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Accounting for certain insurance activities of mutual life insurance enterprises; Statement of position 95-1;

American Institute of Certified Public Accountants. Mutual Life Insurance Task Force

AICPA

STATEMENT OF POSITION 95-1

Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises

January 18, 1995

Prepared by the Mutual Life Insurance Task Force of the AICPA Insurance Companies Committee Accounting Standards Division

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

NOTE

Statements of position of the Accounting Standards Division 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 as sources of established accounting principles that an AICPA member should consider if the 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 this 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 accounting guidance for certain participating insurance contracts of mutual life insurance enterprises. The contracts covered by the SOP have the following characteristics:

- They are long-duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurance enterprise.
- Annual policyholder dividends are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the contribution principle).

Furthermore, the Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, which extends the requirements of FASB Statement Nos. 60, 97, and 113 to mutual life insurance enterprises. Those FASB Statements should be applied to the contracts not covered by this SOP.

The SOP is effective for financial statements issued for fiscal years beginning after December 15, 1995.

Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises

Introduction and Background

1. Most mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies (hereafter collectively referred to as *mutual life insurance enterprises*) issue financial statements prepared in conformity with statutory accounting practices. Practice, however, has been to consider statutory accounting practices as generally accepted accounting principles (GAAP), and mutual life insurance enterprises' statutory financial statements have been described as being in accordance with GAAP.

2. In April 1993, the FASB issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, which concludes that financial statements based on statutory accounting practices can no longer be described as prepared in conformity with GAAP. FASB Interpretation No. 40, as amended by FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, is effective for financial statements issued for fiscal years beginning after December 15, 1995. (FASB Statement No. 120 does not change the disclosure and other transition provisions of Interpretation No. 40.) Accordingly, mutual life insurance enterprises that wish to prepare GAAP financial statements in 1996 and beyond will have to apply pertinent authoritative accounting pronouncements, such as FASB Statements and Interpretations, Accounting Principles Board Opinions, and AICPA Statements of Position, that do not explicitly exempt mutual life insurance companies.

3. When FASB Interpretation No. 40 was issued, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain*

Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, exempted mutual life insurance companies from their provisions. Furthermore, the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies* does not apply to mutual life insurance companies.[1] Accordingly, there was no authoritative guidance that explicitly addressed how to account for certain insurance activities of mutual life insurance enterprises. Recognizing the lack of authoritative guidance, the FASB urged the AICPA to take on a project to address accounting and reporting by mutual life insurance enterprises for their insurance activities. This SOP was prepared in response to that request. Furthermore, concurrent with the issuance of this SOP, the FASB has issued Statement No. 120, which removes the exemption for mutual life insurance enterprises from FASB Statement Nos. 60, 97, and 113 and recognizes that participating life insurance contracts that meet the conditions in paragraph 5 of this SOP should be accounted for under this SOP.

Applicability and Scope

4. This SOP applies to all mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies. This SOP also applies to stock life insurance subsidiaries of mutual life insurance enterprises.

5. This SOP applies to life insurance contracts that have both of the following characteristics:

a. They are long-duration participating contracts that are expected to pay **dividends to policyholders**[2] based on actual experience of the insurance enterprise.

b. **Annual policyholder dividends** are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the *contribution principle*).

[1] The AICPA plans to issue an exposure draft of a revised life and health insurance enterprises audit guide, which will apply to mutual life insurance enterprises. This SOP will be incorporated into the revised guide.

[2] Terms defined in the Glossary are in **boldface type** the first time they appear in this SOP.

6. FASB Statement No. 97 should be applied to investment contracts, limited-payment contracts that do not have the characteristics described in paragraph 5, and universal life-type contracts as defined in FASB Statement No. 97. FASB Statement No. 60 should be applied to short-duration contracts with fixed and variable terms and to long-duration contracts that do not have the characteristics described in paragraph 5 and are not covered by FASB Statement No. 97. FASB Statement No. 113 should be applied to reinsurance contracts.

Accounting and Reporting Models

7. The accounting and reporting model for long-duration insurance contracts issued by insurance enterprises other than mutual life insurance enterprises was established in FASB Statement Nos. 60 and 97. FASB Statement No. 60 addresses long-duration contracts, such as whole-life, guaranteed-renewable term-life, and annuity contracts that are expected to remain in force for an extended period and that are characterized by fixed and guaranteed terms. FASB Statement No. 97 addresses other long-duration contracts—such as universal life-type insurance contracts—that are characterized by flexibility and discretion granted to one or both parties to the contract, limited-payment contracts, and investment contracts.

