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Accounting by insurance enterprises for demutualizations and formations of mutual insurance holding companies and for certain long-duration participating contracts; Statement of position 00-3;

American Institute of Certified Public Accountants. Demutualization Task Force

STATEMENT OF POSITION 00-3

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts

Issued by the Accounting Standards Executive Committee

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) provides guidance on accounting by insurance enterprises for demutualizations and the formation of mutual insurance holding companies (MIHC). The SOP also applies to stock insurance enterprises that apply SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, to account for participating policies that meet the criteria of paragraph 5 of SOP 95-1.

The SOP specifies the following:

- *Financial statement presentation of the closed block.* Closed block assets, liabilities, revenues, and expenses should be displayed together with all other assets, liabilities, revenues, and expenses of the insurance enterprise based on the nature of the particular item, with appropriate disclosures relating to the closed block.

- *Accounting for predemutualization participating contracts after the demutualization date or formation of an MIHC and for stock insurance enterprises that have adopted SOP 95-1.* A demutualized insurance enterprise should continue to apply the guidance of SOP 95-1 to its participating contracts issued before the date of demutualization or formation of the MIHC that are within the scope of SOP 95-1. However, the segregation of undistributed accumulated earnings on participating contracts is meaningful in a stock life insurance company, because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, after the date of demutualization or formation of an MIHC, the provisions of paragraphs 41 and 42 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, relating to dividends on participating contracts should apply to such contracts sold before the date of demutualization or formation of the MIHC.

- *Emergence of earnings*. Cumulative actual closed block earnings in excess of the expected periodic amounts calculated at the date of demutualization or formation of an MIHC or, if not practicable for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, as of the beginning of the year of adoption of this SOP, that will not inure to the stockholders should be recorded as an additional liability to closed block policyholders (referred to as a policyholder dividend obligation).

- *Accounting for participating policies sold outside the closed block after the date of demutualization or formation of an MIHC.* SOP 95-1 should be applied to participating policies that meet its conditions and are sold outside the closed block after the date of demutualization or formation of the MIHC. However, provisions of paragraphs 41 and 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to such contracts sold after the date of demutualization or formation of an MIHC.

- *Accounting for expenses related to a demutualization and the formation of an MIHC*. Direct incremental costs related to a demutualization or formation of an MIHC should be classified as a single line item within income from continuing operations.

- *Accounting for retained earnings and other comprehensive income at the date of demutualization and formation of an MIHC*. An insurance enterprise that demutualizes in a distribution-form demutualization should reclassify all its retained earnings as of the demutualization date to capital stock and additional paid-in capital accounts (the capital accounts). A subscription-form demutualization does not by itself result in reclassification of retained earnings. The equity accounts of an MIHC at the date of formation should be determined using the principles for transactions of companies under common control, with the amount of retained earnings of the demutualized insurance enterprise, before reclassification to the capital accounts, being reported as retained earnings of the

MIHC. Because the accounting bases and carrying amounts of assets and liabilities are not changed as a consequence of demutualization or formation of an MIHC, the amounts in accumulated other comprehensive income should also not be changed as a consequence of demutualization or formation of an MIHC.

- *Accounting for a distribution from an MIHC to its members*. Because the members of an MIHC are also policyholders of the stock insurance subsidiary, a distribution by an MIHC to its members should be accounted for according to the substance of the transaction. Unless there are substantive independent third-party stockholders, the distribution should be accounted for as a policyholder dividend.

This SOP applies to past and future demutualizations or formations of an MIHC. For those that occur after December 31, 2000, this SOP is effective on the date of the demutualization or formation of the MIHC. For a demutualization or formation of an MIHC that occurred on or before December 31, 2000, this SOP, with the exception of paragraph 18, should be applied retroactively through restatement or reclassification, as appropriate, of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. A stock insurance enterprise that has elected to adopt SOP 95-1 and that did not convert from a mutual life insurance enterprise should apply the provisions of paragraph 17 of this SOP retroactively through restatement of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. Paragraph 18 of this SOP is effective upon issuance with restatement required for those expenses presented in financial statements for any period presented for comparative purposes. Early adoption of this SOP is encouraged.

The beginning balance of retained earnings and, if necessary, any other components of stockholders' equity, for the earliest year presented should be adjusted for the effect of restatement or reclassification as of the earliest year restated. In the year this SOP is first applied, the financial statements should disclose the effect on income before extraordinary items, net income, and related per share amounts for each year restated or reclassifed. If the actuarial calculation is prepared as of the beginning of the year of adoption of this SOP, its implementation will not result in restatement to recognize a policyholder dividend obligation. Pro forma information for years prior to a demutualization or formation of an MIHC is not required.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts

Introduction and Background

1. Mutual insurance enterprises differ from stock insurance enterprises in that they do not have stockholders. The enterprise is considered to be owned by policyholders whose insurance contracts embody their rights as insureds and as members of the mutual insurance enterprise. Many mutual insurance enterprises are seeking enhanced financial flexibility and better access to capital markets to support long-term growth and to accomplish strategic initiatives. In light of those economic factors as well as increased competition and regulatory considerations, there has been a recent trend for certain mutual insurance companies to demutualize or to form mutual insurance holding companies (MIHC). The process of **demutualization**[1] or formation of an MIHC is subject to scrutiny and approval by state insurance regulatory authorities. Most states have some form of demutualization statute. A range of demutualization statutes and regulations exist for insurance enterprises. Typically, those laws contemplate a direct and full reorganization of the mutual insurer to a stock form. In accordance with some demutualization statutes, eligible policyholders receive stock, **policy credits**, policyholder benefits, cash, or subscription rights as consideration for their membership interest. This Statement of Position (SOP) uses the term *distribution-form demutualization* to refer to situations in which eligible policyholders receive stock, policy credits,

1. Terms defined in the glossary are in boldface type the first time they appear in this Statement of Position.

additional policyholder benefits, cash or rights to purchase stock at favorable terms. This SOP uses the term *subscription-form demutualization* to refer to situations in which eligible policyholders receive only the right to purchase stock in the insurance enterprise or its parent at terms essentially equivalent to the terms offered to independent third parties.

2. The process for allocating the aggregate consideration among eligible policyholders varies based on individual company circumstances and applicable regulatory statutes. The allocation process generally consists of a fixed and a variable component. The fixed component represents consideration for eligible policyholders' membership interest in the mutual insurer and consists of a given number of shares per policyholder (or sometimes, per policy). The variable component represents consideration for eligible policyholders' contribution to the value of the insurer. The variable component of the aggregate compensation is allocated to policyholders in proportion to the actuarial contributions of their eligible policies, if positive. A policy's actuarial contribution consists of its historical equity share (the policy's past contribution to company equity) and, in most cases, the prospective equity share (the present value of the policy's expected future contributions to company equity).

3. An alternative to demutualization, in the jurisdictions where it is permitted, is for a mutual insurance enterprise to form an MIHC. The mutual insurer is converted to a stock insurance enterprise and becomes a stockholder-owned entity that operates as a subsidiary of the newly formed MIHC. All the initial stock of the reorganized enterprise is issued to the MIHC; MIHC governance is established by the former mutual insurance enterprise's board of directors. The converted stock insurer may generate additional capital through an initial or subsequent public offering; however, most statutes specify that the MIHC must own greater than 50 percent of the voting rights of the converted insurer to ensure that the MIHC maintains effective control. The policyholders of the converted insurer become members of the MIHC through the transfer of their mutual membership interests to the MIHC, retaining the same voting rights they had previously. Policyholders with **participating insurance contracts** retain

their participating contract in the converted stock insurer, but unlike in a demutualization, there is no distribution of equity or subscription rights to policyholders. A number of states have enacted or are currently contemplating enactment of MIHC statutes.

4. A demutualization or formation of an MIHC in and of itself does not constitute a change in ownership that requires a change in the historical accounting bases or **carrying amounts** of assets and liabilities. Paragraph 24 of Financial Accounting Standard Board (FASB) Technical Bulletin (TB) 85-5, *Issues Relating to Accounting for Business Combinations*, states in part, "In the special case of a mutual or cooperative enterprise that converts to stock ownership for purposes of effecting a business combination, the conversion is not a shift of equity ownership from one group of equity owners to another. It is a shift from a form of organization that has no substantive equity ownership to one that has." This SOP does not address what constitutes a change in ownership or reporting entity that would require a change in basis for the reported assets and liabilities.

5. Most of the past demutualizations and at least one of the past MIHC conversions have been accompanied or followed by an initial public offering of the stock of a demutualized insurance enterprise or an intermediate holding company of the MIHC. In connection with a demutualization or the formation of an MIHC, some state insurance departments require that a **closed block** or alternative mechanism be established for certain participating insurance policies to protect the adjustable policy features and dividend expectations of participating life insurance policyholders from the competing interests of stockholders. Typically, the **plan of demutualization** describes how the closed block will operate. The closed block assets and cash flows provided by those assets (see paragraph 8 of this SOP) will not inure to the stockholders of the demutualized company; instead, all cash flows from those assets will be used to benefit the closed block policyholders (absent regulatory approval to the contrary or insolvency of the insurer). Because the insurance enterprise remains obligated to provide for minimum guarantees under the participating policy, it is consequently possible under certain circumstances that funds from outside

the closed block will have to be used to meet the contractual benefits of the closed block policyholders. The assets designated to the closed block are subject to the same liabilities, with the same priority in the case of insolvency or in liquidation, as assets outside the closed block. In many situations, commissions and other expenses (including management expenses) of operating and administering the closed block will not be charged to the closed block. Unless the state insurance department consents to an earlier termination, the closed block will continue in effect until the date on which none of the policies in the closed block remains in force.

6. Alternatives to the closed block have arisen in practice encompassing, for a number of types of contracts, various mechanisms believed by the insurance enterprise and state insurance regulators to be appropriate in the specific circumstances. Closed block alternative mechanisms have been used in lieu of closed blocks for certain participating life contracts to commit to the insurance regulator that the insurance company will continue to follow its established dividend practices. Closed block alternative mechanisms also have been used to protect nonguaranteed elements of participating and **nonparticipating insurance contracts** such as interest credits on deferred annuities and adjustable premiums on adjustable premium term business. In some instances, the methodology and limitations defined in the agreements with the state insurance regulators have considered only specific profit components, such as **mortality** experience on a block of term insurance or investment spreads on a block of annuities, and in other instances have considered virtually all components of product profitability. If there is a limitation on the profits that may inure to the stockholders, there is an agreement between the insurance company and the insurance regulators that defines (*a*) the contracts covered by the limitation, (*b*) the profit limitation calculation, and (*c*) the timing and manner (for example, as policy dividends, reduced premiums, or additional benefits) in which amounts that may not be distributed to stockholders are to be distributed to policyholders. The conclusions reached in this SOP apply to all formal closed blocks and to closed block alternative mechanisms to

the extent the concepts are applicable to them, and are referred to as *closed block* in this SOP.

