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Financial highlights of separate accounts : an amendment to the audit and accounting guide audits of investment companies; Statement of position 03-05

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

STATEMENT OF POSITION 03-5

AICPA

American Institute of Certified Public Accountants

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Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide *Audits of Investment Companies*

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, 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 reporting financial highlights by separate accounts of insurance enterprises.

This SOP requires, among other things, the following:

- *Disclosure of ranges*. Separate accounts with more than two levels of contract charges or net unit values per subaccount may elect to present the required financial highlights for contract expense levels that had units issued or outstanding during the reporting period (including the number of units, unit fair value, net assets, expense ratio, investment income ratio, and total return) for either:

  1. Each contract expense level that results in a distinct net unit value and for which units were issued or outstanding during each reporting period; or
  2. The range of the lowest and highest level of expense ratio and the related total returns, and unit fair values during each reporting period.

  The financial highlights table in the separate account's financial statements should state clearly that the expense ratio considers only the expenses borne directly by the separate account and excludes expense incurred indirectly by the underlying funds or charged through the redemption of units. The disclosure should include ranges of all fees that are charged by the separate account and whether those fees are assessed as direct reductions in unit values or through the redemption of units.

- *Expense ratio*. The expense ratio represents the annualized contract expenses of the separate account, consisting primarily of mortality and expense charges, for each period indicated. This ratio includes only those expenses that result in a direct reduction to unit values. Charges made directly to contract owner accounts through the redemption of units and expenses of the underlying fund are excluded. The financial highlights note should also provide disclosure of the ranges of all charges assessed to the separate account, including discussion of the manner in which the charges are assessed.

- *Total return ratio*. The total return ratio represents the total return for the periods indicated, including changes in the value of the underlying fund, which reflects the reduction of unit value for expenses assessed. This ratio does not include any expenses assessed through the redemption of units. The total return is calculated for each period indicated or from the effective (fund inception) date through the end of the reporting period.
- *Investment income ratio*. The investment income ratio represents the dividends, excluding distributions of capital gains, received by the subaccount from the underlying mutual fund, net of management fees assessed by the fund manager, divided by the average net assets. This ratio excludes those expenses, such as mortality and expense charges, that result in direct reductions to contract owner accounts either through reductions in the unit values or the redemption of units. The recognition of investment income by the subaccount is affected by the timing of the declaration of dividends by the underlying fund(s) in which the subaccount invests.

This SOP is effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. The provisions of this SOP should be applied prospectively from the beginning of the year of adoption. However, if adopting this SOP results in presentation different from prior periods, companies should explain the effects of adoption on their financial highlights calculations.

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 10 of AcSEC's 15 members, and (3) a proposed final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four 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 the 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.

Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide *Audits of Investment Companies*

Introduction and Background

1. In December 2000, the AICPA issued a revised Audit and Accounting Guide *Audits of Investment Companies* (the Guide), that required financial highlights to be disclosed for separate accounts including net assets, unit fair value, and expenses ratio, investment income ratio, and total return ratio as a percentage of average net assets. Constituents raised a number of questions and implementation issues in applying the original guidance in the Guide to separate accounts.

2. Separate accounts often have multiple accumulation unit values that arise from having different product designs and fee structures on the underlying variable contracts. One of the causes of this proliferation in the number of distinct unit values is that a new series of units is often established within each separate account for each new product and combination of optional riders elected by customers. Paragraph 10.54 of the Guide states:

   > Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the following illustrative financial statements because they are not otherwise required by generally accepted accounting principles. In addition, certain disclosures are impractical due to the characteristics of the separate account.

   In recent years, there has been significant growth in (*a*) the number of subaccounts (or investment portfolios) offered to variable contract customers, particularly for *wraparound* annuities in which assets are invested in mutual funds; (*b*) the number of different products in which supporting assets reside in a single separate account (for example, both variable annuities and variable life insurance contracts); and (c) the number of optional riders that may be chosen by variable contract customers, either individually or singularly or in various combinations, with contract charges that vary depending on customer elections.

