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Accounting by life insurance enterprises for deferred acquisition costs on internal replacements other than those covered by FASB statement no. 97: Discussion paper

American Institute of Certified Public Accountants. Insurance Companies Committee

DISCUSSION PAPER

ACCOUNTING BY LIFE INSURANCE ENTERPRISES FOR DEFERRED ACQUISITON COSTS ON INTERNAL REPLACEMENTS OTHER THAN THOSE COVERED BY FASB STATEMENT NO. 97

June 25, 1999

Prepared by the Insurance Companies Committee of the American Institute of Certified Public Accountants Comments should be received by September 25, 1999, and addressed to Elaine M. Lehnert, Technical Manager, Accounting Standards, File 3162, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 or via the Internet to elehnert@aicpa.org, or by fax to 212-596-6064

June 25, 1999

Invitation to Comment

The AICPA Insurance Companies Committee has prepared this Discussion Paper for distribution to financial statement preparers, users, and other interested individuals and organizations for comment.

The Discussion Paper has not been deliberated by the AICPA Accounting Standards Executive Committee (AcSEC) or the Financial Standards Accounting Board (FASB) and does not necessarily represent the views of AcSEC or the FASB.

After considering the comments received, the Insurance Companies Committee will determine whether authoritative guidance is needed on accounting by life insurance enterprises for deferred acquisition costs on internal replacements other than those covered by FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.

The Insurance Companies Committee requests comments on the following issues.

Issue 1:

Whether authoritative guidance is needed on the accounting by life insurance enterprises for deferred acquisition costs (DAC) in situations characterized as internal replacements.

Issue 2:

Which of the views presented herein is most appropriate and whether there are other views that should be considered.

Issue 3:

What criteria can be developed for determining whether a replacement is between contracts that are substantially similar.

Issue 4:

What costs (if any) should be considered as eligible costs for deferral in a replacement transaction.

Issue 5:

What other issues or practical considerations should be examined related to this topic.
Issue 6:

The Insurance Companies would like to further investigate the analogy between internal replacements and modification or exchanges of debt instruments as it relates to deferral of costs (see View C). To do that, the following areas need further exploration.

- What are the criteria that should be used to measure whether an internal replacement is between contracts that are substantially similar (or different)?

- If an internal replacement is between contracts that are substantially similar, what costs should be deferred? If commissions paid to agents or brokers are incurred, is it appropriate to defer those in light of the guidance in EITF 96-19?

After reviewing the comments received, the Insurance Companies Committee will determine whether they believe that accounting guidance is needed on accounting by life insurance enterprises for DAC on internal replacements other than those covered by FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* issued in 1987. If the Insurance Companies Committee determines that authoritative guidance is needed, a prospectus for a project to develop a Statement of Position or Practice Bulletin will be prepared and presented to the Planning Subcommittee of AcSEC.

Comment letters on the discussion paper must be received by **September 25, 1999**. Comment letters received after that date may not be included in the summary of comments received.

Responses should be addressed to Elaine M. Lehnert, Technical Manager, Accounting Standards, File 3162, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775. Responses may also be sent by electronic mail over the Internet to elehnert@aicpa.org, or by fax to 212-596-6064.

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(1998-1999)

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Introduction

1. The AICPA Insurance Companies Committee has been discussing the accounting by insurance enterprises for DAC on internal replacements. The intent of this Discussion Paper is to determine whether diversity exists with regard to the accounting by life insurance enterprises for internal replacements other than those covered by FASB Statement No. 97 and, if so, whether accounting guidance should be provided.

Background

2. At the time universal life-type contracts became popular, these contracts were often purchased as replacements for traditional life insurance contracts issued by the same enterprise. In such cases, the policyholder often used the cash surrender value of the previous contract to make an initial premium deposit for the new, universal life-type contract. FASB Statement No. 97 refers to these transactions as internal replacements and requires that deferred acquisition costs related to the traditional life insurance contracts be written off when these contracts are replaced with universal life-type contracts issued by the same enterprise.

3. FASB Statement No. 97, however, addresses replacements of traditional life contracts by universal life-type contracts only, and does not address the accounting for other internal replacements (such as traditional life with traditional life, universal life with universal life, annuity with annuity). AICPA Practice Bulletin 8, *Application of FASB Statement No. 97 to Insurance Enterprises*, issued in November 1990, clarified that the discussion in FASB Statement No. 97 for internal replacement transactions applied only to the replacement of traditional insurance contracts with universal life-type contracts. Practice Bulletin 8 went on to say that "the accounting for other internal replacements should be based on the circumstances of the transaction."

4. The basis for conclusions of FASB Statement No. 97, paragraphs .70-.72, discusses alternative views of accounting for internal replacements. The FASB rejected the view that unamortized acquisition costs, and the difference between the cash surrender value and the previously recorded liability for policy benefits, should be deferred and amortized as part of the capitalized acquisition costs of the new book of universal life-type contracts. The FASB did not accept the argument that the universal life replacement contract represented a continuing relationship between the insurer and the policyholder, and therefore, the new contract represented only a change in the form of insurance protection.

5. The FASB also rejected the view put forth by respondents to the exposure draft of FASB Statement No. 97 that the incremental costs of replacement transactions are usually less than the costs of sales to new policyholders. These respondents argued that the continued deferral of net amounts related to replaced contracts more nearly equates the costs of contracts issued to different classes of policyholders.