Operation of the Closed Block

7. The process of formation of the closed block is negotiated between the insurance company and the applicable state insurance regulators. Estimated future cash flows are considered in determining the nature and amount of assets designated to the closed block. The assets that are designated to the closed block are expected to produce cash flows sufficient to satisfy the obligations of the closed block, as well as the continuation of policyholder **dividend scales** and policy credits before the demutualization, if the underlying experience continues. Actual policy dividends paid may be increased or decreased based on the effect of future events, such as investment experience, mortality gains or losses, and **persistency** of the closed block policies. The assets designated to the closed block continue to be accounted for as they were before the date of demutualization.

8. The specific policyholder contracts designated for inclusion in the closed block are part of the negotiation process with the insurance regulators. The policyholder liabilities for those closed block participating policies continue to be calculated under the provisions of SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, and FASB Statement of Financial Accounting Standards Nos. 60, *Accounting and Reporting by Insurance Enterprises*, and 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, as well as this SOP.

9. If cash flows from the closed block assets and experience of the closed block are, in the aggregate, more or less favorable than assumed in the funding of the closed block, total dividends paid to closed block policyholders could differ from the original dividend assumptions. Net favorable deviations in closed block performance, unless reversed by subsequent unfavorable experience, will be available for distribution over time only to closed block policyholders and will not be available to the insurance enterprise or its

stockholders. Net unfavorable deviations could result in reduced dividends to closed block policyholders, unless reversed by future favorable experience or ultimately funded from assets outside of the closed block.

10. Regardless of the closed block's performance, the insurance enterprise is obligated to pay guaranteed benefits under the policies in accordance with their terms. If the cash flows from the assets allocated to the closed block and the policies included in the closed block prove to be insufficient to pay the benefits guaranteed under the policies included in the closed block, the insurance enterprise will be required to make those payments from assets outside of the closed block.

Applicability and Scope

11. This SOP is applicable to all insurance enterprises subject to FASB Statement No. 60 that demutualize or form an MIHC or have done so before the effective date of this SOP. However, if an insurance enterprise demutualized before the effective date of FASB Statement No. 120, *Accounting and Reporting by Mutual Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, this SOP does not require the insurance enterprise to apply SOP 95-1 unless it had previously elected to do so. For those stock insurance enterprises that apply the provisions of SOP 95-1, the provisions of paragraph 17 of this SOP apply.

Conclusions

Financial Statement Presentation of the Closed Block

12. Closed block assets, liabilities, revenues, and expenses should be displayed together with all other assets, liabilities, revenues, and expenses of the insurance enterprise based on the nature of the particular item, with appropriate disclosures relating to the closed block. (See paragraphs 24 and 25 of this SOP.)

Accounting for Predemutualization Participating Contracts After the Demutualization Date or Formation of an MIHC

13. The accounting guidance in SOP 95-1 is the appropriate accounting method for participating policies that meet the conditions of paragraph 5 of SOP 95-1 and, therefore, an insurance enterprise should continue to apply that guidance to demutualized insurance enterprises' participating contracts issued before the date of demutualization or formation of an MIHC. However, the segregation of undistributed accumulated earnings on participating contracts is meaningful in a stock life insurance company, because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, after the **date of demutualization** or formation of an MIHC, the provisions of paragraphs 41 and 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to those contracts sold before the date of demutualization or formation of an MIHC.

Emergence of Earnings

14. The amounts to be included in net income relative to assets and liabilities included in the closed block are limited, based on a calculation prepared as of the date of demutualization or formation of an MIHC or, if not practicable for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, as of the beginning of the year of adoption of this SOP **(actuarial calculation date)**. As of the actuarial calculation date, the generally accepted accounting principles (GAAP) carrying amount of closed block liabilities will typically exceed the GAAP carrying amount of closed block assets. Certain of those assets, such as debt securities classified as available-for-sale under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, will be carried at fair value with unrealized holding gains and losses included in other comprehensive income until realized. A demutualization or formation of an MIHC does not, in and of itself, constitute a change in ownership that results in the realization of those unrealized gains and losses. Instead, those unrealized gains and losses

will be realized over the period the closed block policies remain in force, as are all other transactions relating to the closed block assets and liabilities. As a result, the GAAP carrying amounts of the closed block assets must be adjusted to remove those unrealized amounts to determine the maximum future earnings (before items that may not have been considered in the funding of the closed block, such as commissions and maintenance expenses; see paragraph 6 of this SOP) that would be recognized in income over the period the policies in the closed block remain in force. For example, as part of the negotiations surrounding the closed block and demutualization process, the insurance enterprise may agree with the insurance regulator to designate participating policies with a GAAP carrying amount (liability) of $2,500,000,000 for the closed block. Fixed maturity available-for-sale investments with a carrying value and fair value of $2,300,000,000 and an amortized cost of $2,240,000,000 are designated as the closed block assets. If there are no other assets or liabilities included in the closed block, the maximum future earnings from the closed block that would be recognized in income over the period in which the closed block remains in force is $260,000,000.

15. The changes in the **net closed block liability** over time represents the expected closed block GAAP contribution to the earnings of the insurer that inure to the benefit of the stockholders. As of the actuarial calculation date, a calculation is developed that represents the cash flows expected to be generated from the assets and liabilities included in the closed block. Based on that calculation (the **actuarial calculation**), the periodic expected changes in the net closed block liability (on a GAAP basis), which is after the elimination of the effect of the applicable items of other comprehensive income should be derived. The actuarial calculation should be based on a best estimate (with no provision for adverse deviation) of the future performance of the closed block assets and liabilities as of the actuarial calculation date. Cumulative actual closed block earnings in excess of the cumulative expected periodic amounts reflected in the actuarial calculation do not inure to the stockholders and should be recorded as an additional liability to closed block policyholders (referred to as a policy-

holder dividend obligation). Those amounts will result in additional future dividends to closed block policyholders unless otherwise offset by less-favorable-than-expected future performance of the closed block.

Determination of the Policyholder Dividend Obligation

16. The actuarial calculation described above should continue to be used in subsequent accounting periods to determine the change in the policyholder dividend obligation. The actuarial calculation should not be revised in future accounting periods. The amount of the policyholder dividend obligation should be determined by comparing cumulative actual earnings of the closed block from the actuarial calculation date to the date of measurement with the amount of cumulative expected earnings based on the actuarial calculation for the same period. Cumulative actual earnings in excess of cumulative expected earnings based on the actuarial calculation should be recorded as a policyholder dividend obligation. Unrealized investment gains and losses and other amounts related to the closed block normally reported in accumulated other comprehensive income that have arisen after the actuarial calculation date should be included in the determination of the amount of the policyholder dividend obligation limited, in the case of losses, to the extent that the policyholder dividend obligation is otherwise positive. Unrealized investment gains and losses and other items related to the closed block normally reported in accumulated other comprehensive income that have arisen at or after the actuarial calculation date should continue to be reported in accumulated other comprehensive income. Amounts related to the closed block that have arisen after the actuarial calculation date should enter into the determination of the policyholder dividend obligation with an offsetting amount reported in accumulated other comprehensive income. The amount charged to policyholder dividend obligation for losses should be limited to the extent that the policyholder dividend obligation is otherwise positive. Unrealized investment gains and losses, other items of accumulated other comprehensive income, and the amount of offsetting policyholder dividend obligation should not be

netted in the presentation of other comprehensive income. Those amounts should be reported in the income statement and the amounts previously reported in other comprehensive income should be reversed when investment gains and losses and other items of other comprehensive income are realized. Unrealized investment losses and other loss items related to the closed block that would result in a negative policyholder dividend obligation should be recognized in other comprehensive income applicable to stockholders—the policyholder dividend obligation account may not have a negative balance. The policyholder dividend obligation will decrease if experience is less favorable than expected and the dividend scale is not commensurately reduced. If dividends paid are higher than originally expected in the dividend scale, the policyholder dividend obligation will decrease.

Accounting for Participating Policies Sold After the Date of Demutualization or Formation of an MIHC and for Stock Insurance Enterprises That Adopted SOP 95-1

17. The accounting guidance in SOP 95-1 should be applied to demutualized insurance enterprise participating contracts meeting the SOP's criteria issued after the date of demutualization or formation of an MIHC. The segregation of undistributed accumulated earnings on participating contracts in excess of amounts that inure to stockholders is meaningful in a stock life insurance company because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, the provisions of paragraphs 41 and 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to contracts that are sold after the date of demutualization or formation of an MIHC and meet the requirements of SOP 95-1. Those provisions should also be applied by stock insurance enterprises that adopted SOP 95-1 with respect to participating contracts for which limitations exist on the amount of net income that may be distributed to stockholders. If there is a limitation on the amount of income from participating contracts issued after the date of demutualization or formation of an MIHC that may be distributed

to stockholders, the policyholders' share of income on those contracts that may not be distributed to stockholders should be charged to operations with a corresponding credit to a liability. Dividends paid to participating policyholders reduce that liability.

Accounting for Demutualization and MIHC Expenses

18. In connection with a demutualization or formation of an MIHC, an insurance enterprise will incur expenses, including those for legal services, actuarial services, printing, and postage. Direct and incremental costs related to a demutualization or formation of an MIHC should be classified as a single line item within income from continuing operations and should not be classified as an extraordinary item.

Accounting for Retained Earnings and Accumulated Other Comprehensive Income at the Date of Demutualization or Formation of an MIHC

19. Depending on the form of demutualization, a reclassification of retained earnings at the date of demutualization may be appropriate. An insurance enterprise that demutualizes in a distribution-form demutualization should reclassify all its retained earnings as of the date of demutualization to capital stock and additional paid-in capital accounts (the capital accounts). If the enterprise distributes cash or policy credits to policyholders in lieu of capital stock, as part of the demutualization, the distribution should be recorded as a direct reduction to the appropriate capital accounts. A subscription-form demutualization does not, by itself, result in reclassification of retained earnings.