FASB Statement No. 60

8. Under FASB Statement No. 60, premiums for long-duration insurance contracts are recognized as revenue when due from policyholders. A liability for future policy benefits is accrued when premium revenue is recognized. The liability—which represents both the present value of estimated future policy benefits to be paid to or on behalf of policyholders, and related expenses less the present value of estimated future net premiums[3] to be collected from policyholders—is based on a uniform percentage of anticipated premiums and on estimates of expected **investment yields**, mortality, morbidity, terminations, and expenses applicable at the time the insurance contracts are made. FASB Statement No. 60 also requires a provision for the risk of adverse deviation. Original assumptions

[3] FASB Statement No. 60 defines *gross premium* as "the premium charged to a policyholder for an insurance contract." That Statement defines *net premium* as "the portion of the gross premium required to provide for all benefits and expenses."

ordinarily continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (referred to as *lock-in*), unless a premium deficiency exists. Costs that vary with, and are primarily related to, the acquisition of new and renewal insurance contracts (**acquisition costs**) are capitalized and charged to expense in proportion to premium revenue recognized.

FASB Statement No. 97

9. FASB Statement No. 97 requires that a retrospective deposit method be used to account for universal life-type insurance contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder. Premiums are not reported as revenues: Rather, revenues from those contracts represent amounts assessed against policyholders and are reported in the period that the amounts are assessed, unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period. FASB Statement No. 97 also requires that capitalized acquisition costs associated with universal life-type contracts be amortized, based on a constant percentage of the present value of estimated gross profit amounts. Estimates of gross profits should be evaluated regularly, and the total amortization recorded to date is adjusted if actual experience or other evidence suggests earlier estimates should be revised.

Participating Contracts

10. 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, which are covered by this SOP. Furthermore, FASB Statement No. 97 addresses those participating contracts with contract terms that suggest that they are, in substance, universal life-type contracts.

Conclusions on Financial Reporting

11. The following conclusions should be applied to insurance contracts described in paragraph 5 of this SOP and should be read in conjunction with "Background Information and Basis for Conclusions," beginning in paragraph 26 of this SOP. Furthermore, AICPA Practice Bulletin 8, *Application of FASB Statement No. 97*, Accounting

and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, *to Insurance Enterprises*, provides interpretative guidance that, if applicable, should be followed for the contracts covered by this SOP.

Revenue Recognition

12. Premiums from participating insurance contracts should be reported as revenue in the statement of earnings when due from policyholders.

Benefits Recognition

13. Death and surrender benefits incurred should be reported as expenses in the statement of earnings.

Dividends

14. Annual policyholder dividends should be reported separately as an expense in the statement of earnings, and should be based on estimates of amounts incurred for the policies in effect during the period. For example, if a policy has an anniversary date of June 30, at which time annual dividends are paid, at December 31, 19X1, dividends should be accrued for the period July 1, 19X1, through December 31, 19X1, and should be reported separately on the balance sheet. (See paragraph 17 for information on accounting for terminal dividends as part of the liability for future policyholder benefits.)

Liability for Future Policy Benefits

15. A liability for future policy benefits relating to participating life insurance contracts should be equal to the sum of—

a. The **net level premium reserve** for death and endowment policy benefits.

b. The liability for **terminal dividends.**

c. Any probable loss (premium deficiency) as described in paragraphs 35 to 37 of FASB Statement No. 60.

16. The net level premium reserve should be calculated based on the **dividend fund interest rate**, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the

contract. If the dividend fund interest rate is not determinable, the **guaranteed interest rate** used in calculating cash surrender values described in the contract should be used. If the dividend fund interest rate is not determinable and there is no guaranteed interest rate, the interest rate used in determining guaranteed nonforfeiture values should be used. Finally, if none of the above rates exists, then the interest rate used to determine minimum cash surrender values —as set by the National Association of Insurance Commissioners' (NAIC) model standard nonforfeiture law—for the year of issue of the contract should be used. Regardless of the rate used, net premiums should be calculated as a constant percentage of the gross premiums.

17. Terminal dividends should be accrued in the liability for future policy benefits if the following conditions are both met:[4]

a. Payment of the dividend is probable.

b. The amount can be reasonably estimated.

If the two conditions are met (and they ordinarily will be), the terminal dividends should be recognized as an expense over the life of a book of participating life insurance contracts, at a constant rate based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield (net of related investment expenses). If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing the expense amount to be recognized. (The base substituted in this calculation should be the same one substituted in the amortization of deferred acquisition costs discussed in paragraph 20.)

18. Increases in the liability for future policy benefits should be reported as an expense in the statement of earnings.

[4] These conditions should be used in the same sense that they are used in FASB Statement No. 5, *Accounting for Contingencies.*

Acquisition Costs

19. This SOP uses the definition of *acquisition costs* contained in FASB Statement No. 60,[5] and in the following sentence describes those that are ineligible for capitalization under this SOP. Acquisition costs (such as premium taxes) that vary in a constant relationship to premiums or insurance in force, that are recurring in nature, or that tend to be incurred in a level amount from period to period, should be charged to expense in the period incurred.

20. Capitalized acquisition costs should be amortized over the life of a book of participating life insurance contracts at a constant rate, based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield. If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing amortization.

