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STATEMENT OF POSITION 05-1

AICPA

American Institute of Certified Public Accountants

September 19, 2005

Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts

Prepared 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, as amended, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards 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 SOP defines an internal replacement as a modification in product benefits, features, rights, or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. Modifications that result from the election by the contract holder of a benefit, feature, right, or coverage that was within the original contract are not internal replacements subject to this guidance as long as all of the conditions listed in paragraph 9 of this SOP are met.
- The SOP introduces the terms **integrated** and **nonintegrated contract features** and specifies that nonintegrated features do not change the base contract and are to be accounted for in a manner similar to a separately issued contract. Integrated features are evaluated in conjunction with the base contract.
- Contract modifications meeting all of the conditions in paragraph 15 of this SOP result in a replacement contract that is substantially unchanged from the replaced contract and should be accounted for as a continuation of the replaced contract.
- An internal replacement that is determined to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as an extinguishment of the replaced contract. Unamortized deferred acquisition costs, unearned rev-

enue liabilities, and deferred sales inducement assets from the replaced contract in an internal replacement transaction that results in a substantially changed contract should not be deferred in connection with the replacement contract.

- Unamortized deferred acquisition costs and the present value of future profits[1] continue to be subject to premium deficiency testing in accordance with the provisions of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended.
- The notes to the financial statements should describe the accounting policy applied to internal replacements, including whether or not the company has availed itself of the alternative application guidance outlined in paragraphs 18 and 19 of this SOP and, if so, for which kinds of internal replacement transactions.

This SOP is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. Retrospective application of this SOP to previously issued financial statements is not permitted. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date, all prior interim periods of the year of adoption should be restated).

Disclosure of the effect of the change on retained earnings as of the date of adoption is required. If the financial statements of the year of adoption are presented separately or included in comparative financial statements, the notes to the financial statements should disclose (*a*) the fact that this SOP has been adopted and the effective date of adoption, and (*b*) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of this SOP.

1. The *present value of future profits* is as discussed in EITF Issue No. 92-9, *Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*.

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,[2] 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.

2. At the time AcSEC undertook the project, at least five of the seven FASB members were required to not object to AcSEC undertaking this project.

Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts

Introduction and Background

1. Insurance enterprises may offer existing contract holders new products or modifications to **existing contracts**[1] for various reasons, such as increasing administrative efficiency and improving the competitive position of the contract to enhance contract holder satisfaction and retention. For example, at the time universal life-type contracts became popular, they were often purchased as replacements for traditional life insurance contracts issued by the same enterprise. In those cases, the contract holder generally used the cash surrender value of the previous contract to make an initial premium deposit for the new, universal life-type contract. Further, contract holders often request insurance enterprises to make changes to their existing contracts.

2. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, refers to the replacement by an insurance enterprise of one of its traditional life insurance contracts by a universal life-type contract as an **internal replacement**. FASB Statement No. 97 specifies that unamortized deferred acquisition costs related to traditional life insurance contracts replaced with universal life-type contracts issued by the same insurance enterprise shall not be deferred in connection with the **replacement contract**.

1. Terms defined in the "Glossary" are set in boldface type the first time they appear in the text.

3. Diversity in practice exists in accounting for internal replacements other than those specified in FASB Statement No. 97, which discusses internal replacements of traditional life insurance contracts with 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 No. 8, *Application of FASB Statement No. 97 to Insurance Enterprises*, issued in November 1990, clarifies that the accounting specified by FASB Statement No. 97 for internal replacement transactions applies only to the replacement of traditional insurance contracts with universal life-type contracts. Practice Bulletin 8 paragraphs 18 and 19 state:

> .18 *Question 7*: Does the accounting specified by FASB Statement No. 97, paragraph 26, for internal replacement transactions apply only to the replacement of traditional insurance contracts by universal life-type contracts?
> .19 *Answer 7*: Yes, FASB Statement No. 97 addresses only replacements of traditional insurance contracts by universal life-type contracts. The accounting for other internal replacements should be based on the circumstances of the transaction. Paragraphs 70 to 72 of FASB Statement No. 97 discuss the Board's rationale for requiring recognition of loss on the termination of the replaced contract.

4. The basis for conclusions of FASB Statement No. 97 discusses alternative views of accounting for internal replacements. Paragraph 71 of the Statement discusses two alternative views rejected by the FASB:

   a. Continued deferral of costs related to replacement contracts is appropriate based on the continuation of the customer relationship:

   > The replacement of a traditional life insurance contract with a universal life-type contract typically results in the need to account for an amount equal to the sum of (a) the unamortized acquisition costs associated with the replaced contract and (b) the difference between the cash surrender value and the previously recorded liability for policy benefits related to the replaced contract. The AICPA Issues Paper suggested that this net amount should be deferred and amortized as part of the capitalized acquisition costs of the new book of universal life-type contracts. The Issues Paper took the position that the universal life-type replacement contract represented a continuing relationship be-

tween the insurer and the policyholder, and maintained that the new contract represented only a change in the form of the insurance protection.

b. Continued deferral of costs related to replaced contracts more closely equates the cost of replacement contracts and contracts issued to new customers:

> Some respondents also suggested that the incremental costs of replacement transactions are usually less than the costs of sales to new policyholders. In their view, the continued deferral of net amounts related to replaced contracts more nearly equates the costs of contracts issued to different classes of policyholders.

5. As stated in paragraph 72 of FASB Statement No. 97:

> The Board rejected those proposals. The Board recognizes that an insurance enterprise that conducts an internal replacement program may be motivated by a desire to retain its customer base and that the alternative to replacement may be loss of that base. That objective is not, however, different from the objectives of similar transactions undertaken by insurance enterprises and other enterprises for which continued deferral of costs is not permitted, including the refunding of debt.