20. The equity accounts of an MIHC at the formation date should be determined using the principles for transactions of companies under common control, with the amount of retained earnings of the demutualized insurance enterprise, before reclassification to the capital accounts, being reported as retained earnings of the MIHC. Because the accounting bases and carrying amounts of assets and liabilities are not changed as a consequence of demutualization or formation of an MIHC, the amounts in accumulated other

comprehensive income also should not be changed as a consequence of demutualization or formation of an MIHC.

Accounting for the Dividends From a Stock Insurance Subsidiary to an MIHC

21. A dividend payable to stockholders, whether declared by a stock insurer or its holding company, is a common corporate capital transaction. Cash dividends should be recorded on the books of the corporation as a liability on the declaration date. A stock dividend declared by the stock insurer should be accounted for in accordance with Accounting Research Bulletin (ARB) 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 7, "Capital Accounts," section B, Stock Dividends and Stock Split-ups. Under existing laws or regulations, an MIHC is required to own a controlling voting interest in the stock insurance subsidiary and, therefore, should reflect the stock insurer or intermediate holding company on a consolidated basis. As a result, intercompany dividends should be eliminated in the consolidated accounts of the MIHC.

Accounting for a Distribution From an MIHC to Its Members

22. Because the members of an MIHC are also policyholders of the stock insurance subsidiary, a distribution by an MIHC to its members should be accounted for according to the substance of the transaction. Unless there are substantive independent third-party stockholders of the demutualized insurance enterprise or intermediate holding company of the MIHC, the distribution should be accounted for as a policyholder dividend. If there are substantive independent third-party stockholders and the following conditions also are satisfied, the distribution is presumed to be appropriately accounted for as an equity dividend.

   a. There is a mechanism to ensure that policyholder dividends are not a component of the MIHC distribution.

   b. All MIHC members are eligible to receive the MIHC distribution and the allocation of MIHC distribution is consistent with the concept of MIHC membership (depending on the jurisdiction, it may be based on equity share or equally distributed to each MIHC member).

c. The distribution is legally characterized as a membership distribution rather than a policyholder distribution.

23. If a distribution by the MIHC is determined to be a policyholder dividend expense, the insurance subsidiary should reflect the policyholder dividend in its separate financial statements as an expense with recognition of a corresponding capital contribution from the MIHC. The MIHC should reflect the amount of the distribution as a capital contribution to the insurance subsidiary in its separate financial statements. In consolidated financial statements, the expense would be reported and the capital contribution would be eliminated.

Disclosures

24. An insurance enterprise should disclose the nature and terms of a demutualization or formation of an MIHC and the basis of presentation and terms of operation of the closed block. In addition, the insurance enterprise should provide a general description of the method of emergence of earnings from the closed block, presentation of assets and liabilities of the closed block, and the policyholder dividend obligation.

25. An insurance enterprise that has formed a closed block should disclose the following (refer to appendix A, "Illustrative Guidance—Footnote Disclosure for the Closed Block," for an illustrative example):

a. A general description of the closed block, including the purpose of the closed block, the types of insurance policies included, and the nature of the cash flows that increase and decrease the amount of closed block assets and liabilities. The description should indicate the continuing responsibility of the insurance enterprise to support the payment of contractual benefits and the nature of expenses charged to the closed block operations.

b. Summarized financial data of the closed block as of, or for periods ending on the date of, the financial statements presented, which should include, at a minimum, the carrying amounts for the major types of invested assets of the closed block, future policy benefits and policyholders' account balances, policyholder dividend obligation, premiums, net investment income, realized investment gains and losses, policyholder benefits, policyholder dividends, and the amount of maximum future earnings remaining to inure to the benefit of stockholders from the assets and liabilities of the closed block as well as an analysis of the changes in the policyholder dividend obligation.

c. GAAP disclosures that typically would be required for the various specific elements included in the closed block need not be made separately for the closed block if the nature of the information for the closed block would not differ significantly from that already included for the reporting entity as a whole. For example, it is not necessary to show a separate schedule of contractual maturities of closed block fixed maturity securities if the relative composition of contractual maturities is similar to those of the reporting entity taken as a whole. However, if the relative maturities of the closed block fixed maturities securities differ from those of the reporting entity taken as a whole, separate disclosures should be made.

Effective Date and Transition

26. This SOP applies to past or future demutualizations or formations of an MIHC. For those that occur after December 31, 2000, this SOP is effective on the date of the demutualization or formation of the MIHC. For a demutualization or formation of an MIHC that occurred on or before December 31, 2000, this SOP, with the exception of paragraph 18, should be applied retroactively through restatement or reclassification, as appropriate, of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. A stock insurance enter-

prise that has elected to adopt SOP 95-1 and did not convert from a mutual life insurance enterprise should apply the provisions of paragraph 17 of this SOP retroactively through restatement of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. Paragraph 18 of this SOP is effective upon issuance with restatement required for those expenses presented in financial statements for any period presented for comparative purposes. Early adoption of this SOP is encouraged.

27. The beginning balance of retained earnings and, if necessary, any other components of stockholders' equity for the earliest year presented, should be adjusted for the effect of restatement or reclassification as of the earliest year restated or reclassified. In the year this SOP is first applied, the financial statements should disclose the effect on income before extraordinary items, net income, and related per share amounts for each year restated. If the actuarial calculation is prepared as of the beginning of the year of adoption of this SOP, its implementation will not result in restatement to recognize a policyholder dividend obligation. Pro forma information for years prior to a demutualization or formation of an MIHC is not required.

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

Basis for Conclusions

28. This section discusses considerations that were deemed significant by AcSEC members in reaching the conclusions in this SOP. In April 2000, AcSEC issued for public comment an exposure draft of a proposed SOP, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*. During the sixty-day comment period, twelve comment letters were received by AcSEC.

Financial Statement Presentation of the Closed Block

29. In demutualizations to date, practice has been to aggregate closed block assets and liabilities into two single-line captions (one for assets and one for liabilities), which is similar to the presentation of separate account (as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*) assets and liabilities. In addition, practice has been to present the closed block pretax results of operations on one line in the statement of operations as "contribution from the closed block." AcSEC concluded that that presentation was not the most meaningful for obtaining an understanding of the overall operations of an insurance enterprise.

30. The only products of an insurance enterprise that are displayed on a single-line segregated basis on the balance sheet are those included in separate accounts. AcSEC believes that the closed block is not analogous to pure-pass-through separate account arrangements that are displayed on a single-line basis. One significant difference between a closed block and a separate account is that separate account arrangements transfer substantially all investment risk to the policyholder, whereas closed block policies usually provide minimum guaranteed returns in accordance with contractual provisions that are not altered by establishment of the dividend protection mechanism. Another significant difference is that the insurance enterprise directs investment options for policies in the closed block, whereas the policyholder, not the insurance company (sponsor), of the pure-pass-through separate account directs the allocation of the assets among various investment options. In addition, the rights of a separate account contractholder and a closed block policyholder differ as to their priority interest in the dedicated assets in the event of insolvency. Whereas separate account assets are often isolated from the general claims of creditors of the insurance enterprise, including other nonseparate account policyholders, closed block assets are not isolated in the event of insolvency.

31. AcSEC believes that management's funding strategy may influence the level of perceived profitability of the closed block

if a segregated presentation is used. That may occur because the insurance enterprise selects assets used in funding the closed block, and selection of the assets in part determines the level and timing of earnings that will emerge with respect to the closed block. Therefore, a single-line presentation is less meaningful and may be misinterpreted.

32. AcSEC also believes an integrated presentation of the closed block is consistent with the presentation of other contractual arrangements involving dedicated assets. AcSEC believes that a closed block may be analogous in some respects to certain participating group pension contracts that provide for assets that specifically support obligations to the pension contractholders, as well as payment of policyholder dividends. It is accepted practice to classify assets, liabilities, revenues, and expenses for those contracts among the various financial statement accounts.

33. AcSEC believes there is no substantial economic difference between dividend protection mechanisms that operate through formal identification of assets for inclusion in a closed block and those that do not provide for the formal designation. In either case, the dividend protection mechanism may be most similar to arrangements in which the income that may inure to stockholders of the stock insurance enterprise is limited as described in FASB Statement No. 60, paragraph 42. Policy liabilities for contracts under those arrangements, the assets that support them, and the policyholders' share of the results of operations are commingled among the appropriate accounts of the enterprise, with profits that do not inure to the benefit of stockholders recognized as a liability.

34. Because cash flows of assets of the insurance enterprise other than those of the closed block may be used to support the operation of the closed block, AcSEC believes that a single line presentation of only those assets actually designated to the closed block may be misinterpreted. AcSEC further believes that the benefits of integrated financial statement presentation outweigh the benefit of isolating assets whose cash flows cannot, by contract or regulation, inure to the benefit of stockholders, a restriction that can be readily disclosed in a note similar to the disclosure of other restricted assets.

Accounting for Predemutualization Participating Contracts After the Demutualization Date or Formation of an MIHC and for Stock Insurance Enterprises That Have Adopted SOP 95-1

35. Currently the following three situations exist for demutualized insurance enterprises:

    a. Former mutual life insurance enterprises that converted before the effective date of FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, and, as stock insurance companies at the effective date of that Statement, could elect to apply the provisions of SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, to participating policies that meet SOP 95-1's requirements but did not do so

    b. Mutual or stock life insurance enterprises that have published GAAP financial statements and have applied SOP 95-1 to those participating contracts that meet SOP 95-1's conditions

    c. Mutual life insurance enterprises that have not published GAAP financial statements and, therefore, have not yet applied SOP 95-1

36. AcSEC concluded that insurance enterprises described in the first situation outlined in paragraph 35 of this SOP that have not elected to adopt SOP 95-1 should remain grandfathered because of the provisions of FASB Statement No. 120. For insurance enterprises that fall into the second and third situations in paragraph 35 of this SOP, SOP 95-1 should be used for the qualifying participating policies both before and after demutualization or formation of an MIHC. AcSEC believes that SOP 95-1 is the appropriate accounting guidance for participating policies that meet its requirements and, accordingly, that the insurance enterprises in the second and third situations should apply, or continue to apply, the provisions of SOP 95-1 after the effective date of demutualization or formation of an MIHC.