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

Estimated Gross Margins

22. *Estimated gross margin,* as the term is used in this SOP, should include estimates of the following:

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[5] Acquisition costs are addressed in paragraphs 28 to 31 of FASB Statement No. 60.

a. Amounts expected to be received from premiums, plus

b. Amounts expected to be earned from investment of policyholder balances (that is, the net level premium reserve described in paragraph 15*a*), less

c. All benefit claims expected to be paid, less

d. Costs expected to be incurred for contract administration (including acquisition costs not included in capitalized acquisition costs), less

e. Expected change in the net level premium reserve for death and endowment benefits, less

f. Expected annual policyholder dividends, plus or less

g. Other expected assessments and credits, however characterized

Estimated gross margins should be determined on a best estimate basis, without provision for adverse deviation.

23. Several dividend options may be available to the policyholder, in which instances the options generally can be changed during the life of the contract. In estimating gross margins, insurance enterprises should use the best estimate of the dividend options that policyholders will elect.

Disclosures

24. The following should be disclosed in the financial statements with respect to participating contracts:

a. The methods and assumptions used in estimating the liability for future policy benefits

b. The average rate of assumed investment yields used in estimating expected gross margins

c. The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period

Effective Date and Transition

25. This SOP is effective for financial statements for fiscal years beginning after December 15, 1995. Earlier application is encouraged.

The effect of initially applying this SOP should be reported retroactively through restatement of all previously issued annual financial statements presented for comparative purposes for fiscal years beginning after December 15, 1992. Previously issued financial statements for any number of consecutive periods preceding that date may be restated to conform to the provisions of this SOP. The cumulative effect of adopting this SOP should be included in the earliest year restated.

Background Information and Basis for Conclusions

26. The AICPA Accounting Standards Executive Committee's (AcSEC's) conclusions about accounting and reporting for participating life insurance contracts covered by this SOP are based on how the economic substance of those contracts differs fundamentally from nonparticipating contracts (traditional and universal life-type contracts) and from participating contracts that do not have the characteristics described in paragraph 5 of this SOP. The following sections (*a*) describe the factors differentiating the contracts covered by this SOP from those other contracts, (*b*) discuss AcSEC's reasons for concluding that neither FASB Statement No. 60 nor FASB Statement No. 97 in its entirety is appropriate for the contracts covered by this SOP, and (*c*) discuss other considerations deemed significant by AcSEC in reaching its conclusions.

Participating Contracts

27. Participating life insurance contracts are issued for a gross premium that provides policyholders with certain guaranteed benefits as well as with dividends. Generally, the gross premium is calculated with sufficient margin so that each class of contracts is self-supporting. Annual policyholder dividends paid generally reflect the company's experience and performance in investment activity, mortality experience, and contract administration for each class of contracts. It is the dividend determination and distribution that distinguishes participating life insurance from nonparticipating life insurance.

28. The nature of the annual dividend determination varies from company to company but is generally a two-step process. The first step is to determine divisible surplus, which is a determination each company makes based on its financial results. The second step is to distribute divisible surplus to policyholders in an equitable manner.

Actuarial standards require divisible surplus to be distributed among contracts in the same proportion as the contracts contributed to divisible surplus.

Applicability and Scope

29. AcSEC's charge was to address, as much as possible, the accounting and reporting of mutual life insurance enterprises' insurance activities within the framework established in FASB Statement Nos. 60 and 97. In reaching the conclusions in this SOP, AcSEC believes the contracts covered by this SOP are transactions between mutual life insurance enterprises and their customers. After reviewing the nature of a variety of mutual life insurance enterprise contracts, AcSEC concluded that this SOP should address the accounting only for life insurance contracts with the characteristics described in paragraph 5 of this SOP. The dividend scales on such contracts are often referred to as *actively managed*, because dividends paid are based on actual experience; that is, dividend scales are adjusted to reflect significant changes on a reasonably timely basis. FASB Statement No. 120 requires that other insurance contracts of mutual life insurance enterprises, such as annuity contracts, group insurance contracts, disability contracts, universal life-type contracts, and pension guaranteed contracts, should be accounted for under FASB Statement Nos. 60 and 97.

30. AcSEC concluded that separate consideration of the participating life insurance contracts covered by this SOP 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 this SOP have attributes of the contracts covered by FASB Statement Nos. 60 and 97. AcSEC concluded, therefore, that contracts covered by this SOP were not sufficiently similar to those covered by either FASB Statement to warrant applying either of them in its entirety.

31. Participating life insurance contracts covered by this SOP are similar to the conventional life contracts contemplated by FASB Statement No. 60 in the following respects:

a. Permanent participating life insurance is based on the traditional concept of level premiums over the life of the contract.

b. The individual contract functions related to interest, mortality, and expenses are not separately displayed to policyholders and are not explicitly stated in the policy.

c. The pattern of premium payments is specified in the contract and cannot normally be varied after issue.

d. There is no explicit account balance for each policyholder.