Applicability and Scope

6. This Statement of Position (SOP) applies to all entities to which FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended, applies, hereinafter referred to as *insurance enterprises*,[2] [3] and is applicable to modifications and replacements made to contracts defined by FASB Statement No. 60 as short-duration and long-duration contracts, including those contracts defined by FASB Statement No. 97 as investment contracts.

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2. FASB Statement No. 60, as amended, applies to life insurance enterprises, property and liability insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, and fraternal benefit societies. Modifications and exchanges of debt issued by insurance enterprises should follow the guidance in Emerging Issues Task Force (EITF) 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments.*

3. Other relevant accounting guidance, for instance FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short Duration and Long Duration Contracts,* governs the determination of the implications of modifications to insurance and reinsurance contracts on risk transfer assessment and the classification of short-duration contracts as either retroactive or prospective.

Conclusions

7. If an internal replacement (as described in paragraphs 8 through 10 of this SOP) occurs and the rights and obligations of the parties to the contract are substantially unchanged (based on an evaluation of the conditions specified in paragraph 15 of this SOP) from those under the **replaced contract**, the replacement contract should be accounted for as a continuation of the replaced contract in accordance with the guidance in paragraphs 16 through 24 of this SOP. If the internal replacement occurs and results in a replacement contract that is substantially changed from the replaced contract, the replaced contract should be accounted for as extinguished in accordance with the guidance in paragraph 25 of this SOP.

Internal Replacements

8. An internal replacement is a modification in product benefits, features, rights, or **coverages** that occurs by the legal extinguishment of one contract and the issuance of another contract (a **contract exchange**), or by amendment, endorsement, or rider to a contract, or by the election of a benefit, feature, right, or coverage within a contract.

9. Modifications (other than partial withdrawals, surrenders or reductions in coverage that are addressed in paragraph 10 of this SOP) that result from the election by the contract holder of a benefit, feature, right, or coverage that was within the **original contract** are not internal replacements subject to this guidance as long as all of the following conditions are met:

   a. The election is made in accordance with terms fixed or specified within narrow ranges in the original contract.

   b. The election of the benefit, feature, right, or coverage is not subject to any underwriting.

   c. The insurance enterprise cannot decline to provide the coverage or adjust the pricing of the benefit, feature, right, or coverage.

   d. The benefit, feature, right, or coverage had been accounted for since the inception of the contract, for

example, the option to elect the feature is an embedded option within the contract that is required to be accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, (or would have been accounted for under FASB Statement No. 133 if the "grandfathering" provisions of the Statement, for embedded derivatives, had not been elected) or the existence of the option to elect a feature was assessed in the classification of and accounting for of the contract, such as the classification of the contract as an insurance contract under SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts.*

The annuitization phase of a contract is separate and distinct from and cannot be accounted for as a continuation of the accumulation phase, even if annuitization is in accordance with terms fixed in the original contract.

10. Partial withdrawals, surrenders, or reductions in coverage (for example, reduced face amount on a life insurance contract or higher deductibles on a property casualty contract), as allowed by terms that are fixed and specified at contract inception either in the contract or other information available to the contract holder or, if required by state law or regulation, at terms in effect when the reduction is made for that benefit, feature, right, or coverage, whether or not **surrender charges** or other termination charges are assessed, are not internal replacements subject to this guidance, as long as there are no **reunderwriting** or other modifications to the contract, at that time, that would require evaluation under paragraph 15 of this SOP.

Integrated and Nonintegrated Contract Features

11. For long-duration contracts, **integrated contract features** are those for which the benefits provided by the feature can be determined only in conjunction with the account value or other contract holder balances related to the **base contract**, and **nonintegrated contract features** are those for which the determination of benefits provided by the feature

is not related to or dependent on the account value or other contract holder balances of the base contract. Underwriting and pricing for nonintegrated contract features typically are executed separately from other components of the contract, and it is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided.

12. For short-duration contracts, nonintegrated contract features are those that provide coverage that is underwritten and priced only for that incremental insurance coverage, and do not result in the explicit or implicit reunderwriting or repricing of other components of the contract. It is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided. Additional coverage provided by a nonintegrated contract feature would be considered nonintegrated even though the entire coverage provided by the short-duration contract may be subject to only one deductible or limit in the event of an insured loss. For short-duration contracts, integrated contract features are those where there is explicit or implicit reunderwriting or repricing of existing components of the base contract.

Contract Modifications Involving Nonintegrated Contract Features

13. If a contract feature or coverage is nonintegrated, the addition or election of that feature or coverage, in and of itself, does not change the existing base contract and, as a result, further evaluation of the base contract under paragraph 15 of this SOP is not required. The nonintegrated contract feature or coverage should be accounted for in a manner similar to a separately issued contract. Subsequent modifications made only to the nonintegrated contract feature or coverage should be evaluated under paragraphs 9 through 15 of this SOP separately from the base contract, and any deferred acquisition costs related to the nonintegrated contract feature or coverage accounted for accordingly. Subsequent termination of a nonintegrated contract feature or coverage should be accounted for as an extinguishment of only the balances related to the nonintegrated contract feature or coverage.

Contract Modifications Involving Integrated Contract Features

14. For contract modifications involving integrated contract features or coverages (other than those contract modifications described in paragraphs 9 and 10 of this SOP), the insurance enterprise should review the conditions set forth in paragraph 15 of this SOP to determine whether the contract has changed substantially as a result of the modification. A contract modification meeting all of the conditions in paragraph 15 of this SOP results in a replacement contract that is substantially unchanged from the replaced contract, and should be accounted for as a continuation of the replaced contract in accordance with paragraphs 16 through 24 of this SOP. A contract modification that fails any of the conditions in paragraph 15 of this SOP results in a replacement contract that is substantially changed from the replaced contract, and should be accounted for as an extinguishment of the replaced contract in accordance with paragraph 25 of this SOP.