37. Paragraph 32 of FASB Statement No. 120 states that "the Board believes, however, that there are likely to be only a limited number of stock life insurance enterprises with material amounts of those [participating life insurance] contracts and decided not to require those enterprises to comply with the SOP [for those participating life insurance contracts]." Therefore, it was not the FASB's intention to have life insurance companies with significant amounts of participating contracts that meet the conditions of SOP 95-1 apply FASB Statement No. 60 in its entirety to those contracts.

38. Paragraphs 32 and 34 of FASB Statement No. 120 discuss the FASB's decision to permit rather than require stock life insurance enterprises to apply SOP 95-1 to certain participating contracts as follows:

> 32. The Board recognizes that the information provided to users about the insurance and reinsurance activities of life insurance enterprises could be improved by limiting the diversity among insurance enterprises in accounting and reporting for those activities. The Board acknowledges that permitting stock life insurance enterprises with participating life insurance contracts that meet the conditions in paragraph 5 of this Statement to apply the accounting in the SOP to those contracts may cause inconsistencies between insurance enterprises in their accounting for those contracts. The Board believes, however, that there are likely to be only a limited number of stock life insurance enterprises with material amounts of those contracts and decided not to require those enterprises to comply with the SOP....
>
> 34. ...The Board also believes that a decision to require stock life insurance enterprises to apply the SOP's accounting to those contracts would necessitate adding the accounting conclusions in the SOP to this Statement thereby requiring time-consuming deliberations. The Board decided not to require stock life insurance enterprises to apply the provisions of the SOP because the overall benefits of providing timely guidance on the accounting and reporting of insurance activities by mutual life insurance enterprises outweigh the incremental improvement in the consistency and comparability of financial reporting among insurance enterprises that would

result from requiring stock life insurance enterprises to apply the SOP's accounting....

39. AcSEC concluded that the most appropriate accounting for policies of a demutualized insurance enterprise that meet SOP 95-1's scope requirements would be continued application of SOP 95-1's provisions, except that the insurance enterprise should recognize an obligation for future policyholder dividends based on accumulated undistributed earnings in a manner that is consistent with paragraphs 41 and 42 of FASB Statement No. 60. AcSEC believes that the provisions of FASB Statement No. 120 and SOP 95-1 that do not appear to support recognition of such an obligation were intended for mutual life insurance enterprises. Upon conversion to a stock life insurance enterprise, the provisions of paragraphs 41 and 42 of FASB Statement No. 60 are more appropriate to the new stock organization and should be applied to all participating contracts. In paragraph 42 of SOP 95-1, AcSEC acknowledged that segregating undistributed accumulated earnings on participating contracts in a manner similar to minority interest may be meaningful in a stock life company because the objective of that presentation is to identify amounts that are not distributable to stockholders. AcSEC concluded that it would be appropriate to follow accounting guidance based on the nature of the contract, and whether the insurance company is a mutual or stock company is significant to the relevance of segregating undistributed accumulated earnings on participating policies. AcSEC believes, however, that the restriction on the stock insurance enterprise's ability to pay certain amounts of undistributed accumulated earnings to the stockholders should be shown as a liability to the policyholders, as discussed below.

Conflict in the Literature on Accounting for Dividends of Participating Contracts

40. Existing GAAP literature distinguishes whether an obligation for future dividends based on accumulated earnings should be recorded for participating policies primarily based on the form of the issuing insurance enterprise, and there is conflicting guidance for insurance enterprises that convert from mutual to stock form. FASB Statement No. 60

requires an insurance enterprise to recognize a liability for future dividends of earnings attributable to a participating contract that cannot be distributed to stockholders; however, SOP 95-1, paragraph 42, does not appear to support the recognition of a liability. Thus, AcSEC had to determine the circumstances in which recognition of a liability is appropriate in accounting for the participating policies that have been and will continue to be accounted for under SOP 95-1 after designation into a closed block.

41. FASB Statement No. 120 states that participating contracts of mutual life insurance enterprises should be accounted for in accordance with FASB Statement Nos. 60 and 97, as appropriate, unless those contracts meet the conditions in paragraph 5 of FASB Statement No. 120. The conditions in that paragraph are the same as the conditions for a participating contract to be within the scope of SOP 95-1.

42. SOP 95-1, paragraph 10, states in part that "FASB Statement No. 60 addresses accounting for traditional forms of participating contracts issued, but does not address the participating contracts issued by mutual life insurance enterprises...." SOP 95-1 also discusses the differences between the participating contracts considered within FASB Statement No. 60 and those considered in SOP 95-1 as follows:

> 30. AcSEC concluded that separate consideration of the participating life insurance contracts covered by [SOP 95-1] is justified by the differences between those contracts and both traditional nonparticipating life insurance contracts, covered by FASB Statement No. 60, and universal life-type contracts, covered by FASB Statement No. 97. Participating life insurance contracts covered under [SOP 95-1] have attributes of the contracts covered by FASB Statement Nos. 60 and 97. AcSEC concluded, therefore, that contracts covered by [SOP 95-1] were not sufficiently similar to those covered by either FASB Statement to warrant applying either of them in its entirety.

43. Paragraph 32 of SOP 95-1 states the following:

> Despite those similarities in form to FASB Statement No. 60 contracts, the dividend feature introduces a variable that affects the substance of the earnings flow to the company. The dividend feature causes the contracts covered by [SOP 95-1] to more closely resemble contracts in which

> the earnings emerge in relation to margins rather than contracts in which earnings emerge proportional to the level of premiums received in that year. Participating policies covered by [SOP 95-1] share in the results of investment activity, mortality experience, and contract administration costs through dividends, which are not fixed or guaranteed by contract terms. As a result, earnings on those products, after annual policyholder dividends, tend to emerge as the margin recognized on investments, mortality, and expenses.

44. FASB Statement No. 60 states the following in discussing the accounting for policyholder dividends:

> 41. Policyholder dividends shall be accrued using an estimate of the amount to be paid.
>
> 42. If limitations exist on the amount of net income from participating insurance contracts of life insurance enterprises that may be distributed to stockholders, the policyholders' share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders' equity by a charge to operations and a credit to a liability relating to participating policyholders' funds in a manner similar to the accounting for net income applicable to minority interests. Dividends declared or paid to participating policyholders shall reduce that liability; dividends declared or paid in excess of the liability shall be charged to operations. Income-based dividend provisions shall be based on net income that includes adjustments between general-purpose and **statutory** financial statements that will reverse and enter into future calculations of the dividend provision.
>
> 43. For life insurance enterprises for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends (based on dividends anticipated or intended in determining gross premiums or as shown in published dividend illustrations at the date insurance contracts are made) shall be accrued over the premium-paying periods of the contracts.

45. AcSEC believes that SOP 95-1 is the more appropriate guidance in accounting for participating policies whose provisions meet the criteria of that SOP, whether those policies are issued by a mutual insurance enterprise or

were issued by a mutual that converts to a stock insurance company. However, AcSEC believes that the demutualization process changes the nature of the relationship between the enterprise and its policyholders. Therefore, continued application of paragraph 42 of SOP 95-1 in its entirety is not warranted. AcSEC views the new relationship of the closed block policyholders and the insurance enterprise's stockholders as more similar to the relationship that would exist in the situation described in paragraphs 41 and 42 of FASB Statement No. 60 rather than to the relationship that would exist in the situation contemplated in paragraphs 41 and 42 of SOP 95-1. Accordingly, AcSEC believes that the application of the dividend concepts described in paragraph 42 of FASB Statement No. 60 is more appropriate for the participating policies of a demutualized insurance enterprise, whether those policies are issued before or after demutualization.

Emergence of Earnings

46. The process of demutualization or formation of an MIHC does not, in and of itself, change the basis of accounting, other than recognition of a policyholder dividend obligation as discussed in paragraphs 15 and 16 of this SOP; the accounting methods used to measure assets, liabilities, revenues, and expenses remain unchanged. Amortization of **deferred acquisition costs** (DAC) will continue to consider all components of estimated gross margins attributable to the policies, whether the components reside inside or outside the closed block.

47. At the actuarial calculation date, a calculation is developed based on the cash flows expected to be generated from the assets and policy contracts included in the closed block. Based on that calculation, the expected periodic changes in the net closed block liability should be derived (the actuarial calculation). As actual experience emerges, that experience is likely to differ from that expected in the actuarial calculation. Because all the cash flows of the closed block assets and policy contracts will inure to the closed block policyholders pursuant to the plan of demutualization, AcSEC believes that cumulative net favorable experience compared to that contemplated at the actuarial calculation

date represents an obligation to closed block policyholders. Such favorable experience will ultimately be paid to closed block policyholders in the form of dividends, unless otherwise offset by future performance of the closed block that is less favorable than originally expected.

48. The concept of establishing a liability for participating insurance contracts where profit limitations exist, and of recording a liability for policyholder dividends on those policies using an estimate of the amount to be paid, is contemplated by paragraphs 41 and 42 of FASB Statement No. 60 and paragraph 77 of FASB Statement No. 97. Paragraph 77 of FASB Statement No. 97 states the following, in part:

> 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.

49. In paragraph 42 of SOP 95-1, AcSEC stated that it is not appropriate or meaningful to segregate undistributed accumulated earnings on participating contracts in the context of a mutual insurance enterprise. However, AcSEC acknowledged in that same paragraph the relevance of such accounting treatment for a stock life insurance company, as follows:

> Annual policyholder dividends of participating contracts covered by this SOP are based on actual company performance. Accordingly, AcSEC believes dividends on participating contracts covered by this SOP are not similar to either of the types of dividends discussed in FASB Statement No. 60. While AcSEC acknowledges that segregating undistributed accumulated earnings on participating contracts in a manner similar to minority interests may be meaningful in a stock life insurance company, it is not meaningful for a mutual life insurance enterprise, because the objective of such presentation is to identify amounts that are not distributable to stockholders.

50. Based on the above guidance, AcSEC believes that the provisions of FASB Statement No. 120 and SOP 95-1 do not recognize the segregation of accumulated earnings on participating contracts for mutual life insurance companies. However, AcSEC believes a mutual life insurance enterprise, upon

conversion to a stock life insurance company, should continue to apply SOP 95-1 modified by the provisions of paragraphs 41 and 42 of FASB Statement No. 60 in accounting for SOP 95-1 contracts. In essence, the conversion from a mutual life insurance enterprise to a stock life insurance enterprise creates an additional measurement requirement for accumulated undistributed earnings because of the newly established stockholder constituency. The establishment of a policyholder dividend obligation recognizes that a portion of earnings in certain cases will not inure to the stockholders of the insurance company.