32. 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 this SOP 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 this SOP 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 these products, after annual policyholder dividends, tend to emerge as the margin recognized on investments, mortality, and expenses.

33. AcSEC concluded that because the earnings after annual policyholder dividends from the contracts covered by this SOP tend to evolve in a manner similar to universal life-type contracts, most of the provisions of FASB Statement No. 97 should be applied to the contracts covered by this SOP. Nevertheless, AcSEC concluded that because the contracts covered by this SOP have terms similar to the terms of conventional life products, it was not feasible or appropriate to apply FASB Statement No. 97 in its entirety.

34. The recommendations in this SOP differ from the accounting in FASB Statement No. 97 for universal life-type contracts in two significant respects:

a. Whereas under FASB Statement No. 97 premiums are not reported as revenue and benefit payments representing a return of policyholder balances are not reported as expenses in the statement of earnings, under this SOP premiums should be recognized as revenue and benefit payments charged to expense.

b. Whereas FASB Statement No. 97 does not address dividends, under this SOP dividends should be charged to expense.

35. AcSEC recognizes that the FASB chose to exclude traditional participating life insurance contracts issued by stock life insurance companies from the scope of FASB Statement No. 97. However, AcSEC notes that in making that decision, the FASB did not consider participating policies of mutual life insurance enterprises, which AcSEC believes differ substantively from many of the participating policies issued by stock life insurance companies. Furthermore, the FASB's consideration of participating policies may have been influenced by the fact that participating policies are generally a less significant portion of stock life insurance companies' business than of mutual life insurance enterprises' business.

Revenue Recognition

36. AcSEC recognizes that reporting premiums as revenues may appear inconsistent with the accounting model set forth in this SOP. AcSEC believes, however, that recognizing premiums as revenue for the contracts covered by this SOP is justified for two reasons, both of which are based on the economic substance of the relationship between the issuer and the policyholder.

37. First, premiums received under participating contracts fit the definition of *revenues* in FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*. AcSEC believes the fact that premiums generally are level, fixed, and payable at predetermined points in return for a guaranteed death benefit and cash surrender value is significant. Furthermore, unlike the purchaser of a universal life-type insurance contract, the purchaser of a participating life insurance contract generally cannot vary the amount and timing of premium payments, and no account balance information is communicated to the policyholder. In addition, premiums are not credited to a policyholder account balance. Accordingly, AcSEC believes reporting premiums as revenues is consistent with the FASB Concepts Statement No. 6 definition of *revenues* as inflows from delivering services that constitute an entity's ongoing major or central operations.

38. Second, for many mutual life insurance enterprises it would not be practicable or meaningful to report premiums received as deposits. AcSEC considered how mutual life insurance companies

would report premiums as such and concluded that mortality, expense, and surrender charges would be reported as revenues. For those amounts to be relevant, the elements of dividends related to each would have to be determined. AcSEC believes that making such allocations would be arbitrary. AcSEC further believes the costs of making such allocations would far exceed the benefits derived from reporting the amounts separately. Furthermore, the lack of an explicit policyholder balance or separate assessments or charges for contract services and credits for interest—which exist for universal life-type contracts—makes separate measurement of the advance funding and contract service functions impractical.

Benefit Recognition

39. AcSEC concluded that to be consistent with the reporting of premiums as revenues when due from the policyholder, actual death and surrender benefits incurred during the accounting period should be reported as expenses.

Dividends

40. FASB Statement No. 97 does not explicitly address the treatment of dividends for participating contracts accounted for as universal life-type contracts. Some may believe that under that model, annual policyholder dividends would be allocated among interest credited, death benefits or mortality charges, and expenses, rather than reported as an expense. Others may believe that the entire annual policyholder dividend is one of the "other assessments and credits" described in paragraph 23 of FASB Statement No. 97. AcSEC concluded that, especially because this SOP recommends premiums should be reported as revenues when due from the policyholder, actual dividends incurred during the accounting period should always be reported as an expense; dividends should not be charged directly to equity in any circumstance.

41. Furthermore, FASB Statement No. 60 defines two alternative accounting treatments for policyholder dividends based on whether the contracts included restrictions on the net income amount that may be distributed to stockholders. For participating contracts that have no net income restrictions, and that use life insurance dividend

scales unrelated to actual net income, policyholder dividend liabilities should be accrued over the premium-paying period of the contracts (1) based on dividends anticipated in determining gross premiums, or (2) as shown in published dividend illustrations at the date insurance contracts are made. For contracts limiting the amount of net income that may be distributed to stockholders, the net income amount that cannot be distributed to shareholders is excluded from stockholders' equity by a charge to operations and a credit to a liability, a method similar to the accounting for net income applicable to minority interests. However, for either type of participating contract, dividends are reported as expenses in the statement of earnings as "dividends to policyholders" or "provision for policyholders' share of earnings on participating business."

42. 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.