Determining Substantial Changes

15. An internal replacement (other than those not subject to the SOP as described in paragraphs 9 and 10 of this SOP) is determined to involve contracts that are substantially unchanged only if all the following conditions exist:

    a. The insured event, risk, or period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.

    b. The nature of the investment return rights (for example, whether amounts are determined by formulae specified by the contract, pass through of actual performance of referenced investments, or at the discretion of the insurer), if any, between the insurance enterprise and the contract holder has not changed.

    c. No additional deposit, premium, or charge relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract, is required to effect the transaction; or if there is a reduction in the original benefit or coverage, the deposit, premiums,

or charges are reduced by an amount at least equal to the corresponding reduction in benefits or coverage.

d. Other than distributions to the contract holder or contract designee or charges related to newly purchased or elected benefits or coverages, there is no net reduction in the contract holder's account value or, for contracts not having an explicit or implicit account value, the cash surrender value, if any.

e. There is no change in the participation or dividend features of the contract, if any.

f. There is no change to the amortization method or revenue classification of the contract.

If any of the conditions above are not met, an internal replacement is determined to involve a replacement contract that is substantially changed from the replaced contract.

Accounting for Contracts That Are Substantially Unchanged

16. An internal replacement that is determined to result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as a continuation of the replaced contract.[4] Unamortized deferred acquisition costs,[5] unearned revenue liabilities, and deferred sales inducement assets associated with the replaced contract should continue to be deferred and amortized or earned in connection with the replacement contract. Other balances associated with the replaced contract, such as any liability for minimum guaranteed death benefits (MGDBs) or guaranteed minimum income benefits (GMIBs), should be accounted for in a similar manner, that is, as if the replacement contract is a continuation of the replaced contract.

4. However, even if both accumulation and annuitization phase contracts are investment contracts involving no life contingencies, the annuitization phase of a contract is separate and distinct from and cannot be accounted for as a continuation of the accumulation phase of the contract. For a short-duration contract, renewal results in a separate and distinct contract that cannot be accounted for as a continuation of the previous contract.

5. If the replaced contract was acquired in a purchase business combination, any present value of future profits established in accordance with EITF Issue No. 92-9, *Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*, should be accounted for in a similar manner.

Accounting for FASB Statements No. 91, No. 97, and No. 120 Contracts—General

17. For contracts accounted for under FASB Statements No. 97 and No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, the estimated gross profits of the replacement contract are treated as revisions to the estimated gross profits or margins of the replaced contract in the determination of the amortization of deferred acquisition costs and deferred sales inducement assets and the recognition of unearned revenues. For contracts to which the FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, interest method amortization methodology is applied, the replacement contract represents revisions to the cash flows of the replaced contract, and unamortized deferred acquisition costs and deferred sales inducement assets are adjusted accordingly. Other balances that are determined based on activity over the life of the contract, such as a liability for MGDBs (which, under the provisions of SOP 03-1, is determined based on assessments and benefit costs) should be calculated considering the entire revised life of the contract, including activity during the term of the replaced contract.

Accounting for FASB Statements No. 91, No. 97, and No. 120 Contracts—Practicability Considerations

18. If it is not reasonably practicable for an insurance enterprise to account for, in the manner described in paragraph 17 of this SOP, a contract exchange that has resulted in a replacement contract that is substantially unchanged from the replaced contract, the insurance enterprise should determine the balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract and utilize estimated gross profits only of the replacement contract to determine future amortization. The total balance of unamortized deferred acquisition costs prior to the internal replacement should be allocated between replaced contracts and contracts remaining in the original book of business based on a reason-

able and systematic allocation process. Appendix D, "Illustration of Deferred Acquisition Costs and Unearned Revenue Liability Amortization for a FASB Statement No. 97 Internal Replacement That Is Determined to Result in a Substantially Unchanged Contract," of this SOP illustrates one such allocation approach.

19. In conjunction with the guidance in paragraph 18 of this SOP, the balance of unamortized deferred acquisition costs and other contract-related balances should be updated based on the most current assumptions at the time of the internal replacement. All related accounting balances that use estimated gross profits or assessments as a base for amortization or recognition should be handled in a similar manner.

Accounting for FASB Statement No. 60 Long-Duration Contracts

20. For long-duration contracts accounted for under FASB Statement No. 60, the replacement contract generally should be viewed as a *prospective revision* of the replaced contract with future amortization of unamortized deferred acquisition costs adjusted, accordingly, on a prospective basis. Under the prospective revision methodology, the unamortized deferred acquisition costs and benefit liability balances at the time of replacement are unchanged. Future increases and decreases to the unamortized deferred acquisition costs and benefit reserve balances should reflect the revised revenue expected from the replacement contract at the time of replacement. This approach preserves the "lock-in" principle and is consistent with the treatment of other premium changes on indeterminate premium life insurance and guaranteed renewable health insurance contracts accounted for under the provisions of FASB Statement No. 60. The prospective revision methodology should be applied consistently for liabilities for policy benefits and unamortized deferred acquisition costs. Where the modification is a reduction in benefits with a directly proportionate reduction in premiums, the modification should result in an immediate proportionate reduction in unamortized deferred acquisition costs rather than a prospective revision.

Accounting for FASB Statement No. 60 Short-Duration Contracts

21. Similar to long-duration contracts accounted for under FASB Statement No. 60, a revision to a short-duration contract generally is viewed as a prospective revision with future recognition of unearned premium and amortization of unamortized deferred acquisition costs adjusted, accordingly, on a prospective basis. Consistent with the guidance in paragraphs 13 and 29 of FASB Statement No. 60, unearned premium is recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided, amortization of deferred acquisition costs continues to be recognized in proportion to the premium recognized, and the revised amortization ratio is used prospectively. Where the modification is a reduction in benefits with a directly proportionate reduction in premiums, the modification should result in an immediate proportionate reduction in unamortized deferred acquisition costs rather than a prospective revision.