3. In January 2002, in response to the implementation questions, the AICPA issued a series of Technical Practice Aids (TPAs) (Sections 6910.11–.15)[1] to address whether the requirement for presentation of financial highlights as noted in the Guide applies to separate accounts, and if so, what information should be presented. Questions still remained after the issuance of the TPAs about the application of the required financial highlight disclosures.

Applicability and Scope

4. This Statement of Position (SOP) applies to all entities that are separate accounts within the scope of the Guide.

Conclusions

5. Paragraph 7.66 of the Guide, which requires per share information to be disclosed as financial highlights, is amended by adding the underlined text as follows.[2]

   7.66 The following per share information should be presented for registered investment companies, and for investment companies that compute unitized net asset value (a more detailed discussion of calculation methods for registered investment companies may be found in the instructions for preparation of registration statements on Forms N-1A and N-2):

   a. Net asset value at the beginning of the period.

1. TPAs Section 6910.11 through 6910.15 are rescinded upon the effective date of this SOP.

2. The Statement of Position 03-6, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships, An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships, will also amend paragraph 7.66 of the AICPA Audit and Accounting Guide *Audits of Investment Companies*.

b. Per share net investment income or loss, which, for registered investment companies, is calculated in accordance with the requirements of Form N-1A or N-2. Other methods, such as dividing net investment income by the average or weighted average number of shares outstanding during the period, are acceptable. If used by a registered investment company, the method employed must be disclosed in a note to the table in conformity with SEC requirements.

c. Realized and unrealized gains and losses per share, which are balancing amounts necessary to reconcile the change in net asset value per share with the other per share information presented. The amount shown in this caption might not agree with the change in aggregate gains and losses for the period. If such is the case, the reasons should be disclosed.

d. Total from investment operations, which represents the sum of net investment income or loss and realized and unrealized gain or loss.

e. Distributions to shareholders should be disclosed as a single line item except that tax return of capital distributions should be disclosed separately. Details of distributions should conform to those shown in the statement of changes in net assets.

f. Purchase premiums, redemption fees, or other capital items.

g. Payments by affiliates (paragraphs 7.49 through 7.51).

h. Net asset value at the end of the period.

i. Market value at the end of the period (Form N-2 registrants only).

<u>The information required in items *b* through *g* above is not required for separate accounts that represent an ownership interest in the underlying separate account portfolios or mutual funds. Refer to paragraphs 10.53 through 10.58 of the Guide for information regarding financial highlights for separate accounts and illustrative financial statements.</u>

6. Paragraph 10.54 of the Guide, including related footnotes, is amended by adding the underlined text as follows.

10.54 Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the following illustrative financial statements because they are not otherwise required by generally accepted accounting principles. In addition, certain disclosures are impractical due to the characteristics of the separate account. These disclosures include the following:

- The total cost, for federal income tax purposes, of the portfolio of investments according to rule 12-12 of Regulation S-X.
- The components of net assets presented as a separate schedule or in the notes to the financial statements according to rule 6-05.5 of Regulation S-X. However, the net asset values per unit at the beginning and end of each period and the total net assets at the end of the period are to be provided for the most recent five years.

Separate accounts with more than two levels of contract charges or net unit values per subaccount may elect to present the required financial highlights for contract expense levels that had units issued or outstanding during the reporting period (including number of units, unit fair value, net assets, expense ratio, investment income ratio, and total return), for either:

a. Each contract expense level that results in a distinct net unit value and for which units were issued or outstanding during each reporting period; or

b. The range of the lowest and highest level of expense ratio and the related total return and unit fair values during each reporting period.[5]