Capital Gains and Losses

43. The guidance in FASB Statement No. 97, as amended by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, on capital gains and losses, which also is incorporated in FASB Statement No. 60, applies to the contracts covered in this SOP. Paragraph 28 of FASB Statement No. 97, as amended, states:

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

Furthermore, in paragraph 77 in appendix A of FASB Statement No. 97, the FASB addressed the issue of whether certain realized gains and losses should be deferred and recognized over the remaining life of the insurance contracts with the following:

> The Board notes that generally accepted accounting principles require that realized investment gains and losses be reflected in the period in which they occur. The Board acknowledges that some contracts with policyholders may entitle policyholders to an amount equal to a portion of specific investment performance. The recording of liabilities to reflect amounts to which those policyholders are entitled is appropriate, but the deferral of realized gains and losses is not justified.

Liability for Future Policy Benefits

Proxy for Account Balance

44. Under FASB Statement No. 97, the liability for future policy benefits includes the policyholder's account balance as of the balance sheet date. However, because participating contracts usually lack a stated account balance, a proxy for account balance had to be determined. AcSEC considered six possible proxies:

a. **Dividend fund**

b. Net level premium reserve, using statutory valuation mortality and interest

c. Commissioners reserve valuation method (CRVM) reserves

d. Cash surrender value

e. Net level premium reserve, using guaranteed mortality and interest

f. Net level premium reserve, using the guaranteed mortality and dividend fund interest

45. After considering all the above possible account balances, AcSEC concluded that the net level premium reserve using the guaranteed mortality and dividend fund interest generally should be used as the proxy for account balance. Furthermore, AcSEC notes that there may be policies that do not meet normal underwriting standards for which additional amounts may be included in the net level premium reserve.

46. If experience is more favorable than what was anticipated in determining the dividends guaranteed in the policy, a mutual life insurance enterprise's objective is to distribute the favorable experience as dividends. If experience is less favorable than what was anticipated in determining the dividends guaranteed, the company must at least provide the guaranteed values. Therefore, if there is an unfavorable experience, a premium deficiency may result, which would be recognized under paragraph 15*c* of this SOP. Accordingly, the liability determined, based on guaranteed benefits, provides an appropriate measure of the liability to policyholders because, to the extent experience is more favorable than the guarantees, the company pays the difference to policyholders in dividends. This estimate of the liability is consistent with the view that the mutual life insurance enterprise is liable for the guaranteed provisions of the policies it sells and for paying dividends related to favorable experience. AcSEC believes that for many participating policies the net level premium reserve for guaranteed benefits will best reflect the amount that has accrued to the benefit of policyholders for participating contracts. AcSEC therefore concluded that the net level premium reserve is consistent with FASB Statement No. 97's description of the liability as "the balance that accrues to the benefit of individual policyholders [that] represents the minimum measure of an insurance enterprise's liability. . . ."

47. Nevertheless, this SOP recommends that a mutual life insurance enterprise with a determinable dividend fund interest rate should calculate the net level premium reserve for guaranteed benefits based on the dividend fund interest rate rather than on the rate used in determining guaranteed cash surrender values. AcSEC believes that in practice the dividend fund interest rate and the interest rate guaranteed in computing cash surrender values often will be the same. If those interest rates differ, the calculation based on the dividend fund interest rate usually reflects the pattern of anticipated annual policyholder dividends more accurately.

48. Some mutual life insurance enterprises have a dividend fund for participating policies. Though that dividend fund generally is not disclosed to the policyholder, it is the amount specified by management at contract inception to which interest is credited and from which mortality and expense charges are assessed in the dividend determination mechanism. Accordingly, many believe the dividend

fund is the economic equivalent of the account balance of universal life-type contracts. Though most companies with dividend funds define the dividend fund account balance in their dividend resolutions, there are a variety of ways in which a dividend fund is defined but no consistent practices for company management to apply in defining the amount. Furthermore, not all mutual life insurance enterprises have a dividend fund. Accordingly, AcSEC concluded that the dividend fund lacked the objectivity and comparability necessary to be an appropriate proxy for the account balance.

49. AcSEC also rejected the statutory net level premium reserve and the statutory CRVM as proxies for account balance, because the assumptions used in determining such amounts are based on statutory requirements, which are not necessarily related to either policy nonforfeiture guarantees or the dividend calculation.

50. AcSEC also rejected the cash surrender values as the proxy for account balance, because AcSEC believes the amount does not reflect the amount that accrues to a continuing policyholder's benefit. AcSEC believes the decision not to use cash surrender values as the proxy for account balance is consistent with FASB Statement No. 97, which requires the use of an account balance instead of the cash surrender value when both exist. Though participating policies lack an explicit account balance, AcSEC believes the net level premium reserve determined under this SOP is an appropriate proxy for the account balance. AcSEC notes that cash surrender values generally will be less than the liability for future policy benefits calculated under this SOP. Cash surrender values are frequently developed using methods similar to those used to compute the liability for future policy benefits calculated under this SOP, but are net of an implicit surrender charge.