Costs Related to Internal Replacements That Are Substantially Unchanged

22. Costs incurred in connection with an internal replacement that results in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as policy maintenance costs and charged to expense as incurred. The portion of renewal commissions paid on the replacement contract that meets the criteria for deferral in accordance with the provisions of FASB Statements No. 60 and No. 97, as appropriate, limited to the amount of the future deferrable renewal commissions on the replaced contract that would have met the deferral criteria, continues to be deferrable under the provisions of FASB Statements No. 60 and No. 97.

Sales Inducements to Contract Holders Offered With Internal Replacements of Long-Duration Contracts That Are Substantially Unchanged

23. In certain situations, an insurance enterprise may assess a surrender charge on the replaced contract that is offset by an immediate **sales inducement to a contract holder** on the

replacement contract. In this situation, the insurance enterprise should offset any surrender charges assessed against the contract holder's account balance under the replaced contract against any stated immediate sales inducement to determine whether there has been a net reduction in the contract holder's account value in accordance with paragraph 15 (d) of this SOP.

24. The liability for a sales inducement to a contract holder offered in conjunction with an internal replacement of a long-duration contract that is determined to result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for from the date of its addition to the replacement contract in accordance with the guidance in paragraph 36 of SOP 03-1:

> Sales inducements provided to the contract holder, whether for investment or universal life-type contracts, should be recognized as part of the liability for policy benefits over the period in which the contract must remain in force for the contract holder to qualify for the inducement or at the crediting date, if earlier, in accordance with paragraph 20 of this SOP. No adjustments should be made to reduce the liability related to the sales inducements for anticipated surrender charges, persistency, or early withdrawal contractual features.

The criteria in paragraph 37 of SOP 03-1 for recognition of a related sales inducement asset cannot be satisfied in these circumstances because the sales inducement was not specifically identified in the original contract.

Accounting for Contracts That Are Substantially Changed

25. An internal replacement that is determined to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as an extinguishment of the replaced contract. Unamortized deferred acquisition costs,[6] unearned revenue liabilities, and de-

6. If the replaced contract was acquired in a purchase business combination, any present value of future profits established in accordance with EITF Issue No. 92-9, *Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*, should be accounted for in a similar manner.

ferred sales inducement assets from the replaced contract in an internal replacement transaction that results in a substantially changed contract should not be deferred in connection with the replacement contract. Other balances associated with the replaced contract, such as any liability for MGDBs or GMIBs, should be accounted for in a similar manner; that is, accounted for based on an extinguishment of the replaced contract and issuance of a new contract. Acquisition costs related to the replacement contract should be evaluated for deferral in accordance with the provisions of FASB Statements No. 60 and No. 97, as appropriate.

Contract Assessments Related to Internal Replacements of Long-Duration Contracts

26. Front-end fees assessed in connection with an internal replacement of a long-duration contract should be evaluated for deferral in accordance with existing authoritative accounting literature. For contracts accounted for under FASB Statements No. 91, No. 97, and No. 120, both new and existing front-end fees on an internal replacement that results in a replacement contract that is substantially unchanged from the replaced contract should be adjusted to reflect the revisions to the estimated gross profits.

Recoverability

27. Unamortized deferred acquisition costs and the present value of future profits continue to be subject to premium deficiency testing in accordance with the provisions of FASB Statement No. 60.

Disclosures

28. The notes to the financial statements should describe the accounting policy applied to internal replacements, including whether or not the company has availed itself of the alternative application guidance outlined in paragraphs 18 and 19 of this SOP and, if so, for which types of internal replacement transactions.

Effective Date and Transition

29. The provisions of this SOP are effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. Retrospective application of this SOP to previously issued financial statements is not permitted. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date, all prior interim periods of the year of adoption should be restated).

Internal Replacements Occurring Prior to the Year of Adoption

30. Unamortized deferred acquisition costs and other balances, such as unearned revenue on front-end fees and unamortized deferred sales inducements, related to internal replacement transactions occurring prior to the year of adoption of this SOP should not be adjusted to the amounts that would have been reported had this SOP been in effect when the internal replacements occurred.

Internal Replacements Occurring After the Date of Adoption

31. Prior to the adoption of the SOP, an enterprise's accounting policy would have treated certain internal replacements as continuations of the replaced contract, while others may have been treated as extinguishments. Under the provisions of this SOP, the enterprise's accounting policy may change for certain internal replacements. Changes in unamortized deferred acquisition costs,[7] unearned revenue liabilities, and deferred sales inducement assets that result from the impact on estimated gross profits of changes in accounting policy due solely to the adoption of this SOP, as applied to previously anticipated future internal replacements, and

7. If the replaced contract was acquired in a purchase business combination, any present value of future profits established in accordance with Emerging Issues Task Force (EITF) Issue No. 92-9, *Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*, should be accounted for in a similar manner.

any related income tax effects, should be reported in a manner similar to the cumulative effect of a change in accounting principle with offsetting adjustments to the opening balance of retained earnings as of the date of adoption.

Disclosures

32. Disclosure of the effect of the change on retained earnings as of the date of adoption is required. If the financial statements of the year of adoption are presented separately or included in comparative financial statements, the notes to the financial statements should disclose (*a*) the fact that this SOP has been adopted and the effective date of adoption, and (*b*) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of this SOP. Disclosure of the pro forma effects of retrospective application (or, prior to the adoption of FASB Statement No. 154, retroactive application as discussed in paragraph 21 of Accounting Principles Board Opinion [APB] No. 20, *Accounting Changes*) or the pro forma effect on the year of adoption is not required.

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

APPENDIX A

Background and Basis for Conclusions

A.1 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 March 2003, AcSEC issued for public comment an exposure draft of a proposed SOP, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97*. During the 60-day comment period, AcSEC received 10 comment letters. In November 2004, after further deliberation and revisions to certain significant conclusions proposed in the March 2003 exposure draft, AcSEC issued for public comment a second exposure draft of a proposed SOP, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements*. During the 40-day comment period, AcSEC received 10 comment letters.