The Form S-6[*6] expense table requires the presentation, under separate captions, of the expense ratio of each separate account and the underlying fund(s) in which it may invest, as well as a combined expense ratio. The financial highlights table in the separate account's financial statements need not aggregate these ratios; however, the table should state clearly that the expense ratio considers only the expenses borne directly by the separate account and excludes expenses incurred directly by the underlying funds or charged through the redemption of units. If the ranges of expense ratios, total returns, and unit fair values are presented, the insurance enterprise should disclose instances in which individual contract values do not fall within the ranges presented (for example, if a new product is introduced late in a reporting period and the total return does not fall within the range). The expense disclosure should also include ranges of all fees that are charged by the separate account and a description of those fees, including whether they are assessed as direct reductions in unit values or through the redemption of units for all policies contained within the separate account.

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5. The calculation of the ranges for the total return ratio and unit fair values should correspond to the groupings that produced the lowest and highest expense ratios.

*6. In April 2002, the SEC adopted a new Form N-6 to replace Forms N-8B-2 and S-6 (Release No. 33-8088), with the objectives of improving disclosure and streamlining the registration process by introducing a single form tailored directly to variable life products. See paragraph 10.30 for effective date information.

7. Paragraph 10.58(6) of the Guide, which presents illustrative footnotes, is amended by adding the underlined text and deleting the crossed out text as follows.

10.58 **6. Unit Values**[68] A summary of unit values and units outstanding for variable annuity contracts, net assets, net investment income ratios, total return ratios, and the expense ratios, excluding expenses of the underlying funds and expenses charged through the redemption of units, for each of the five years in the period ended December 31, 20X3, follows.

a. The following format should be presented if the insurance enterprise chooses to disclose each contract expense level that results in a distinct net unit value and for which units were issued or outstanding during each of the five years ended December 31, 20X3.

Units	Net Assets Unit Fair Value	Net Assets (000s)	~~Net Investment Income as a % of Average Net Assets~~ Investment Income Ratio[9]	~~Expenses as a % of Average Net Assets**~~ Expense Ratio[10]	Total Return[11]
Money Market Investment Division					
December 31					
20X3					
4,136,795	$13.83	$57,232	5.25%	1.00%	5.30%
20X2					
5,028,360	13.13	66,042	5.02	1.00	5.07
20X1					
5,873,517	12.50	73,398	8.46	1.00	8.54
20X0					
2,058,353	11.52	23,705	8.23	1.00	8.31
20W9					
967,550	10.63	10,291	6.24***	1.00***	6.30
7/1/W9*					
500,000	10.00	5,000			

(continued)

	Net Assets		~~Net Investment Income as a % of Average Net Assets~~ Investment Income Ratio[9]	~~Expenses as a % of Average Net Assets**~~ Expense Ratio[10]	
Units	Unit Fair Value	(000s)			Total Return[11]
Equity Index Division					
December 31					
20X3					
19,674,291	$17.83	$350,752	2.23%	1.00%	12.68%
20X2					
8,412,134	15.82	133,110	2.35	1.00	24.16
20X1					
3,140,024	12.74	40,009	3.12	1.00	(9.50)
20X0					
3,879,972	14.08	54,630	3.24	1.00	11.94
20W9					
2,162,080	12.58	27,195	3.98	1.00	6.20

~~* Commenced operations.~~

~~** For the year ended December 31, excluding the effect of the expenses of the underlying fund portfolios and charges made directly to contract holder accounts through the redemption of units.~~

~~*** Annualized.~~

9. These amounts represent the dividends, excluding distributions of capital gains, received by the subaccount from the underlying mutual fund, net of management fees assessed by the fund manager, divided by the average net assets. These ratios exclude those expenses, such as mortality and expense charges, that are assessed against contract owner accounts either through reductions in the unit values or the redemption of units. The recognition of investment income by the subaccount is affected by the timing of the declaration of dividends by the underlying fund in which the subaccount invests.