51. Several respondents to the exposure draft of the SOP expressed a view that realization of cumulative closed block earnings in excess of the amount indicated by the actuarial calculation, in and of itself, is insufficient to require recognition of a policyholder dividend obligation and believed that the continued application of SOP 95-1, without modification, was sufficient to measure the emergence of earnings of the closed block. Those respondents acknowledge that earnings in excess of the amount indicated by the actuarial calculation would be reasonably expected to be returned to policyholders through adjustment of dividend scales, but believe that the obligating event required for accounting recognition takes place upon the actual adjustment of the dividend scales rather than at the earlier date at which the earnings are measured. Those respondents believe that the regulatory supervision of the activity of the closed block results in timely adjustments of the dividend scales, and the recordkeeping requirements necessary for the establishment of a policyholder dividend obligation do not meet a cost/benefit test. Although the actual adjustment of the dividend scales is a necessary condition for identification of the recipients of the amounts to be distributed, AcSEC does not believe that such identification is a necessary prerequisite for accounting recognition under the guidance of FASB Statement of Accounting Concepts No. 6, *Elements of Financial Statements*. Paragraph 36 of FASB Concepts Statement No. 6 states the following, in part:

> Liabilities commonly have other features that help identify them—for example, most liabilities require the obligated entity to pay cash to one or more identified other enti-

> ties and are legally enforceable. However, those features are not essential characteristics of liabilities.... That is, liabilities may not require an entity to pay cash but to convey other assets, to provide or stand ready to provide services, or to use assets. And the identity of the recipient need not be known to the obligated entity before the time of settlement.

52. AcSEC believes that given the regulatory supervision of operations of a closed block, the insurance enterprise has only limited discretion as to the timing of its adjustment of dividend scales under the circumstances where this SOP requires recognition of a policyholder dividend obligation but cannot adjust those dividend scales contemporaneously. AcSEC also believes that, at a given point, assets in excess of the amounts contemplated at the actuarial calculation date represent undistributed accumulated earnings that ultimately will be distributed to policyholders under the terms of the closed block agreements unless offset by future experience less favorable than that indicated by the actuarial calculation. Those incremental assets, therefore, will not become available for distribution to stockholders. Accordingly, AcSEC believes that the usefulness of financial statements may be compromised if the obligation is not recognized until the actual adjustment of dividend scales takes place.

53. Several respondents to the exposure draft of the SOP expressed a belief that recognition of a policyholder dividend obligation under the circumstances when it would be required under the guidance herein would result in a pattern of income recognition based on a predetermined actuarial calculation and therefore would not be appropriately responsive to changes in experience of the closed block. However, AcSEC believes that in the absence of a policyholder dividend obligation for participating policies in the closed block if there are closed block cumulative earnings in excess of the amount indicated by the actuarial calculation, earnings and net assets reported to stockholders will fail to recognize the obligation of the insurance company to distribute excess returns from the designated assets to the closed block policyholders in future periods. The recogni-

tion of favorable experience deviations that will not inure to stockholders as earnings would result in reduced earnings when the results of that experience are ultimately distributed by means of increased dividends to closed block policyholders. As a consequence, the integrity and usefulness of financial statements during periods if there are cumulative earnings in excess of the amount indicated by the actuarial calculation may be compromised by reporting amounts as earnings of stockholders that those stockholders cannot ultimately realize.

54. AcSEC also considered whether it would be appropriate to recognize a negative balance in the policyholder obligation account in the event of the following:

  a. There is cumulative experience of the closed block less favorable than anticipated in the actuarial calculation

  b. The insurance company expects to reduce future dividends or anticipates future favorable performance of the closed block.

Net unfavorable deviations may result in reduced dividends to closed block policyholders, unless offset by future favorable experience of the closed block or subsidized by the insurance company using assets outside of the closed block. Although some, including several respondents to the exposure draft of the proposed SOP, believe that a policyholder dividend receivable is a consistent extension of the policyholder dividend obligation concept and it could be potentially recoverable based on future dividend adjustments, AcSEC believes that recognition of a negative balance as an asset is not supported by paragraph 42 of FASB Statement No. 60. Due to competitive pressures and other considerations, the board of directors of an insurance enterprise may choose not to reduce dividends to closed block policyholders. If an insurance enterprise has favorable experience it is compelled to pass it along to the closed block policyholders. If the insurance enterprise has unfavorable experience, the insurance enterprise has the ability to pass it on but may be constrained by the marketplace in its ability to do so.

Determination of the Policyholder Dividend Obligation

55. AcSEC determined that cumulative net favorable experience of the closed block in relation to expectations indicated by the actuarial calculation that will be paid to policyholders, unless otherwise offset by future performance of the closed block that is less favorable than expected in the actuarial calculation, should not be reflected in earnings of stockholders for the reasons previously discussed in the "Emergence of Earnings" section.

56. Therefore, in the absence of unusual circumstances, the maximum earnings from closed block assets and liabilities that will inure to stockholders is the amount of closed block liabilities in excess of the closed block assets, adjusted for the related items in accumulated other comprehensive income at the actuarial calculation date. Further, AcSEC believes that experience gains and losses of the closed block ultimately may result in an adjustment of dividends or other variable policy benefits paid to policyholders. Therefore, the actuarial calculation provides the expected earnings to be used by the insurance enterprise to measure net positive experience that should not be reflected in the earnings of stockholders.

57. This SOP requires the portion of the unrealized investment gains and losses that have arisen after the actuarial calculation date to be included in the determination of the amount of the policyholder dividend obligation. AcSEC determined that it was necessary to separate the portion of unrealized investment gains and losses that are attributable to the policyholders and not the stockholders; such amounts should be displayed fully and not netted in the presentation of other comprehensive income, as appropriate. In reaching that conclusion, AcSEC considered the guidance in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to determine the treatment of unrealized and realized gains and losses of closed block assets. Under FASB Statement No. 115, assets classified as available-for-sale are reported at fair value with unrealized gains and losses excluded from earnings as a separate component of stockholders' equity until realized.

58. AcSEC considered whether the actuarial calculation should be revised after the actuarial calculation date for purposes of revising the measurement described above. One alternative considered was to revise the actuarial calculation at each financial reporting date. Under that approach, the measurement of excess experience gains would be based on the current estimate (giving effect to past events and current expectations for future events) of the timing of maximum closed block earnings inuring to stockholders. AcSEC believes that the principal assumptions other than investment performance affecting the timing of stockholder earnings from the closed block over the long-term would be persistency and mortality. Persistency and mortality affect the assumed amount of life insurance **in force** and the life of the block of business, which are key factors in the recognition of stockholder earnings. Cash flow effects of differences between assumptions and actual should result in revised dividends or policy benefits to policyholders. AcSEC rejected frequent revisions of the actuarial calculation because short-term movements in persistency and mortality for a block of business with a life of up to 100 years should not have a significant effect on the timing of recognizing earnings that will ultimately be realized by stockholders. AcSEC believes that the "lock in" alternative is most appropriate because the actuarial calculation is developed solely to measure the performance of the closed block in relation to a maximum amount of earnings that will inure to stockholders. Negative performance in relation to the actuarial calculation is recognized currently, and positive performance is recognized as a policyholder dividend obligation. AcSEC also believes periodic loss-recognition tests would identify situations in which significant negative experience should result in the recognition of additional losses to stockholders. Further, AcSEC believes the purpose of the actuarial calculation is to serve as an approach to measure aggregate favorable experience that will not inure to stockholders and may not achieve the intended objective if the actuarial calculation is revised.

59. AcSEC also considered whether the actuarial calculation should be revised upon (*a*) the occurrence of a significant unanticipated event, (*b*) the determination that there has

been a significant change in the assumptions for persistency or mortality, or (c) the designation of significant additional assets for the closed block that would not revert to the stockholders. AcSEC rejected that approach because the actuarial calculation is a measure of the maximum amount of earnings that would be recognized over the life of the block of business. Actual results of the closed block will flow into stockholder income unless cumulative earnings to date are in excess of the maximum that can be recognized based on the actuarial calculation. Therefore, positive performance of the closed block in relation to the actuarial calculation results in a policyholder dividend obligation, and negative performance results in either reduced dividends to closed block participating policyholders or lower earnings than anticipated at the actuarial calculation date. Cumulative negative performance of the closed block represents an amount included in the excess of closed block liabilities over closed block assets that may have to be funded with assets outside the closed block unless offset by future positive performance of the closed block or reduced policyholder dividends. It is believed that a designation of additional assets for the closed block business would result from historical negative performance of the closed block. This negative performance would have been recognized in income as it occurred because negative performance in relation to the actuarial calculation does not result in recognition of an asset.

Accounting for Participating Policies Sold After the Date of Demutualization or the Formation of an MIHC

60. AcSEC considered whether a demutualized insurance enterprise should apply FASB Statement No. 60 or SOP 95-1 to participating policies sold after the date of demutualization or the formation of an MIHC. AcSEC concluded that a demutualized insurance enterprise should continue to apply SOP 95-1 to participating policies that meet the scope requirements of SOP 95-1. If the scope requirements of SOP 95-1 are not met, FASB Statement Nos. 60 or 97 should be applied. In the application of SOP 95-1, the stock insurance enterprise should recognize an obligation for future policyholder dividends based on accumulated undistributed earn-

ings in a manner that is consistent with paragraphs 41 and 42 of FASB Statement No. 60. (See paragraph 39 of this SOP for the basis for establishing an obligation for future policyholder dividends for SOP 95-1 policies.)