Background

A.2 In 1999, the Insurance Companies Committee of the American Institute of Certified Public Accountants (AICPA) issued a discussion paper, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97*, for informal public comment. Eleven comment letters were received with differing responses to the accounting alternatives presented.

A.3 The discussion paper included three alternative accounting views to be considered:

a. The accounting guidance provided in Financial Accounting Standards Board (FASB) Statement of Fi-

nancial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, for internal replacements of traditional life products with universal life-type products should be extended by analogy to all types of internal replacement transactions.

b. Internal replacement transactions represent a continuation of a contractual relationship and, therefore, the unamortized deferred acquisition costs relating to the original contract and any new deferred acquisition costs should be capitalized and amortized over the life of the new contract assuming appropriate recoverability tests are met.

c. Internal replacements of one insurance or investment contract with another insurance or investment contract with substantially different terms should be accounted for similar to an extinguishment of debt.

Basis for Conclusions

Internal Replacements

A.4 AcSEC concluded that, for purposes of this SOP, an *internal replacement* is defined as a modification in product benefits, features, rights, or coverages that occurs by the legal extinguishment of one contract and the issuance of another contract (a contract exchange) or by amendment, endorsement, or by rider to a contract, or the election of a benefit, feature, right, or coverage within the contract. Modifications to contract terms can be achieved through a variety of different legal structures and the form of the modification may be a result of company preference and convenience or regulatory constraints. AcSEC believes that, in concept, the legal form of a modification should not determine the accounting applicable to the transaction and the accounting should be based on the substance of the transaction, regardless of whether it takes the form of an amendment, endorsement, or rider to the contract or the issuance of a new contract in a contract exchange.

A.5 Many respondents to the March 2003 and November 2004 exposure drafts expressed the view that the proposed definition of internal replacements was overly broad. Those respondents believe that the exercise of features or riders contained in the existing contract should not result in a requirement to evaluate the contract under the provisions of this SOP. Many long-duration contracts, particularly those accounted for under FASB Statement No. 97, contain features that are flexible and discretionary and, in general, current practice does not view the utilization of those elections by the contract holder as an internal replacement. AcSEC was concerned that, given the flexibility of many insurance contract designs, benefit, coverage, and feature elections could be designed such that the execution of these elections could substantially change the replaced contract. AcSEC reaffirmed that the form of the transaction should not determine the accounting.

A.6 After review of the comments received and further discussion, AcSEC concluded that the election of a benefit, feature, right, or coverage, made in accordance with terms (including price) established in the original contract, for which the insurance enterprise is required to provide the benefit or coverage and it is not subject to underwriting, does not represent a new negotiation between the contract holder and the insurance enterprise if the existence of the feature was accounted for at the inception of the contract. AcSEC concluded that, in these circumstances, the insurance enterprise has essentially written an option providing for the feature, coverage, or rider election. This written option should be evaluated at contract inception as a possible derivative requiring recognition under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended,[1] or if not a derivative under FASB Statement No. 133, for accounting recognition under other applicable literature, for example, as an annuitization guarantee under SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration*

1. Election by an insurance enterprise of the "grandfathering" provision of FASB Statement No. 133 for embedded derivatives is considered to have satisfied the requirement in paragraph 9(d) of this SOP to account for the option from the inception of the contract.

Contracts and for Separate Accounts. For instance, if the contract holder can elect to add a guaranteed minimum withdrawal benefit (GMWB) rider, the terms and the charges for which are fixed in the original contract, the option to add the GMWB may constitute an embedded derivative requiring bifurcation under FASB Statement No. 133. The written option also may have implications for contract classification, for example, the right to subsequently elect to add to an annuity contract a minimum guaranteed death benefit (MGDB) rider, with terms that are fixed in the original contract, may result in the contract being classified as an insurance contract from inception of the contract. If the existence of the feature is assessed in the contract classification at contract inception, election of the feature at a later time generally would not be expected to result in a change in the accounting model applicable to the contract. Several respondents to the November 2004 exposure draft commented that paragraph 9(b) was not a criterion but rather the accounting implication of the other criteria of paragraph 9. After discussion of these comments, AcSEC concluded it was appropriate to retain the guidance in paragraph 9(b) of the exposure draft (paragraph 9(d) of this SOP). AcSEC noted that paragraph 7 of FASB Statement No. 97 supports the conclusion that the annuitization phase of a contract is separate and distinct from and cannot be accounted for as a continuation of the accumulation phase of the contract, and that the establishment of a liability for an annuitization guarantee does not change that conclusion.

A.7 AcSEC also noted that the contractual elections not subject to the guidance of this SOP are only those explicitly stated in the original contract, with terms that are fixed and determinable and specific enough that the contract holder is able to evaluate whether to elect the feature in current and future market conditions. Certain terms of the contract may be specified as a range, however, such a range should be narrow enough to provide a meaningful guarantee to the contract holder. Contractual provisions that allow the contract holder to elect to add future coverage at then-current rates, subject to a stated minimum and maximum, generally are not specific enough to satisfy this requirement unless the range between the current rates at contract inception and maximum is narrow.

A.8 At times, insurance enterprises will amend contracts by making available additional features to a group or series of contracts through unilateral endorsements. One type of endorsement represents an offer to add additional features. This is not considered a contract modification, and does not require evaluation under the guidance in this SOP, at the point of availability, if it requires the acceptance of the offer and benefit by the contract holder. In this situation, it is the election of the offered benefit feature or coverage by the contract holder that would constitute acceptance of the offer and trigger a contract modification that would require evaluation under the guidance in this SOP. If the insurance enterprise can legally withdraw a contract feature that has not yet been elected by the contract holder, the feature represents an offer. Election of such feature by the contract holder is considered an internal replacement and would require evaluation under the guidance of this SOP. Withdrawal of such a feature by the insurance enterprise prior to acceptance by the contract holder is not considered a contract modification as it represents the withdrawal of an offer, and does not require evaluation under the guidance of this SOP. Another type of endorsement adds a benefit feature or coverage that is effective without contract holder election. This contract modification should be evaluated under the guidance of this SOP at the date of endorsement because the benefits or coverages provided by the contract have changed.