10. These amounts represent the annualized contract expenses of the separate account, consisting primarily of mortality and expense charges, for each period indicated. These ratios include only those expenses that result in a direct reduction to unit values. Charges made directly to contract owner accounts through the redemption of units and expenses of the underlying fund have been excluded.

11. These amounts represent the total return for the periods indicated, including changes in the value of the underlying fund, and expenses assessed through the reduction of unit values. These ratios do not include any expenses assessed through the redemption of units. Investment options with a date notation indicate the effective date of that investment option in the variable account. The total return is calculated for each period indicated or from the effective date through the end of the reporting period.

b. The following format should be presented if the insurance enterprise chooses to present the range of the lowest to highest level of expense ratio and the related total return and unit fair values during each of the five years ended December 31.

20X3. Certain of the information is presented as a range of minimum to maximum values, based on the product grouping representing the minimum and maximum expense ratio amounts.

	At December 31			For the Year Ended December 31		
	Units (000s)	**Unit Fair Value Lowest to Highest**	**Net Assets (000s)**	**Investment[12] Income Ratio**	**Expense Ratio[13] Lowest to Highest**	**Total Return[14] Lowest to Highest**
Money Market Investment Division						
20X3	4,137	$10.51 to $14.06	$57,232	5.25%	1.00% to 2.65%	4.10% to 5.30%
20X2	5,028	10.00 to 13.20	66,042	5.02	1.00 to 2.60	4.01 to 5.07
20X1	5,874	9.37 to 13.21	73,398	8.46	1.00 to 2.60	7.45 to 8.54
20X0	2,058	8.72 to 12.23	23,705	8.23	1.00 to 2.55	5.65 to 8.31
20W9	968	8.25 to 12.50	10,291	6.24	1.00 to 2.45	5.25 to 6.30
Equity Index Division						
20X3	19,674	$10.51 to $19.06	$350,752	2.23%	1.00% to 2.65%	5.10% to 12.18%
20X2	8,412	10.00 to 20.20	133,110	2.35	1.00 to 2.60	6.80 to 24.16
20X1	3,140	9.37 to 14.21	40,009	3.12	1.00 to 2.60	(9.50) to 9.10
20X0	3,880	8.72 to 15.23	54,630	3.24	1.00 to 2.55	5.65 to 11.94
20W9	2,162	8.25 to 13.50	27,195	3.98	1.00 to 2.45	5.25 to 6.20

12. These amounts represent the dividends, excluding distributions of capital gains, received by the subaccount from the underlying mutual fund, net of management fees assessed by the fund manager, divided by the average net assets. These ratios exclude those expenses, such as mortality and expense charges, that are assessed against contract owner accounts either through reductions in the unit values or the redemption of units. The recognition of investment income by the subaccount is affected by the timing of the declaration of dividends by the underlying fund in which the subaccount invests.

13. These amounts represent the annualized contract expenses of the separate account, consisting primarily of mortality and expense charges, for each period indicated. The ratios include only those expenses that result in a direct reduction to unit values. Charges made directly to contract owner accounts through the redemption of units and expenses of the underlying fund have been excluded.

(*continued*)

14. These amounts represent the total return for the periods indicated, including changes in the value of the underlying fund, and expenses assessed through the reduction of unit values. These ratios do not include any expenses assessed through the redemption of units. Investment options with a date notation indicate the effective date of that investment option in the variable account. The total return is calculated for each period indicated or from the effective date through the end of the reporting period. As the total return is presented as a range of minimum to maximum values, based on the product grouping representing the minimum and maximum expense ratio amounts, some individual contract total returns are not within the ranges presented.

c. An insurance enterprise may choose to present all expenses that are charged by the separate account in either a table or narrative format. The disclosure should list all fees that are charged by the separate account and a description of those fees, including whether they are assessed as direct reductions in unit values or through the redemption of units for all policies contained within the separate account. For this example, expenses disclosed are based on the ranges of all products within the separate account; the expenses may also be listed in more detail (for example, individual charges broken out by products within the separate account) in either table or narrative format.

