prior-period information that has been retrospectively adjusted
b. The effect of the change in accounting principle 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 caption, and any affected per-share amounts for any prior periods retrospectively adjusted
c. The cumulative effect of the change in accounting principle 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.

Board Ratification

16. At its September 20, 2006 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

17. No further EITF discussion is planned.

Exhibit 06-5A

EXAMPLE OF THE APPLICATION OF THE CONSENSUS ON ISSUE 06-5

The following example illustrates the application of the consensus in this Issue.

On January 1, 19X7, 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 will be paid the stated death benefit of the certificate when the insured dies. The policy contains a surrender charge of $50,000 per certificate if a certificate is surrendered. If all of the certificates are surrendered at once (that is, if the group policy is surrendered) the surrender charge is waived. The policy includes a Claims Stabilization Reserve (CSR) account and a provision that allows for the recovery of the upfront Deferred Acquisition Costs (DAC) tax over 11 years on a certificate-by-certificate basis even when an individual certificate is surrendered. The remaining balance in the CSR is paid out in cash to TKO upon surrender of the final certificate. At December 31, 20X5, the individual components of TKO's policy have the following values:

Policy Account Balance = $9,700,000
Cash Surrender Value (CSV) = $8,700,000
CSR = $500,000
DAC tax (on a discounted basis) = $250,000

The following is an illustration of the amounts to be included in TKO's financial statements at December 31, 20X5, under this Issue:

CSV	$ 8,700,000
CSR	500,000
DAC tax	250,000
	$ 9,450,000

Evaluation: In determining the amount that could be realized under the insurance contract, TKO considers the CSV (Policy Account Balance of $9,700,000 less surrender charge of $1,000,000), the CSR, and the DAC tax as each of these amounts is realizable based on the contractual terms and is not dependent on surrendering all of the policies at once. The CSR is included in the amount that could be realized because the CSR will be recovered when the final policy is surrendered and is not dependent on the surrender of all of the policies at once. The surrender charge of $1,000,000 (20 certificates at $50,000 per certificate) is not assumed to be waived because the waiver of those charges requires the surrender of all of the certificates at once.

Exhibit 06-5B

DEFINITIONS OF KEY TERMS

Definitions of the following terms are included for purposes of clarifying the Task Force's consensus and the related examples of the application of the consensus. The terms are not consistently used among contracts. When determining the applicability of one of these terms, the economic substance of the item shall be taken into consideration.

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).

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.

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."

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. These costs are known as the DAC tax and are based on a percentage of the premium received as specified by the Internal Revenue Code. The initial DAC tax is deducted from a policyholder's 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.

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.

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, a 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).

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.

Suggested Index Entries for Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4"