A.9 Also in response to comments received on the March 2003 exposure draft, AcSEC acknowledged the potential administrative complexities involved with the additional tracking required for all contract modifications and, to alleviate some potential system modifications, agreed that insurance enterprises should classify contract modifications as integrated contract modifications or nonintegrated contract modifications.

Integrated and Nonintegrated Contract Features

A.10 AcSEC understands that it is common industry practice for insurance enterprises to account for nonintegrated riders, benefit features, endorsements, and coverages as separate contracts apart from the existing contract within their ad-

ministrative systems. AcSEC concluded that it is appropriate for insurance enterprises to account for nonintegrated riders, benefit features, endorsements, and coverages as separate contracts as these features are not related or involved with the existing base contract. AcSEC believes that this change from the March 2003 exposure draft to allow insurance enterprises to continue to account for nonintegrated riders and benefit features as separate contracts and to evaluate modifications to nonintegrated benefit features on a stand-alone basis should alleviate some of the potential system modifications that some companies believed may otherwise have been necessary.

A.11 Internal replacements may involve contract features, benefits, or coverages that are either integrated or nonintegrated with the base contract. Several respondents to the November 2004 exposure draft indicated that the definitions of integrated and nonintegrated contract features were unclear, especially with regards to application to short-duration contracts. In response to these comments, AcSEC redeliberated and concluded that it would be clearer to describe the criteria for determining whether a contract feature should be considered integrated or nonintegrated separately for long-duration and short-duration contracts as a result of the inherent differences in the types of products.

A.12 For long-duration contracts, AcSEC concluded that a contract feature is considered integrated if the determination of the benefit resulting from the feature can only be made in conjunction with the account value or other contract holder balances related to the base or replacement contract. Examples of integrated contract features for long-duration contracts include minimum guaranteed death benefits (MGDBs), guaranteed minimum accumulation benefits (GMABs), and guaranteed minimum income benefits (GMIBs); in all cases for these features, the benefit provided cannot be determined independently of the annuity contracts. For short-duration contracts, integrated contract features are those in which there is explicit or implicit reunderwriting or repricing of other components of the base or replaced contract. An example of an integrated contract feature for a short-duration contract is an experi-

ence refund provision in a worker's compensation insurance contract.

A.13 AcSEC also concluded that nonintegrated contract features for long-duration contracts are those for which the determination of benefits provided by the feature is not related or dependent on the account value or other contract holder balances of the base contract. Underwriting and pricing for nonintegrated contract features typically are executed separately from other components of the contract and it is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided. For short-duration contracts, nonintegrated contract features are those that provide coverage that is underwritten and priced only for that incremental insurance coverage, such that the additional premium charged for that incremental insurance coverage is not in excess of an amount that is commensurate with the incremental insurance coverage provided and does not result in the explicit or implicit re-underwriting or repricing of other components of the contract. AcSEC concluded that for short-duration contracts, additional coverage provided by a nonintegrated contract feature would be considered nonintegrated even though the entire coverage provided by the short-duration contract may be subject to only one deductible in the event of an insured loss. Examples of nonintegrated contract features include a long-term care (LTC) rider added to an annuity or disability contract, a term life rider added to an annuity contract, paid up additions to a life insurance contract, a newly acquired automobile added to an existing personal automobile contract, and a personal articles floater added to a homeowner's contract. In these examples, the benefit provided can be determined independently of the base contract. AcSEC noted that many of the common modifications to property and casualty contracts, as described in Appendix B, "Application of Statement of Position Product and Product Feature Examples," of this SOP, involve nonintegrated contract features.

A.14 AcSEC also noted that some contract features can be either integrated or nonintegrated depending on the contract terms. One example of this concept is a waiver of premium

benefit, which provides that a contract holder who is disabled retains coverage under the contract without having to pay premiums or cost of insurance charges, depending on the contract. A waiver of premium feature that provides for the waiver of a contractually specified premium amount would be considered a nonintegrated contract feature as the determination of the amount to be waived was set at contract inception and is not related to current contract account balances. However, a waiver of premium feature that waives the cost of insurance charges is a function of the contract account value at the time the benefit is utilized, and would be considered an integrated contract feature.

A.15 AcSEC concluded that the addition or election of nonintegrated contract features is in substance equivalent to the issuance of an additional contract, as the new contract features are not interrelated with or dependent on the balances of the replaced contract. AcSEC concluded that for a contract modification involving several added or elected contract features or coverages, the insurance enterprise should separately evaluate whether the individual contract features or coverages are integrated or nonintegrated with the base contract. AcSEC also concluded that in a contract exchange that involves a replaced or replacement contract with a nonintegrated contract feature, the contract and the nonintegrated feature should be accounted for as separate contracts under the guidance in paragraph 13 of this SOP, and the insurance enterprise should review the guidance in paragraphs 9 through 15 of this SOP separately for modifications to the base contract and modifications to the nonintegrated feature to determine the appropriate accounting.

Applicability of Guidance

A.16 Some respondents to the March 2003 exposure draft questioned if the guidance in this SOP applies to the present value of future profits (PVP), a contract-related intangible asset recognized in a purchase business combination. AcSEC noted that issues related to purchase accounting are not within the scope of this SOP. Emerging Issues Task Force (EITF) Issue No. 92-9, *Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life In-*

surance Company, notes that PVP is similar in nature to deferred acquisition costs and is amortized and evaluated for impairment in the same manner as deferred acquisition costs. AcSEC concluded that for an internal replacement transaction that involves a contract for which there is a contract-related intangible asset accounted for under EITF Issue No. 92-9, the guidance in this SOP would be applicable to determine whether the contract was a continuation and the accounting implication of that determination. A respondent to the November 2004 exposure draft requested that the SOP specifically address the accounting implications when the contract is substantially changed and the Value of Business Acquired (VOBA) is viewed as part of the contract holder liability. AcSEC noted that paragraphs 16 and 25 of this SOP provide guidance on accounting for other balances associated with the replaced contract.