ABC Variable Annuity Separate Account I

Mortality and Expense Charge	
Basic charges are assessed through reduction of unit values.	1.00%–1.70%
Death Benefit Options	
The options are assessed through reduction in unit values:	
• Ratchet Option—Equal to the highest account balance among prior specified anniversary dates adjusted for deposits less partial withdrawals since the specified anniversary date	0.15%–0.20%
• Roll Up Option—Equal to the total of deposits made to the contract less an adjustment for partial withdrawals, accumulated at a specified interest rate	0.20%–0.40%
Guaranteed Minimum Income Benefits	
These benefits are assessed through reduction in unit values and provide that the periodic annuity benefits will:	
• Not fall below a contractually specified level.	0.20%–0.55%
• Be based on the higher of actual account values at the date the policy owner elects to annuitize or a contractually specified amount.	0.30%–0.40%
Administrative Charge	
This charge is assessed through the redemption of units.	Years 1–5: $30 Years 6 +: $10

Alternatively, the expense ratio represents the annualized contract expenses of ABC Variable Annuity Separate Account I for the period indicated and includes only those expenses that are charged through a reduction of the unit value. Included in this category are mortality and expense charges, and the cost of any riders the policy holder has elected. These fees range between 1.00 percent and 2.65 percent, depending on the product and options selected. Expenses of the underlying fund portfolios and charges made directly to contract owner accounts through the redemption of units are excluded. For this separate account, charges made through the redemption of units ranged from $10 to $30 per policy annually.

Effective Date and Transition

8. The provisions of this SOP are effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. The provisions of this SOP should be applied prospectively from the beginning of the year of adoption. However, if adopting this SOP results in presentation different from prior periods, companies should explain the effects of adoption on their financial highlight calculations.

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

APPENDIX

Basis for Conclusions

A1. This section discusses considerations that were deemed significant by the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). In July 2003, AcSEC issued for public comment an exposure draft of a proposed SOP, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies. During the 60-day comment period, AcSEC received four comment letters.

Applicability of Financial Highlights

A2. As defined in SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts,* a legal separate account is:

> A separate investment account established and maintained by an insurance enterprise under relevant state insurance law to which funds have been allocated for certain contracts of the insurance enterprise or similar accounts used for foreign originated products. Often for administrative purposes, separate account subaccounts with differing investment objectives are created within a single separate account.

A3. AcSEC concluded that separate accounts should provide relevant financial highlights in their financial statements as discussed in Chapter 7 of the AICPA Audit and Accounting Guide *Audits of Investment Companies* (the Guide), because paragraph 1.03 of the Guide includes "certain separate accounts of life insurance companies" in the reference to types of investment companies. Paragraph 10.01 of the Guide specifies that "separate accounts are registered investment companies under the Investment Company Act of 1940 (the 1940 Act), without an applicable exemption."

A4. AcSEC also clarified the scope of this SOP from the exposure draft, specifying that this SOP is applicable to all entities that are separate accounts that are within the scope of the Guide. Paragraph 11 of SOP 03-1 specifies conditions that must be met to obtain separate account accounting for generally accepted accounting principles (GAAP) purposes. Separate account arrangements that do not meet the specified conditions are to be accounted for (measured and presented) the same as other general account assets as prescribed in paragraphs 45 through 51 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended. This SOP applies to all separate accounts that are within the scope of the Guide, including arrangements that do not meet the separate account conditions of SOP 03-1 and separate accounts of life insurance enterprises under FASB Statement No. 60.