Terminal Dividends

51. AcSEC believes the rights to terminal dividends accumulate to policyholders over a policy's life. Accordingly, the event that creates the liability is the continuance of the contract by the policyholder, not the termination of the policy. If the payment of terminal dividends is probable and the amount can be reasonably estimated, the liability should be recognized. Furthermore, AcSEC believes terminal dividends are similar to amounts previously assessed against policyholders

that are refundable on the contract's termination under paragraph 17*c* of FASB Statement No. 97.

Adverse Deviation

52. FASB Statement No. 60 requires that assumptions used in calculating the liability for future policy benefits include a provision for the risk of adverse deviation. The notion of adverse deviation is (1) to include in benefit reserves the risk assumed by the insurer that actual experience will be more adverse than the basic assumptions underlying premium rates, and (2) to include the gradual release from this risk in periodic net income as actual experience emerges. However, under FASB Statement No. 97, a provision for adverse deviation is not permitted. Because the liability for future policy benefits defined in this SOP generally follows the FASB Statement No. 97 model, AcSEC concluded that provision for adverse deviation should not be made. AcSEC agrees with the FASB's reasons for rejecting adverse deviation in FASB Statement No. 97. Furthermore, for participating contracts covered by this SOP, most adverse experience could be recovered from policyholders, as it emerges, through lower future dividends.

Acquisition Costs

53. FASB Statement No. 97 requires that gross profit estimates used as a basis for amortizing capitalized acquisition costs be evaluated regularly, and that total amortization recorded to date be adjusted by a charge or credit to the statement of earnings if actual earnings or other evidence suggests revision of earlier estimates of expected gross profits. AcSEC concluded that the expected gross margins resulting from participating life contracts issued by mutual life insurance companies are economically similar to the expected gross profits of universal life-type contracts. Accordingly, because the conclusions in this SOP are primarily based on the conclusions in FASB Statement No. 97, AcSEC decided to retain the retrospective adjustment of deferred acquisition costs in this SOP.

Estimated Gross Margins

54. Under FASB Statement No. 97, the emergence of earnings for universal life-type contracts is based on gross profits. Similarly, under this SOP profits would emerge based on gross margins. However,

due to the different way in which values are communicated to the policyholder and maintained by a mutual life insurance company, gross margins need to be determined differently from universal life-type contracts.

55. Paragraph 23 of FASB Statement No. 97 defines the terms to be considered in calculating the estimated gross profits for universal life-type contracts, as follows:

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

56. Those terms are presented in the form of specific margins. Participating life contracts have similar margins but the charges and credits are not structured in the same way as in universal life-type contracts. Because of this difference, certain items used in determining gross profits for universal life-type contracts are not readily available for participating contracts. AcSEC resolved this problem by using a list of elements, which AcSEC believes develops gross margins consistent with the FASB Statement No. 97 definition of *gross profit.*

57. The gross margin elements used in this SOP are not identical to the elements used in FASB Statement No. 97. Specifically, the following elements are included in FASB Statement No. 97 but not in this SOP:

a. Amounts expected to be assessed for mortality
b. Amounts expected to be assessed for contract administration
c. Interest credited to policyholder balances

The following are elements in this SOP that are not in FASB Statement No. 97:

a. Amounts expected to be received from premiums

b. The expected change in the net level premium reserve for death and endowment policy benefits

c. Expected annual policyholder dividends

58. Those lists differ because, for participating contracts covered under this SOP, dividends, premiums, and the liability for policy benefits are not separated into the various charges, credits, and deposits. This different view of gross margins is consistent with the proposed presentation of earnings for participating contracts under this SOP.

Interest Rates

59. Under FASB Statement No. 97, the rate that accrues to policyholder balances (the *contract rate*) is used to accrue interest to policyholder balances, to compute the present value of estimated gross profits, and to accrue interest to the unamortized balance of capitalized acquisition costs. AcSEC believes the dividend interest rate is the rate most comparable to the contract rate. However, AcSEC has concluded that using the dividend fund interest rate to determine the net level premium reserve is preferable to using the dividend interest rate, because the dividend fund interest rate is more objectively determinable. AcSEC concluded that using the investment yield to calculate the present value of estimated gross margins, and to accrete interest on the unamortized balance of capitalized acquisition costs, is preferable to using the dividend interest rate because the investment yield is more objectively determinable and would result in approximately the same income pattern as if the dividend fund interest rate were used.

Other Methods Considered

60. AcSEC considered, and rejected, a modified FASB Statement No. 60 approach whereby the earnings from mutual life participating insurance contracts would emerge in relation to premiums and not in relation to expected gross margins. This consideration was prompted by a concern that reporting premiums as revenues, but having profits

emerge based upon gross margins, may produce incongruous results. In addition, the lack of an explicit policyholder's account balance, and the lack of a predominant function or service representative of the pooling of the aggregation of services, are characteristics of insurance contracts as defined under FASB Statement No. 60. FASB Statement No. 60 requires that expenses should be recorded (and therefore earnings would emerge) in relation to premiums.