A.17 Some respondents to the March 2003 exposure draft also questioned whether this SOP should be applied to reinsurance contracts. AcSEC concluded that the reinsurer has a contract with the ceding company, and that is the contract that the reinsurer should evaluate for modifications. AcSEC also concluded that while the criteria in this SOP may not be directly applicable to reinsurance contracts, based on the specific facts and circumstances of a transaction, the concepts are useful in evaluating the implications on deferred acquisition costs of modifications to reinsurance contracts or the underlying reinsured contracts. AcSEC noted that other relevant accounting guidance, for instance FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, governs the determination of the implications of modifications to insurance and reinsurance contracts on risk transfer assessment and the classification of short-duration contracts as either retroactive or prospective.

A.18 Some respondents to the March 2003 and November 2004 exposure drafts commented as to whether the concepts in this SOP are applicable to internal replacements occurring between affiliated companies and how the concepts should be applied. AcSEC observed that other existing accounting literature may be applicable in accounting at the individual company level; for instance, whether the internal replace-

ment is a transaction in the normal course of business or a transfer under common control. For purposes of consolidated financial statements, the guidance of this SOP should be applied at the consolidated level. AcSEC also noted that there may be circumstances under which the accounting at the individual company level may be different than at the consolidated level. That is, an internal replacement occurring between affiliated companies may result in an extinguishment of a contract at the subsidiary level being reported in the separate company financial statements of that subsidiary but, on a consolidated basis, the replacement meets the conditions to be accounted for as a continuation of the replaced contract.

Substantial Changes

A.19 In general, life insurance and annuity products are financial instruments. The insurance enterprise has a contractual obligation to deliver cash, and the customer has a contractual right to receive cash. Paragraph 15 of FASB Statement No. 97 requires that investment contracts issued by an insurance enterprise be accounted for in a manner consistent with the accounting for interest-bearing instruments. Paragraph 72 of FASB Statement No. 97 refers to APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by FASB Statement No. 76, *Extinguishment of Debt*, and as subsequently amended by FASB Statements No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, as the governing literature, which requires the write-off of unamortized costs associated with extinguished debt if the extinguished debt is replaced by a new liability to the same party. EITF Issue No. 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments*, interpreted the guidance in FASB Statement No. 125 and concluded that certain debt exchanges do not represent substantive modifications to existing debt, resulting in the deferral of both unamortized amounts related to the old debt and new fees related to the new debt, amortization of those deferred amounts over the

life of the new debt, and the expensing of costs incurred with third parties. FASB Statement No. 125 was superseded by FASB Statement No. 140, but the guidance in FASB Statement No. 125 that was interpreted by EITF Issue No. 96-19 was carried forward to FASB Statement No. 140 without reconsideration.

A.20 AcSEC believes instruments issued by financial institutions should be accounted for consistently, as noted in FASB Statement No. 97, paragraph 39:

> While many investment contracts are issued primarily by insurance enterprises, the Board believes that similar financial instruments should be accorded similar treatment regardless of the nature of the issuing enterprise.

A.21 In EITF Issue No. 96-19, the EITF reached a consensus that an exchange of debt instruments with substantially different terms should be accounted for and reported in the same manner as an extinguishment. The EITF observed that a debtor could achieve the same economic effect by making a substantial modification of the terms of an existing debt instrument. Accordingly, the EITF reached a consensus that a substantive modification of terms should be accounted for and reported in the same manner as an extinguishment. Substantive modifications of debt terms materially affect the present value of future cash flows on the debt, necessitating the abandonment of the existing amortization with "fresh-start" measurements.

A.22 EITF Issue No. 96-19 provided quantitative guidance and noted 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. AcSEC considered a 10-percent test similar to that adopted by the EITF. AcSEC ultimately concluded that such analysis would not be reliable in reaching a conclusion concerning contract similarity because of the potential subjectivity of assumptions and complex nature of many insurance and investment contracts. Rather, AcSEC adopted a qualitative analysis to be used in determining whether the replacement or modification of an insurance or investment contract results in the contract

being considered substantially unchanged. AcSEC believes that the use of a qualitative analysis will result in an improvement in practice by providing a framework to evaluate internal replacements. AcSEC believes that framework will significantly narrow the circumstances that will result in costs associated with the replaced contract continuing to be deferred with the replacement contract.

A.23 A number of respondents to the March 2003 exposure draft expressed a view that the proposed guidance was inconsistent with EITF Issue No. 96-19, and should be revised to eliminate qualitative criteria and to include similar quantitative analysis. AcSEC reaffirmed its belief that applying solely quantitative analysis to the internal replacement of an insurance or investment contract to determine whether the contract was substantially unchanged is not appropriate. Instead, AcSEC decided to strengthen the qualitative conditions included in the framework, which also contain quantitative components. The format used in the SOP of the conditions, to determine whether an internal replacement involves contracts that are substantially unchanged, was revised from the March 2003 exposure draft, as some of the factors had been combined together in the concept of "inherent nature" in the March 2003 exposure draft. The condition in paragraph 15 (a), change in the insured event, is essentially the same concept included in the discussion of inherent nature in the March 2003 exposure draft. In an effort to make the guidance in the SOP simpler to apply, AcSEC revised how insurance enterprises determine whether an internal replacement involves contracts that are substantially changed or unchanged, but kept the same basic concepts. The concept of primary benefits that existed in the March 2003 exposure draft was replaced with the concepts of integrated and nonintegrated benefit features.

Conditions for Determining Whether a Contract Is Substantially Unchanged

A.24 AcSEC concluded that changes to certain contract features are always indicative of substantial changes to the substance of the replaced contract, and that it would be appropriate to conclude that these types of changes would always result in a substantially changed contract for finan-

cial reporting purposes. Therefore, AcSEC concluded that the determination of whether a contract has changed substantially should be based on a qualitative evaluation of the existence of certain key components in the internal replacement transaction.