A5. AcSEC discussed whether the financial highlights disclosures prescribed by paragraph 7.66(b) through (g) of the Guide are required for separate accounts that comprise units that represent an ownership interest in the underlying separate account or mutual funds portfolios.[1] AcSEC concluded that because this information is also separately disclosed by the mutual fund, there is no need for it to be disclosed by the separate account. If the separate account held and managed its own investments (that is, not units in a separate mutual fund), the disclosures would be required. AcSEC also noted that differences in expense levels that result from customers' selection of a specific product within an array of products or election of optional riders are not considered to result in separate classes of units, as discussed in paragraph A7 of this SOP. As a result, AcSEC concluded that the disclosures required by paragraphs 7.66(b) through (d) of the Guide would be redundant with information already presented in the statement of operations, except that such amounts would be presented on a per-unit basis, determined using the aggregate number of units outstanding during the period. The disclosures required by paragraphs 7.66(e) through (g) of the Guide are

1. In the United States, this type of separate account is generally referred to as a *unit investment trust*.

not relevant to separate accounts due to the manner in which these products are taxed.

Disclosing Range of Expenses

A6. It is not unusual for separate accounts to have 50 or more subaccounts, 10 or more products, and multiple combinations of elective contract benefits or *riders* (for example, enhanced death benefits), each having different contract charges associated with them. AcSEC noted that for such accounts, the volume of information that would be required if each contract variation and fee structure was treated as a separate class of shareholder in accordance with paragraphs 7.65 through 7.68 of the Guide would likely be overwhelming and detract from the relevance and usefulness of the financial statements. For example, a separate account having 50 subaccounts, 10 products, and 7 combinations of contract riders would require 87,500 items of information (including unit fair values, number of units, expense ratio, investment income ratio, and total return) to be presented to comply with the financial highlights requirement (50 x 10 x 7 x 5 items x 5 years). Proliferation in the number of different unit values leads to the need to consider the level of additional information required by paragraphs 7.65 through 7.68 of the Guide that would be most useful to the users of the financial statements.

A7. AcSEC discussed whether the presence of multiple products and fee structures within a separate account creates multiple reporting classes or units that must be separately disclosed when reporting financial highlights, and concluded that differences in expense levels that result from customers' selection of a specific product within an array of products or election of optional riders are not considered to result in separate classes of units. This is based on the considerations that all units are invested in the same classes of underlying fund shares and all unit holders have similar claims on the assets held by the separate account (that is, there are not different *classes* or legal standings among the unit holders). If the units were to differ in a manner other than the expense level associated with the contracts, separate disclosure would be appropriate. Based on that discussion, AcSEC concluded that an insurance enterprise may elect to present the required financial highlights for contract expense levels either for (*a*) each contract expense level that results in a distinct net unit value and for which units were issued or outstanding during the reporting period or (*b*) the ranges of the lowest and highest level of expense ratio and the related total return and unit fair value during each reporting period. AcSEC noted that an insurance enterprise should be allowed to choose the presentation format, as some insurers may wish to disclose individual expense amounts in some instances, such as when a separate account does not have many products. AcSEC also believes that comparability of ratios between companies is not diminished by the presentation of ranges because separate accounts contain different mixes of products across companies and within individual separate accounts. Respondents to the exposure draft generally agreed, commenting that the use of ranges for disclosure should alleviate some of the practical difficulties associated with the volume of disclosures required when separate accounts have multiple subaccounts containing multiple products and combinations of elective contract benefits. One respondent disagreed with the disclosure of ranges rather than each specific and distinct unit value highlights, but also noted that disclosure for each unit value would add such excessive material to the reports that most investors would not use it.

Expense Ratio

A8. Preparers of separate account financial statements have indicated that the comparability of the expense ratio between various variable products is difficult because some charges are assessed to the contract owner through a direct reduction in unit value, while other charges (for example, annual contract maintenance charge) are charged directly to contract owner accounts through the redemption of separate account units.

A9. AICPA *Technical Practice Aids* (TPA) Section 6910.12, *Reporting of Per Share or Per Unit Data When Reporting Fi-*

nancial Highlights by Separate Accounts, states in part the following:

> [The expense ratio represents] the annualized contract expenses of the separate account, consisting primarily of mortality and expense charges, for each period indicated. [This ratio includes] only those expenses that result in a direct reduction to unit values. Charges made directly to contract owner accounts through the redemption of units and expenses of the underlying funds are excluded.