6. The FASB provided an analogy between the accounting for the deferral of costs by insurance enterprises in replacement situations and the accounting for the extinguishment of debt, including extinguishments in which the old and the new liability are to the same party, by other enterprises as discussed in Accounting Principles Board (APB) Opinion No. 26, *Early Extinguishment of Debt*, as amended by FASB Statement No. 76, *Extinguishment of Debt*.

Summary of the Issue

7. The life insurance industry has witnessed the rapid introduction of new forms of insurance products, many of which can be marketed to existing investors as replacements. Diversity in practice exists in accounting for internal replacements other than those covered by FASB Statement No. 97, and there is a need for definitive guidance on the accounting for acquisition costs to promote consistency in the reporting of these transactions.

Alternative Accounting Views

View A

8. View A proponents believe that the accounting guidance provided in FASB No. 97 that calls for the write-off of unamortized acquisition costs and other costs in cases of internal replacements of traditional life products with universal life products should be extended by analogy to all types of internal replacement transactions (for example, traditional life with traditional life, universal life with universal life, annuity with annuity).

9. According to proponents of View A, the FASB rejected the view, stated in paragraph 71 of FASB Statement No. 97, that the universal life-type replacement contract represented a continuing relationship between the insurer and the policyholder and that the new contract represented only a change in the form of insurance protection. These proponents reason that related acquisition costs follow the contract instead of the customer and extend the FASB's view, by analogy, to other kinds of replacement transactions.

10. The proponents of View A argue that the proliferation of new products was not contemplated at the time that FASB Statement No. 97 and Practice Bulletin 8 were considered. Accordingly, the FASB's restriction on its guidance on replacements was appropriate to the products under discussion at the time and not necessarily reflective of

the FASB's views on other kinds of replacements.

View B

11. Proponents of View B believe that the internal replacement transaction represents a continuation of a contractual relationship and, therefore, the DAC relating to the original contract and any new DAC should be capitalized and amortized over the life of the new contract assuming appropriate recoverability tests are met. They believe that the absence of broader guidance in FASB Statement No. 97 and Practice Bulletin 8 indicates that the FASB and AICPA both had opportunities and chose not to extend the narrow guidance contained therein to other replacement situations.

12. Practice Bulletin 8 specifically states that the accounting for other internal replacements should be based on the circumstances of the transactions. Proponents of "View B" interpret this to mean that there are circumstances where it may be entirely appropriate to retain the DAC related to the original contract.

View C

13. Proponents of View C believe that an internal replacement of one insurance/investment contract with another insurance/investment contract with substantially different terms than the initial contract should be accounted for similar to an extinguishment of debt, which triggers the write-off of any deferred costs related to the initial contract. The replacement of contracts with substantially similar terms should not result in a write-off of existing DAC.

14. Proponents of View C observe that FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* has superseded FASB Statement No. 76, *Extinguishment of Debt*. FASB Statement No. 125 raised several issues regarding extinguishments of debt, which is the very analogy used in FASB Statement No. 97 to support the conclusions regarding internal replacements. In Emerging Issues Task Force (EITF) No. 96-19, *Debtors Accounting for a Modification or Exchange of Debt Instrument*, the EITF reached a consensus that an exchange of debt instruments with substantially different terms is a debt extinguishment. They also concluded that a substantial modification of terms should be accounted for like, and reported in the same manner as, an extinguishment. In reaching these conclusions, however, the EITF explicitly acknowledged that, and exchange or modification in terms that are substantially similar did not result in an extinguishment.

15. Among other things, the EITF reached a consensus regarding (1) when an exchange or modification is considered substantial and (2) how to account for fees paid and costs incurred as part of an exchange or modification. The EITF went on to provide guidance that debt instruments are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument.

Detailed guidance is provided on the how to calculate the present value of the cash flows for purposes of applying the 10-percent test.

16. In discussing fees paid and costs incurred, the EITF reached a conclusion that if the transaction is not accounted for as a debt extinguishment, fees paid between the parties associated with the new debt along with unamortized amounts from the old debt should be amortized over the remaining term of the replaced or modified debt instrument. Costs incurred with third parties related to the modification, such as legal fees, should be expensed as incurred.

17. Proponents of View C believe that the analogy of internal replacement transactions to a modification or exchange of debt instruments is appropriate. Although two insurance/investment contracts may be different, there could be situations in which they are not substantially different and, therefore, the replacement of one with another should not give rise to extinguishment accounting.

18. **Pertinent Authoritative Accounting Literature**

- 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*
- FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- AICPA Practice Bulletin No. 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
- Emerging Issues Task Force Issue No. 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments*
- AICPA Industry Audit Guide, *Audits of Stock Life Insurance Companies*

Additional information about this document from AICPA Center for Knowledge and Research Services.

This document was created by the Insurance Companies Committee of the AICPA and circulated to individuals in the insurance industry and others known to have a particular interest in this issue. It was never circulated to the general membership or others, who have a standing order for Exposure Drafts, or available in any way other than from the committee, because it did not have the backing of one of the senior technical committees.

The CKRS received it, because we also received the Comment Letters that were sent in as responses to the document. We are making it available through our catalog and collection, so persons in the future will be better able to trace any developments that come from it.