61. A modification to FASB Statement No. 60 was discussed, however, to provide for mutual life insurance contracts in which dividend scales are actively managed. Each change in the dividend scale represents, in essence, a repricing and the establishment of new expectations. Therefore, the emergence of earnings based upon the original pricing assumptions no longer would be relevant to financial measurements.

62. In applying FASB Statement No. 60 to mutual life insurance contracts in which the dividend scales are actively managed, each change in the dividend scale would result in an unlocking of the previously used assumptions. The new assumptions would be used in subsequent accounting periods, until the dividend scales are changed again. The unlocking of assumptions would be prospective in nature and would provide stability to the matching of benefits and expenses with revenue.

APPENDIX A

Illustration of Computation of Gross Margins

Schedule 1—Computation of Estimated Gross Margins

Year	Premium	Interest on NLPR	Interest on Current Activity	Death Benefits Incurred	Surrender Benefits Incurred
	(*a*)	(*b*)	(*c*)	(*d*)	(*e*)
1	$ 210,000	$ 0	$ 16,244	$ (9,000)	$ 0
2	184,611	10,719	14,280	(10,549)	0
3	169,621	19,994	13,120	(13,731)	(7,148)
4	155,763	27,955	12,048	(14,835)	(14,984)
5	142,990	34,735	11,060	(15,661)	(21,760)
6	131,222	40,440	10,150	(15,622)	(17,237)
7	124,333	46,665	9,617	(16,578)	(20,989)
8	117,768	52,317	9,109	(16,824)	(24,427)
9	111,526	57,417	8,627	(17,526)	(27,566)
10	105,582	61,982	8,167	(18,603)	(30,406)
11–20	779,517	760,283	60,296	(311,112)	(398,831)
21–55	589,392	1,222,685	45,589	(1,187,632)	(686,079)
Total	$2,822,325	$2,335,192	$218,307	$(1,647,673)	$(1,249,427)

Present values at earned rate of 8.5%:

(*a*) Gross premiums.

(*b*) Interest, at the 8.5% 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% 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.

Recurring Expenses Incurred	*(Increase) Decrease in NLPR*	*Dividends Incurred*	*Post-dividend Gross Margins*	*Revised Gross Margins at Year 2*
(f)	*(g)*	*(h)*	*(i)*	
$ (18,900)	$(126,103)	$ (18,857)	$ 53,384	$ 53,384
(16,615)	(109,116)	(21,399)	51,931	50,546
(15,266)	(93,669)	(24,230)	48,691	47,419
(14,019)	(79,754)	(26,574)	45,600	44,432
(12,869)	(67,117)	(28,509)	42,869	41,797
(11,810)	(73,236)	(30,043)	33,864	32,880
(11,190)	(66,499)	(32,301)	33,058	32,126
(10,599)	(60,005)	(34,367)	32,972	32,089
(10,037)	(53,706)	(36,230)	32,505	31,669
(9,502)	(47,485)	(37,915)	31,820	31,028
(70,157)	(162,077)	(424,092)	233,827	227,980
(53,041)	938,767	(669,668)	200,013	195,591
$(254,005)	$ (0)	$(1,384,185)	$840,534	$820,941
			$371,261	$362,945

Schedule 2—Computation of Amortization Rate

		Original Estimate	*Revised Estimate*
Present value of estimated gross margins, years 1–55, evaluated at issue (from Schedule 1)	(*a*)	$371,261	$362,945
Present value of capitalized acquisition costs, years 1–55, evaluated at issue	(*b*)	$263,309	$263,309
Amortization rate = (*b*) / (*a*)	(*c*)	70.923%	72.548%

Schedule 3—Illustration of Amortization

Capitalized costs, year 1		$241,500	$241,500
Interest accrual at 8.5%	(*d*)	20,528	20,528
Amortization, year 1			
Gross margin of 53,384 (from Schedule 1) at rate (*c*) above	(*e*)	(37,862)	(38,729)
Balance, end of year 1	(*f*)	224,166	223,299
Additional capitalized costs, year 2		9,231	9,231
		233,397	232,530
Interest accrual at 8.5%	(*g*)	19,839	19,765
Amortization, year 2			
Gross margin of 50,546 (from Schedule 1, revised column) at revised rate (*c*) above	(*h*)	(36,670)	(36,670)
Balance, end of year 2		$216,566	$215,625
Balance based on original estimate		$216,566	
Balance based on revised estimate		215,625	
Adjustment required		$ (941)	
Net amortization recognized:			
In year 1 (*d* + *e*)		$ 17,334	
In year 2 (*g* + *h* based on revised estimates + difference between *f* at original estimate and at revised estimate)		$ 17,772	

APPENDIX B

Discussion of Comments Received on Exposure Draft

An exposure draft of a proposed statement of position, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, was issued on March 24, 1994, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Thirty-five comment letters were received on the exposure draft. The most significant and pervasive comments received were in the following five areas: (*a*) the FASB Statement No. 60 approach, (*b*) limited-payment contracts, (*c*) dividend utilization in estimated gross margin calculations, (*d*) retrospective adjustment of deferred acquisition costs balances, and (*e*) effective date.