Because the expense ratio excludes charges made directly to contract owner accounts through the redemption of units, different expense ratios may be presented for products that may have similar fee levels and that are otherwise comparable from an economic perspective.

A10. AcSEC concluded that the expense ratio calculation for separate accounts should exclude charges made directly to contract owner accounts through the redemption of units because these represent capital transactions and the various charges that may be assessed against a particular contract are already disclosed in the product prospectus. Respondents to the exposure draft generally agreed that the expense ratio should only include charges made through a direct reduction to unit values. One respondent to the exposure draft disagreed with the expense ratio conclusion because of the potential lack of comparability between separate accounts.

A11. AcSEC also concluded that the expense ratio calculation is consistent with the discussion in paragraph 5.52 of the Guide because the expense ratio includes charges that are reported in the statement of operations, and excludes charges that are reported in the statement of changes in net assets and are assessed through the redemption of units.

> 5.52 *Financial Highlights.* The financial highlights for the reporting fund in a fund-of-funds structure are usually similar to a standalone feeder fund in a master-feeder structure. Net investment income and expense ratios should be computed based upon the amounts reported in the statement of operations, and portfolio turnover should be measured based on the turnover of investments made by the reporting fund in the investee funds, not looking through the investee funds to their portfolio activity.

A12. AcSEC also noted that the various product-specific fees are disclosed in the product prospectus and in the related statement of additional information (SAI). The prospectus and SAI are provided to all contract holders at the time of purchase. The prospectus is also provided annually to contract holders, and the SAI is available annually on request. For a contract holder, the fee rates and manner of assessment generally do not change for the duration of the particular product. Additionally, fees are generally assessed consistently across all funds within a single product. The contract holder is not dependent upon the separate account financial statements for product level comparisons in determining which product to purchase, because the relevant individual product information is provided in its prospectus. As noted in paragraph 2 of this SOP, there currently exists a number of unit values for each new product and combination of contract riders elected by contract holders that represent charges that reduce the unit values. AcSEC noted that calculating the expense ratio by including all charges assessed, whether through reduction of unit values or redemption of units, would only add to the proliferation of unit values and data disclosed. The expense ratio would be an aggregation of all products included in the specific separate account, and may not reflect the various product combinations selected by the contract holders nor be presented in any manner that the contract holder will recognize.

A13. AcSEC also noted that requiring preparers to consider the many possibilities of different combinations of products and riders by including all charges assessed in the determination of the range of expense ratios would enhance neither the comparability of expense ratios nor the usefulness of the financial statements. The comparability of separate account financial statements is limited due to the fact that separate accounts frequently include the financial activity of products currently being offered as well as those products no longer being marketed. It would not be unusual for an insurance company to have ten or more separate accounts, and for a separate account to contain 20 or more insurance products, each with a unique product prospectus, and each having numerous elective features. It would be virtually impossible for a contract holder to determine which product's financial results are being depicted in a particular separate account, or to use the separate account financial statements to compare products of two or more competitors. Comparability is further challenged by the manner in which insurance charges are assessed. For example, some contracts reduce certain customer charges after specified policy anniversary dates. Comparison of the expense ratio of such contracts with newly issued contracts may not be useful.

A14. AcSEC concluded that to help the contract holder understand the components of the expense ratio, additional disclosure in the financial highlights note should present either the ranges or summary of individual charges assessed to the contract holder for the products within a separate account with an explanation of how the charges are assessed (such as, monthly through the redemption of units) and whether the charges are included in the expense ratio amount. For those contracts that have multiple features available, the individual feature charges may be described in narrative form or through the use of a table if the options and charges are complex.