Accounting for Demutualization and MIHC Expenses

61. Paragraph 20 of Accounting Principles Board (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*, provides the two criteria that must be met for an event or transaction to be classified as an extraordinary item as stated in part below:

> Extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Thus, both of the following criteria should be met to classify an event or transaction as an extraordinary item:
>
> a. Unusual nature—The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.
>
> b. Infrequency of occurrence—The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

62. Demutualizations and formations of MIHCs are changes in legal forms of organizations. Several respondents to the exposure draft of the proposed SOP said that demutualizations and formations of MIHCs satisfy the above criteria and that the associated costs should therefore be classified as an extraordinary item. However, AcSEC believes that the events represent consequences of customary and continuing activities in efforts to remain competitive in the financial services industry. AcSEC believes that such events do not possess a sufficient degree of abnormality required by paragraph 20(a) of APB Opinion 30. AcSEC recognizes

that the prior practice in demutualizations to date has been to classify such costs as extraordinary. However, AcSEC considered the environment in which the insurance industry operates and the nature of the activities of the individual mutual insurance enterprises which have continued to evolve in recent years. AcSEC believes a demutualization has characteristics similar to other forms of corporate reorganizations and restructurings in which costs do not meet the criteria for extraordinary treatment. Because one of the criteria of paragraph 20 of APB Opinion 30 is met, the direct incremental costs associated with a demutualization or formation of an MIHC should be reported as a separate component of income from continuing operations. Further, AcSEC believes that such classification of expenses should be limited to costs that are direct and incremental to the transaction and should not include allocations of general and administrative-type costs.

Accounting for Retained Earnings and Other Comprehensive Income at the Date of Demutualization or Formation of an MIHC

63. Stockholders' equity usually is displayed in two broad categories: contributed or paid-in capital and retained earnings. Contributed or paid-in capital represents the amount provided by stockholders or resulting from subsequent transactions with stockholders. Retained earnings represents the amount of the enterprise's previous income that has not been distributed to owners as dividends or transferred to contributed or paid-in capital.

64. A demutualization is a change in legal form of organization "from a form of organization that has no substantive equity ownership to one that has" (FASB Technical Bulletin 85-5, *Issues Relating to Accounting for Business Combinations*, paragraph 24); thus, the distribution of shares of stock represents the distribution of the then-existing equity to the owners of the mutual insurer's equity. Several respondents to the exposure draft of the proposed SOP said that because a demutualization does not, in and of itself, result in a change of the historical carrying values of the assets and liabilities of the resulting stock insurance enterprise, the transaction also

should not result in the reclassification of accumulated retained earnings as of the demutualization date. AcSEC believes, however, that it is appropriate to reflect the substance of this transaction by reclassifying accumulated retained earnings as of the demutualization date to the capital stock and additional paid-in capital accounts. Therefore, AcSEC concluded that all retained earnings after capital transactions resulting from the demutualization should be reclassified, as of the demutualization date, to capital stock and paid-in capital accounts for a distribution-form demutualization.

65. This SOP uses the term *subscription-form demutualization* to refer to situations in which eligible policyholders receive only the right to purchase stock in the insurance enterprise or its parent at terms essentially equivalent to the terms offered to independent third parties. AcSEC believes that a subscription-form demutualization is very similar to the kinds of demutualizations that have taken place in the savings and loan industry. Consistent with practice for those kinds of transactions that has not resulted in a reclassification of retained earnings, AcSEC concluded that a subscription-form demutualization does not, by itself, result in reclassification of retained earnings because retained earnings are not being distributed.

66. The process of demutualization or formation of an MIHC does not, by itself, change the basis of accounting, and therefore there is no change in other comprehensive income. As of the actuarial calculation date, the existing accumulated other comprehensive income may relate to items included in the closed block. At the actuarial calculation date, existing accumulated other comprehensive income items related to the closed block should be identified and segregated in the financial records of the insurance enterprise. For example, unrealized investment gains and losses reflect the present value of the difference between market interest rates and the stated interest rates of the closed block fixed income securities or unrealized appreciation or depreciation of closed block equity securities at the actuarial calculation date. As with all such assets, the future contribution to earnings that will be recognized in the financial statements associated with those assets will

be based on their cost or amortized cost. Therefore, existing unrealized investment gains and losses will be part of net investment income or realized investment gains when realized. Accordingly, the actuarial calculation of the earnings of the closed block should be determined on the basis of cost or amortized cost of the invested assets at the actuarial calculation date.

Accounting for the Dividends From a Stock Insurance Subsidiary to an MIHC

67. Subsequent to the formation of an MIHC and conversion of the mutual insurer to a stock insurance company, the stock insurer's board of directors would be expected to declare and pay cash dividends to its stockholders as deemed appropriate in view of the insurer's operating results and capital needs. The National Association of Insurance Commissioners' whitepaper titled *Mutual Insurance Holding Company Reorganizations* indicates that states should "prohibit the MIHC from waiving dividends payable by its stock subsidiaries to ensure that dividend earnings are received by the MIHC and are therefore available to benefit its members." For example, Iowa law protects member interests in earnings distributions by assuring that the class of stock held by the MIHC has dividend and other rights no less favorable than any other class of stock. A dividend declared by a stock insurer (or its holding company, or both) payable to its stockholders is a standard corporate capital transaction and should be accounted for accordingly.

Accounting for a Distribution From an MIHC to Its Members

68. Dividends or other distributions may be made to the MIHC by the insurer or intermediate holding company. At some point, it is possible the MIHC board of directors, with the concurrence of the insurance regulator, may conclude that it is appropriate to distribute some portion of the MIHC's accumulated funds to or on behalf of the members. The form of this distribution could be cash directly to the members or it could be in the form of policy credits, additional

policy benefits, or both, purchased by the MIHC from the subsidiary insurance company.

69. Membership interests are not securities under the federal securities laws; the Uniform Commercial Code defines a security as an "obligation of an issuer or a share, participation or other interest in an issuer or in property or an enterprise of an issuer... and which by its terms is divisible into a class or series of shares, participations, interests or obligations...." There is an argument that because membership interests are not securities and have not been unitized, members do not have "equity" interests. It is conceptually difficult to argue that a distribution is a capital transaction when the recipient does not have an equity interest. One might compare a member distribution with a patronage refund made by a cooperative, which is a distribution of allocated member-sourced earnings to members and is recorded as a capital transaction. However, the same analogy could be made for policyholder dividends, which are accounted for as expenses.

70. Some respondents to the exposure draft of the proposed SOP requested that AcSEC not provide guidance on MIHC distributions until the related legal and tax issues have been more thoroughly examined. However, AcSEC believes it is appropriate to provide conceptual guidance related to MIHC distributions, which it believes should be applied to those transactions so that they will be accounted for in accordance with their economic substance. Because of the ongoing dual relationship of MIHC members as policyholders of the insurance subsidiary, the distributions from the MIHC to its members, whether made directly or through the purchase of contract benefits from its insurance subsidiary, should be accounted for at fair value based on an evaluation of the specific facts and circumstances. AcSEC believes that the threshold criteria that need to be present to constitute a capital transaction are the following:

   a. The existence of substantive independent third-party stockholders in the stock life insurance subsidiary or intermediate holding company

   b. An equivalence in the dividend from the MIHC to its members relative to the dividends from the stock life subsidiary or intermediate holding company

Until there are substantive independent third-party stockholders, a distribution should not be accounted for as a capital transaction.

71. MIHC distributions accounted for as dividends would have no impact on the insurance company's or intermediate holding company's net income, except to the extent the MIHC purchased policy credits and benefits from the insurance company. If the purchase of policy credits and benefits were on the same terms as available to third parties (considering the impact of lower or nonexistent acquisition costs), the insurance company would account for the policy credits and benefits in the same manner as for third-party transactions.

72. MIHC distributions accounted for as policyholder dividends would result in the insurance company reflecting a policyholder benefit expense for the amount of the dividend distribution and a capital contribution from the MIHC in an equal amount. The MIHC would reflect the amount of the distribution as a capital contribution to the insurance subsidiary.

Disclosures

73. If the financial statements of the reporting entity include disclosures for assets, liabilities, revenues, and expenses that are attributed to the closed block in whole or in part, a determination shall be made about whether disclosures of similar data for the closed block elements alone would be similar, in all material respects, to that related to the financial statements of the reporting entity. For example, depending on the debt securities included in the closed block, the contractual maturity information disclosed as of the date of the most recent statement of financial position presented as required by FASB Statement No. 115, paragraph 20, may be materially consistent for closed block assets to that presented for the reporting entity. For any such items where disclosure related to the closed block item would not be consistent, in all material respects, to that presented for the reporting entity, disclosure for the particular closed block items should be presented separately.

74. Several respondents to the exposure draft of the proposed SOP suggested that the disclosures, as illustrated in appendix A, are more extensive than necessary. AcSEC's intention was

to provide an illustrative reference for auditors and preparers of financial statements to become familiar with the mechanics of the numbers involved in typical disclosures. The level of detail in appendix A is not required but is intended to be illustrative.

Effective Date and Transition

75. AcSEC acknowledged the practical concerns, identified by a number of respondents to the exposure draft of the proposed SOP, associated with implementation of the transition provisions proposed in the exposure draft that would have required restatement of all earlier financial statements presented by insurance enterprises that had demutualized or formed an MIHC prior to the issuance of this SOP. AcSEC believes that companies should prepare the actuarial calculation as of the date of demutualization or formation of an MIHC. In rare circumstances, it may not be practicable to prepare the actuarial calculation as of such date because an enterprise demutualized many years prior to January 1, 2001, and the information needed to prepare the calculation as of such date is not available or to do so would be a time-consuming and expensive process; under those circumstances the calculation may be prepared as of the beginning of the year of adoption of this SOP.

76. In those rare circumstances when it is not practicable, for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, to prepare the actuarial calculation as of the date of demutualization or formation of an MIHC as described above, the actuarial calculation described in paragraph 16 is prepared as of the beginning of the year of adoption of this SOP. In those circumstances, the SOP's implementation will not result in restatement to recognize a policyholder dividend obligation and there will not be a cumulative effect resulting from the implementation of this SOP.

77. AcSEC concluded that for a demutualization or formation of an MIHC that occurs after December 31, 2000, this SOP should be effective on the date of the demutualization or formation of the MIHC. AcSEC also considered the financial reporting for demutualizations or formations of an MIHC that

occurred on or before December 31, 2000. For those transactions, AcSEC believes that improved reporting is needed as soon as practicable, and that the benefits of comparability outweigh the costs and efforts of restatement of earlier periods presented. Accordingly, AcSEC concluded that financial statements of earlier periods presented should be restated to conform to the SOP's provisions. However, AcSEC notes that certain entities may not have readily available information to comply with the provisions of paragraphs 16 and 17 of this SOP for prior periods, and that entities that are engaged in the transactions covered by this SOP may require modifications to their systems and procedures to conform with the provisions of this SOP. To allow adequate time for implementation, an entity that demutualized or formed an MIHC on or before December 31, 2000, should apply this SOP, with the exception of paragraph 18, retroactively through restatement or reclassification, as appropriate, of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. AcSEC also concluded that a stock insurance enterprise that has elected to adopt SOP 95-1 and did not convert from a mutual life insurance enterprise should apply the provisions of paragraphs 41 and 42 of FASB Statement No. 60 retroactively through restatement of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. However, the provision of paragraph 18 of this SOP, to report expenses associated with a demutualization or formation of an MIHC as a single line item within income from continuing operations is effective upon issuance of this SOP. Accordingly, presentation of those expenses presented in financial statements for any period presented for comparative purposes should be restated, if necessary.