FASB Statement No. 60 Approach

Several respondents preferred a modified FASB Statement No. 60 approach whereby the earnings from mutual life participating insurance contracts would emerge in relation to premiums and not in relation to expected gross margins. AcSEC considered most of the arguments in favor of the modified FASB Statement No. 60 approach in the comment letters during the process leading up to the exposure draft, and continues to support the approach recommended in this SOP.

Limited-Payment Contracts

The exposure draft would have required revenue recognition for limited-payment contracts to be in a constant relationship to insurance in force to the extent that gross premiums exceed net premiums. Many respondents asked AcSEC to reconsider that accounting, because it is inconsistent with the fundamental premise of the SOP that income should be recognized in relation to gross margins. AcSEC believes that for limited-payment contracts with actively managed dividend scales those arguments are persuasive. Accordingly, AcSEC was convinced that the accounting model in the SOP would preclude inappropriate front-end recognition of income on most limited-payment contracts, and eliminated the special accounting requirement for limited-payment contracts.

Dividend Utilization in Estimated Gross Margin Calculations

A variety of dividend options are available to policyholders, including receiving the dividends in cash and purchasing additional paid-up insurance. The exposure draft would have required, in many instances, mutual life insurance enterprises to assume that annual policyholder dividends are paid in cash in estimating gross margins, regardless of the options actually used. Many respondents noted that, for many mutual life insurance enterprises, dividends are more often used to purchase additional paid-up insurance, and that reliable estimates of the effects of dividend options can be made. In response to that information, AcSEC changed paragraph 23 of this SOP to require mutual life insurance enterprises to make the best estimate of the dividend options that policyholders will elect.

Retrospective Adjustment of Deferred Acquisition Costs Balances

Many respondents from the mutual life insurance industry objected to the retrospective adjustment of deferred acquisition costs. They believe that because dividends are actively managed and will be used to prospectively recover or pay out differences that result from changes in expectations, the accounting for such changes should also be prospective. Furthermore, they note that retrospective calculations are much more complicated and difficult to understand than prospective calculations. However, AcSEC continues to believe that retrospective adjustment of deferred acquisition costs, consistent with the provisions of FASB Statement No. 97, is appropriate for policies covered by this SOP for the reasons discussed in paragraph 53.

Effective Date

In the exposure draft the effective date was for financial statements issued for fiscal years beginning after December 15, 1994, consistent with the effective date of FASB Interpretation No. 40. A majority of respondents considered that effective date unreasonable, given the magnitude and significance of the changes that mutual life insurance enterprises will have to make to prepare financial statements in accordance with GAAP. AcSEC agreed and extended the effective date by one year, and urged the FASB to extend the effective date of Interpretation No. 40 similarly. The FASB subsequently issued FASB Statement No. 120, which amends FASB Interpretation No. 40, to be effective for financial statements issued for fiscal years beginning after December 15, 1995.

Glossary

Acquisition costs. Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include 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).

Annual policyholder dividends. Amount of dividends to policyholders calculated and paid each year, representing the policyholders' share of divisible surplus.

Dividend fund. The amount specified by management at contract inception to which interest is credited and from which mortality and expense charges are assessed in the dividend determination mechanism.

Dividend fund interest rate. The interest rate determined at policy issuance used to determine the amount of the dividend fund. It is the rate used to credit interest to the dividend fund, and against which experience is measured to determine the amount of the interest portion of dividends paid to individual policyholders.

Dividend interest rate. The total interest rate the company pays on its dividend fund.

Dividends to policyholders. Nonguaranteed amounts distributable to policyholders of participating insurance contracts and based on actual performance of the insurance enterprise. Under various state insurance laws, dividends are apportioned to policyholders on an equitable basis. Dividends to policyholders include annual policyholder dividends and terminal dividends.

Guaranteed interest rate. The interest rate guaranteed in a policy's cash surrender value or nonforfeiture value calculation.

Investment yield. The interest rate the company expects to earn on the assets supporting the policies, net of investment expense.

Net level premium reserve. The excess, if any, of the present value of future guaranteed death and endowment benefits over the present value of future **net premiums.**

Net premiums. A constant ratio of guaranteed maximum gross premiums. The ratio is calculated at issue, so that the present value of all guaranteed death and endowment benefits is equal to the present value of all net premiums.

Terminal dividends. Dividends to policyholders calculated and paid upon termination of a contract, such as on death, surrender, or maturity.

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