A15. AcSEC also discussed whether the calculation of lowest to highest ranges for the expense ratio, total return ratio, and unit fair value should be calculated independently of one another, or whether all categories should be calculated based on the product combination that produced the lowest to highest ranges for the expense ratio.

A16. AcSEC concluded that, even though an expense ratio may not be provided in the financial highlights, the lowest to highest ranges should first be determined for the expense ratio for contracts issued, and then the total return ratio and unit fair value should be calculated from the same product groupings. AcSEC noted that this presents the amounts on a consistent basis and allows the users of the financial statements to clearly understand the relationship between the expense ratio and the total return ratio and unit fair value. It was also noted that there may be contracts that fall outside the total return ratio and unit fair value ranges due to the introduction of new products during the year and other market factors. AcSEC concluded that the separate account notes should include an explanation of how the ranges in the total return ratio and unit fair value categories are related to the expense ratio, and why some contracts may be outside the disclosed ranges. Respondents to the exposure draft agreed, commenting that providing the total return ratio and unit fair value disclosures relating to the lowest and highest expense ratio range will provide users with the most relevant information while effectively addressing the cost/benefit of providing additional disclosures for each unique product design.

Total Return Ratio

A17. AcSEC considered whether the total return ratio also should include only mortality and expense charges deducted from the separate account through a reduction in unit value. The current definition of total return, according to the Guide, is based on the change in net asset value per share during the period. AcSEC concluded that the definition of total return according to the Guide supports including only charges that result in a direct reduction to unit values and not including charges that are assessed through the redemption of units. AcSEC also discussed whether it would be feasible to convert the expenses assessed through the redemption of units to amounts that could be reliably included in the total return ratio. The conversion of charges assessed through the redemption of units into equivalent reductions in unit values would introduce hypothetical numbers into the total return calculation. The resulting amounts would not be on a comparable basis since the hypothetical expenses would be annualized, and the total return is calculated for the actual effective period. AcSEC concluded that the benefit of disclosing a combined total return ratio would not outweigh the possible misleading results, and the significant cost and time involved with producing hypothetical amounts. Consistent with the treatment of other 1940 Act funds, AcSEC concluded that the total return should not be annualized for funds that did not have units outstanding for the entire year. Respondents to the exposure draft generally agreed that the total return should not include charges made through a direct redemption of units or be annualized for units that were not outstanding for the full year, but commented that both facts should be clearly disclosed.

Investment Income Ratio

A18. AcSEC discussed how the investment income ratio should be determined for each subaccount of the separate account. The current definition of the investment income ratio is set forth in TPA Section 6910.12, which states in part the following:

> [The investment income ratio represents] the dividends, excluding distributions of capital gains, received by the subaccount from the underlying mutual fund, net of management fees assessed by the fund manager, divided by the average net assets. These ratios exclude those expenses, such as mortality and expense charges, that result in direct reductions in the unit values. The recognition of investment income by the subaccount is affected by the timing of the declaration of dividends by the underlying fund in which the subaccounts invest.

A19. AcSEC concluded that the investment income ratio should be disclosed by the separate account, and should be calculated based on the distribution of dividends from the fund(s) since that is the amount that is presented in the statement of operations as investment income. It was noted that the investment income ratio disclosed by the separate account is wholly dependent on the distributions made by the fund(s), and would fluctuate based on the timing of the distributions.

Effective Date and Transition

A20. Respondents to the exposure draft commented that the proposed effective date for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial adoption, provides a reasonable period of time to adopt the provisions of this SOP, since the majority of the guidance in this SOP is the same as the guidance contained in the previously issued TPAs. AcSEC also considered requiring restatement of previously issued separate account financial highlights, but again noted that the majority of the guidance is the same as the TPAs that were issued before December 15, 2001. AcSEC agreed that restatement should be permitted but not required, since the potential benefit would not exceed the cost due to the volume of data for companies with large separate accounts.

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