APPENDIX A

Illustrative Guidance—Footnote Disclosure for the Closed Block

A.1. This Appendix provides specific examples that illustrate the disclosures that this Statement of Position (SOP) requires and depicts the application of certain principles of this SOP. The formats and level of detail, including the shaded areas, in the illustrations are not requirements. the Accounting Standards Executive Committee (AcSEC) encourages a format that provides the information in the most understandable manner in the specific circumstances. Entities are not required to display the disclosure information contained herein in the specific manner illustrated. Alternative ways of disclosing the information are permissible as long as the disclosure requirements of this SOP, as described in paragraphs 24 and 25, are met. The following illustrations are for a single hypothetical insurance enterprise, referred to as ABC Life Insurance Company.

Example Footnote Disclosures for the Closed Block

X. Policy Footnote (in Part) Related to the Demutualization

At the effective date (January XX, 20X1) of the Plan of Demutualization, eligible policyholders received, in the aggregate, approximately $XX million of cash, $XX million of policy credits, and XX million shares of common stock of ABC Holding Company in exchange for their membership interests in ABC Life Insurance Company. The demutualization was accounted for as a reorganization. Accordingly, ABC Life Insurance Company's retained earnings at the Plan Effective Date (net of the aforementioned cash payments and policy credits, which were charged directly to retained earnings) were reclassified to common stock and capital in excess of par.

Z. Closed Block

As of January XX, 20X1, ABC Life Insurance Company established a closed block for the benefit of certain classes of individual participating policies for which ABC Life Insurance Company had a dividend scale payable in 20X0 and that were in force on January XX, 20X1. Assets were allocated to the closed block in an amount that, together with anticipated revenues from policies included in the closed block, was reasonably expected to be sufficient to support such business, including provision for payment of benefits, certain expenses, and taxes, and for continuation of dividend scales payable in 20X0, assuming experience underlying such scales continues. Assets allocated to the closed block inure solely to the benefit of the holders of the policies included in the closed block and will not revert to the benefit of stockholders of ABC Life Insurance Company. No reallocation, transfer, borrowing, or lending of assets can be made between the closed block and other portions of ABC Life Insurance Company's general account, any of its separate accounts, or any affiliate of ABC Life Insurance Company without the approval of the Z State Insurance Department.

If, over time, the aggregate performance of the closed block assets and policies is better than was assumed in funding the closed block, dividends to policyholders will be increased. If, over time, the aggregate performance of the closed block assets and policies is less favorable than was assumed in the funding, dividends to policyholders could be reduced.

The assets and liabilities allocated to the closed block are recorded in ABC Life Insurance Company's financial statements on the same basis as other similar assets and liabilities. The carrying amount of closed block liabilities in excess of the carrying amount of closed block assets at the date of demutualization (adjusted to eliminate the impact of related amounts in accumulated other comprehensive income) represents the maximum future earnings from the assets and liabilities designated to the closed block that can be recognized in income over the period the policies in the closed block remain in force. ABC Life Insurance Company has developed an actuarial calculation of the timing of such maximum future stockholder earnings, and this is the basis of the policyholder dividend obligation.

If actual cumulative earnings are greater than expected cumulative earnings, only expected earnings will be recognized in income. Actual cumulative earnings in excess of expected cumulative earnings represents undistributed accumulated earnings attributable to policyholders, which are recorded as a policyholder dividend obligation because the excess will be paid to closed block policyholders as an additional policyholder dividend unless otherwise offset by future performance of the closed block that is less favorable than originally expected. If actual cumulative performance is less favorable than expected, only actual earnings will be recognized in income.

The principal cash flow items that affect the amount of closed block assets and liabilities are premiums, net investment income, purchases and sales of investments, policyholders' benefits, policyholder dividends, premium taxes, and income taxes. The principal income and expense items excluded from the closed block are management and maintenance expenses, commissions and net investment income, and realized investment gains and losses of investment assets outside the closed block that support the closed block business, all of which enter into the determination of total gross margins of closed block polices for the purpose of the amortization of deferred acquisition costs. The amounts shown in the following tables for assets, liabilities, revenues, and expenses of the closed block are those that enter into the determination of amounts that are to be paid to policyholders.

Summarized financial information for the closed block follows (in millions):

The shaded information is intended to depict the application of the principles of this SOP, and does not represent required disclosure.

	December 31, 20X2	*20X2 Activity*	*December 31, 20X1*
Closed block liabilities:			
Future policy benefits and policyholder account balances	$ 8903	$ (8) B	$ 8911
Policyholder dividends payable	88		88
Policyholder dividend obligation	163	93 E (10) C	80

(*continued*)

	December 31, 20X2	20X2 Activity	December 31, 20X1
Other closed block liabilities	12		12
Total closed block liabilities	9166	75	9091
Assets designated to the closed block:			
Fixed maturities:			
Held to maturity, at amortized cost (estimated fair value, 20X2, $275; 20X1, $319)	289		289
Available for sale, at estimated fair value (amortized cost, 20X2, $3,809; 20X1, $3,502)	4001	307 D 93 E	3601
Equity securities, at estimated fair value	202		202
Mortgage loans on real estate	1273	(307) D	1580
Policy loans	1766		1766
Real estate	105		105
Short-term investments	62		62
Cash and cash equivalents	119	82 A	37
Other closed block assets	76		76
Total closed block assets	7893	175	7718
Excess of reported closed block liabilities over assets designated to the closed block	1273	(100)	1373
Portion of above representing other comprehensive income			
—increase in unrealized appreciation	192	93	99
—increase in policyholder dividend obligation	(93)	(93)	
Total	99	0	99
Maximum future earnings to be recognized from closed block assets and liabilities	$ 1372	$ (100)	$ 1472

Change in Policyholder Dividend Obligation:

	December 31, 20X2	December 31, 20X1
Balance at beginning of year	$ 80	$ 0
Impact on net income before income taxes	(10)	5
Unrealized investment gains (losses)	93	75
Balance at end of year	$ 163	$ 80

Change in Other Comprehensive Income:

	December 31, 20X2	Change for 20X2	December 31, 20X1
Fixed maturities available for sale:			
Fair value	$ 4001	$ 400	$ 3601
Amortized cost	3809	307 D	3502
Unrealized appreciation	$ 192	$ 93 E	$ 99

	20X2		20X1
Closed Block Operations:			
Closed block revenues:			
Premiums	$ 303	A	$ 318
Net investment income	205	A	215
Realized investment gains (losses)	(2)	A	10
Other closed block revenues	5	A	5
Total closed block revenues	511		548
Closed block benefits and expenses:			
Policyholder benefits	402	A	376
Change in policyholder benefits and interest credited to policyholder account balances	(8)	B	17
Dividends to policyholders	8	A	8
Change in policyholder dividend obligation	(10)	C	5
Other closed block expenses	10	A	10
Total closed block benefits and expenses	402		416
Closed block revenues, net of closed block benefits and expenses, before income taxes	109		132
Income taxes	9	A	10
Closed block revenues, net of closed block benefits and expenses and income taxes	$ 100		$ 122
Maximum future earnings from closed block assets and liabilities:			
Beginning of year	$ 1472		$ 1594
End of year	1372		1472
Change during the year	$ (100)		$ (122)

Assumed 20X2 activity for assets and liabilities (similarly identified in statement of operations as applicable):

A items are assumed settled in cash, with net impact reflected in "Cash and cash equivalents."

B and C are given effect in their respective balance sheet accounts.

D represents the assumed sale of mortgage loans at book value and reinvestment of the proceeds in available-for-sale fixed maturities.

E represents the increase in unrealized appreciation on available-for-sale securities held at both December 31, 20X1 and December 31, 20X2. It is assumed that there are no related taxes and that the available-for-sale fixed maturities sold (see above) had fair value equal to book value both at December 31, 20X1, and when sold.

It is further assumed that the unrealized appreciation at December 31, 20X1, is equal to that at the date of demutualization. Unrealized appreciation that arises since the date of demutualization is to be included in the determination of the policyholder dividend obligation.

APPENDIX B

Illustrations for Accounting for Closed Block Business

B.1. The accompanying schedules illustrate the accounting for closed block business (meaning those assets and liabilities both inside and outside of the closed block that relate to or support the closed block policies) after the demutualization date. The illustrations display the computations involved in (*a*) determining the amount of the policyholder dividend obligation (PDO) (*b*) deriving estimated gross margins (EGM) for purposes of amortizing deferred acquisition costs (DAC) and (*c*) revising EGM as actual experience emerges.

B.2. To simplify the example, the illustrations assume the closed block has not been funded for income taxes. In practice, the closed block may or may not be funded for income taxes. If the closed block is funded for income taxes, the actuarial calculation would be constructed on a post-tax basis. However, for the purpose of determining PDO and EGM, pretax amounts should be used. Generally, this would be accomplished by converting post-tax actuarial calculation values to corresponding pretax values for purposes of determining EGM and PDO amounts. If the closed block is funded for income taxes, a change in income tax rates would result in an experience gain or loss that would affect closed block cash flows and, therefore, estimated gross margins and amortization of deferred acquisition costs.

B.3. Schedule 1 is the illustration of the computation of estimated gross margins that appears in schedule 1 of appendix A, "Illustration of Computation of Gross Margins," of Statement of Position 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*. This schedule illustrates the projection of the estimated gross margins of the closed block business. The closed block business is assumed to be written in year 1, with demutualization occurring at the end of year 5.

B.4. Schedule 2 illustrates the contribution to the EGM in schedule 1 from the closed block (meaning, those assets and liabilities actually included in the closed block). As discussed more fully in paragraph 15 of this Statement of Position, this schedule is based on the actuarial calculation for the closed block developed at the demutualization date and represents the expected changes in the net closed block liability (closed block deficit) over the life of the closed block. The data in this schedule will be compared to actual results throughout the life of the closed block to determine the need for a PDO (as illustrated in footnote X). Schedule 2 depicts an increase in interest rates in year 6 from 8.5 percent to 9.5 percent, which results in the board of directors increasing dividends in years 7 through 10. All other assumptions are held constant.

B.5. Schedule 3 illustrates the closed block business EGM contribution associated with the assets and liabilities outside of the closed block. Schedule 3 also shows the total EGM's used to amortize DAC for the closed block business. Those EGMs differ from those shown in schedule 1 based on the emergence of actual experience in year 6 and the creation of the PDO.

*Schedule 1—Computation of Estimated Gross Margins**

Year	Premium (a)	Interest on NLPR (b)	Interest on Current Activity (c)	Death Benefits Incurred (d)	Surrender Benefits Incurred (e)	Recurring Expenses Incurred (f)	(Increase) Decrease in NLPR (g)	Dividends Incurred (h)	Post-dividend Gross Margins (i)	Revised Gross Profit at Year 2
1	$ 210,000	$ 0	$ 16,244	$ (9,000)	$ 0	$ (18,900)	$(126,103)	$ (18,857)	$ 53,384	$ 53,384
2	184,611	10,719	14,280	(10,549)	0	(16,615)	(109,116)	(21,399)	51,931	50,546
3	169,621	19,994	13,120	(13,731)	(7,148)	(15,266)	(93,669)	(24,230)	48,691	47,419
4	155,763	27,955	12,048	(14,835)	(14,984)	(14,019)	(79,754)	(26,574)	45,600	44,432
5	142,990	34,735	11,060	(15,661)	(21,760)	(12,869)	(67,117)	(28,509)	42,869	41,797
6	131,222	40,440	10,150	(15,622)	(17,237)	(11,810)	(73,236)	(30,043)	33,864	32,880
7	124,333	46,665	9,617	(16,578)	(20,989)	(11,190)	(66,499)	(32,301)	33,058	32,126
8	117,768	52,317	9,109	(16,824)	(24,427)	(10,599)	(60,005)	(34,367)	32,972	32,089
9	111,526	57,417	8,627	(17,526)	(27,566)	(10,037)	(53,706)	(36,230)	32,505	31,669
10	105,582	61,982	8,167	(18,603)	(30,406)	(9,502)	(47,485)	(37,915)	31,820	31,028
11-20	779,517	760,283	60,296	(311,112)	(398,831)	(70,157)	(162,077)	(424,092)	233,827	227,980
21-55	589,392	1,222,685	45,589	(1,187,632)	(686,079)	(53,041)	938,767	(669,668)	200,013	195,591
Total	$2,822,325	$2,335,192	$218,307	$(1,647,673)	$(1,249,427)	$(254,005)	$ (0)	$(1,384,185)	$840,534	$820,941
Present values at an earned rate of 8.5 percent:									$371,261	$362,945

Explanation of columns:

(a) Gross premiums.

(b) Interest, at 8.5 percent earned rate, on net level premium reserve (NLPR) at the end of the previous year. The NLPR is based on guaranteed mortality and the dividend fund interest rate.

(c) Interest, at the 8.5 percent earned rate, on current-year cash flow. This illustration assumes premiums are received, and all expenses incurred, at the start of the year. This illustration assumes death benefits, surrender benefits, and dividends are all at the end of the year.

(d) Death benefits, not reduced by related NLPR.

(e) Surrender benefits, not reduced by related NLPR.

(f) Recurring expenses not included in capitalized acquisition costs.

(g) Net decrease (increase) in aggregate NLPR in the year.

(h) Policyholder dividends for the year.

(i) Sum of (a) through (h) inclusive.

* This schedule is taken from SOP 95-1, appendix A, "Illustration of Computation of Gross Margins."

Schedule 2—Closed Block Components

Year	Premium (a)	Interest on Closed Block Assets (b)	Interest on Current Activity (c)	Death Benefits Incurred (d)	Surrender Benefits Incurred (e)	(Increase) Decrease in NLPR (g)	Dividends Incurred (h)	Estimated Gross Margin (i)	(Increase)/ Decrease in Policyholder Dividend Obligation (j)	Closed Block Initial Estimated Gross Margin (k)
1–5	n/a	n/a	n/a	n/a	n/a	(475,759)	n/a	n/a	n/a	n/a
6	$ 131,222	$ 11,200	$ 12,466	($ 15,622)	($ 17,237)	($73,236)	($ 30,043)	$ 18,750	($2,491)*	$ 16,259
7	124,333	17,839	10,568	(16,578)	(20,989)	(66,499)	(33,061)	15,613	549	16,162
8	117,768	24,819	10,010	(16,824)	(24,427)	(60,005)	(35,127)	16,214	595	16,809
9	111,526	31,298	9,480	(17,526)	(27,566)	(53,706)	(36,990)	16,515	646	17,161
10	105,582	37,266	8,974	(18,603)	(30,406)	(47,485)	(38,675)	16,653	701	17,354
11–20	779,517	585,648	66,259	(311,112)	(398,831)	(162,077)	(424,092)	135,312	0	135,312
21–55	589,392	1,103,633	50,099	(1,187,632)	(686,079)	938,767	(669,668)	138,512	0	138,512
Total	$1,959,340	$1,811,703	$167,856	($1,583,897)	($1,205,535)	$ 0	($1,267,656)	$357,569	($ 0)	$357,569

Remarks

1) Example assumes demutualization begins in year six.
2) Expenses assumed to be excluded from the closed block.
3) Closed Block policyholder dividend obligation (PDO) Calculation

* Cumulative Closed Block EGM:

Actual as of Measurement Date	$18,750
– Initial Actuarial Calculation	$16,259
= PDO at Measurement Date	$ 2,491

4) Shaded figures indicate differences from the example shown in Schedule 1.

Expenses assumed to be excluded from the closed block.

Notes: g. (475,759) represents the cumulative (increase) decrease in net level premium reserve (NLPR) reported in Schedule 1, column (g) for years one to five

j. PDO as of end of last year minus PDO as of end of current year.

k. (i) + (j)

Schedule 3—Open Block Components

Year	Interest on Open Block Assets (b)	Interest on Current Activity (c)	Recurring Expenses Incurred (f)	Open Block EGM (i)	Closed Block EGM (k)	Total EGM (l)	DAC Amortization (m)
1–5	n/a	n/a	n/a	n/a	n/a	$242,474	$ 63,336
6	$ 33,998	($ 1,122)	($ 11,810)	$ 21,066	$ 16,259	$37,324	$ 9,409
7	29,037	(951)	(11,190)	16,896	16,162	33,058	7,263
8	27,663	(901)	(10,599)	16,163	16,809	32,972	7,854
9	26,234	(853)	(10,037)	15,344	17,161	32,505	8,248
10	24,776	(807)	(9,502)	14,467	17,354	31,821	8,535
11–20	174,635	(5,963)	(70,157)	98,515	135,312	233,827	66,591
21–55	119,052	(4,510)	(53,041)	61,501	138,512	200,013	70,265
Total Year 6–55	$435,395	($15,107)	($176,336)	$243,957	$357,569	$601,520	$178,164
Grand Total						$843,994	$241,500

Notes:

l. (i) + (k)

m. Deferred acquisition costs (DAC) balance as of end of prior year minus DAC balance as of end of current year.

GLOSSARY

actuarial calculation. The periodic expected changes in the net closed block liability (on a generally accepted accounting principles basis), which is after the elimination of the effect of applicable items of other comprehensive income. The amortization of deferred acquisition costs is not a component of the actuarial calculation because deferred acquisition costs are not a closed block asset.

actuarial calculation date. The date as of which the actuarial calculation is performed, which is as of the date of demutualization or formation of a mutual insurance holding company (MIHC) or, if not practicable for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, as of the beginning of the year of adoption of this Statement of Position.

carrying amount. The amount of an item as displayed in the financial statements.

closed block. A mechanism to preserve (over time) the reasonable dividend expectations of individual policyholders with individual life, health, or annuity policies for which dividends are currently being paid or are expected to be paid under the current dividend scale. A closed block comprises a defined, limited group of policies and a defined set of assets, and is governed by a set of operating rules.

date of demutualization. The date the plan of reorganization becomes effective.

deferred acquisition costs (DAC). Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees).

demutualization. The conversion of a mutual insurance enterprise to a stock insurance enterprise.

dividend scales. The actuarial formulas used by life insurance companies to determine amounts payable as dividends on participating policies based on experience factors relating, among other things, to investment results, mortality, **lapse rates**, expenses, premium taxes and policy loan interest.

fair and equitable. The term *fair and equitable* is generally the terminology used in the demutualization or mutual insurance holding company state regulation to describe how the allocation of consideration to eligible policyholders should be determined.

in force. Generally, policies and contracts written and recorded on the books of an insurance carrier that are unexpired as of a given date.

lapse rate. The rate at which insurance contracts terminate through failure of the insureds to continue required premium payments. The lapse rate may also be considered a rate of *non-persistence*. It is usually expressed as a ratio of the number of contracts that terminated by reason of failure of insureds to make premium payments during a given period, to the total number of contracts at the beginning of the period from which those lapses occurred.

mortality. The relative incidence of death in a given time or place.

net closed block liability. The carrying amount of closed block liabilities in excess of the carrying amount of closed block assets each adjusted to eliminate the impact of related amounts in accumulated other comprehensive income at the actuarial calculation date. Deferred acquisition costs are not assets of the closed block.

nonparticipating insurance contracts. Insurance contracts that are not entitled to dividends. Usually issued by a stock life insurance entity at premium rates that are usually lower than those charged where dividends are payable. Mutual entities may issue nonparticipating contracts.

participating insurance contracts. Insurance in which the contractholder is entitled to share in the entity's earnings through dividends that reflect the difference between premium charged and the actual experience.

persistency. Percentage of life insurance policies or annuity contracts remaining in force between measurement dates.

plan of demutualization. The plan of reorganization (including all exhibits and schedules thereto), as it may be amended from time to time, which is adopted by the board of directors of the demutualizing company, pursuant to which the company demutualizes.

policy credits. Additional values applied to a policy through dividends, increases in fund values, accumulation values or accumulation account values or extensions of coverages.

statutory. An other comprehensive basis of accounting principles required by statute, regulation, or rule, or permitted by specific approval, that an insurance enterprise is required to follow when submitting its financial statements to state insurance departments.

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