A.25 AcSEC also concluded that certain changes would always result in an internal replacement with a substantially unchanged replacement contract if evaluated under the conditions of paragraph 15 of this SOP. Examples of these types of changes would include:

a. Changes in the allocation of the contract holder's account balance among investment alternatives provided for in the contract, even if reallocated 100 percent to a specific investment alternative

b. Additional investment allocation alternatives added to a contract with multiple investment alternatives

AcSEC observed that changes in the cost of insurance charges, interest-crediting rates, or similar provisions within ranges outlined in the contract, without any other change in benefits or coverages, are not modifications to the contract and are not internal replacements. AcSEC also observed that partial withdrawals or surrenders or reductions in coverage (for example, reduced face amount on a life insurance contract or higher deductibles on a property casualty contract), as allowed by the terms of the contract, whether or not surrender charges or termination fees are assessed, are not internal replacements subject to the guidance of this SOP as long as there are no other modifications to the contract, at that time, that would require evaluation under paragraph 15 of this SOP. Under certain contracts, for example, employee group health contracts and worker's compensation contracts, the insured population is regularly adjusted as employees are hired and terminated. These changes and the associated charges are made in accordance with terms specified in the contract and are not internal replacements for purposes of this guidance. Another example of a similar insurance contract in which the insured population typically is adjusted in accordance with contractual terms, is a commercial automobile contract providing coverage for a fleet of cars.

A.26 Some respondents to the March 2003 exposure draft expressed a view that the fundamental nature of the transaction and the economics of the transaction should also be reviewed to determine the appropriate accounting. In their view, criteria should include:

a. Is the transaction fundamentally the surrender of the replaced contract and a new issue or is it a modification to an existing coverage?

b. Is the transaction expected to preserve or improve the insurer's future margins associated with the contract?

AcSEC reaffirmed that the scope of this SOP includes modifications to contracts, not just contract exchanges, and, therefore, concluded that the first question was not a defining criterion. AcSEC did, however, acknowledge that, for many companies, permitting different approaches to modifications and contract exchanges could mitigate administrative complexity and related costs. As for the second suggested criterion, AcSEC reaffirmed its conclusion that it is the substance of the contract between the insurance enterprise and the contract holder that is to be evaluated and not just the economics to the insurance enterprise that is critical to determining whether an internal replacement results in a substantially changed contract.

Mortality, Morbidity, or Other Insurance Risk

A.27 AcSEC concluded that significant changes in the kind or degree of mortality, morbidity, or other insurance risks would result in a replacement contract that is substantially changed from the replaced contract, as these risks are defining components of the substance and classification of a contract. An example of a significant change in the degree of mortality risk would be an internal replacement of a variable annuity with a minimal death benefit to a variable annuity with a "rich" death benefit, which would result in a replacement contract that is substantially changed from the replaced contract. AcSEC concluded that an exchange of a contract with one type of death benefit for a contract with another type of death benefit requires review of the terms to determine whether the degree of mortality is similar. An ex-

ample of an insignificant change in the degree of mortality risk would be an internal replacement of a variable annuity with a **roll-up death benefit** to a variable annuity with a **ratchet death benefit** of similar relative expected cost, which would not result in a substantial change to the mortality benefit, as both variable annuities contained significant and similar levels of mortality risk related to premature death. An example of a significant change in the type of mortality risk would be an exchange of a life insurance contract for a solely life-contingent payout annuity. AcSEC noted that, in determining whether a change in the degree and kind of risks of a contract is significant, the focus should be on the substance of the risks of the contract, and not the form of the contract. Factors to consider in determining whether there are significant changes in insurance risks may include changes in actuarially estimated costs for that benefit feature or the SOP 03-1 benefit ratio related to that benefit feature. Reunderwriting the entire contract generally would indicate a substantial change resulting from a change in the kind or degree of mortality, morbidity, or other insurance risk.

A.28 Some respondents to the March 2003 exposure draft questioned whether the guidance in this SOP is applicable to short-duration contracts. AcSEC noted that the guidance in this SOP applies to all entities to which FASB Statement No. 60 applies, which includes both short-duration and long-duration contracts, but believed that it would be beneficial to solicit additional comments from preparers and auditors in the November 2004 exposure draft as to whether the guidance is clear and operational for short-duration contracts. Some respondents to the November 2004 exposure draft commented that it was unclear how to apply the definition of nonintegrated and integrated contract features to short-duration contracts. AcSEC concluded that it would be clearer to discuss the definitions of nonintegrated and integrated contract features separately for short-duration and long-duration contracts as a result of inherent differences in the products.

A.29 Some respondents to the March 2003 exposure draft also questioned whether the guidance in this SOP is applicable to group life insurance. AcSEC noted that evaluation of all

the related facts and circumstances of a group contract is required to determine whether a contract should be analyzed at the group contract level or individual certificate (under the group contract) level for purposes of applying the guidance in this SOP. AcSEC again stated that the form of the transaction should not determine the accounting. For example, a traditional group life contract that covers all full-time employees at a base amount (for example, coverage at a fixed amount per life or at one-times-salary) with no underwriting required, should be viewed at the aggregate group contract level when applying the guidance in this SOP, as the individuals covered are not significant in determining the insured event. In contrast, a group keyman life insurance contract that covers a company's top management with individual underwriting for each employee covered should be viewed at the individual certificate level when applying the guidance in this SOP, as each employee is separately underwritten and each life should be considered a separate contract for purposes of applying the guidance of this SOP.

Investment Reward Rights

A.30 In the March 2003 exposure draft, AcSEC concluded that the nature of investment reward rights was a significant component in the contractual relationship between the contract holder and the insurance enterprise. Therefore, for contracts that pass through the performance of a pool of assets (for example, variable contracts), the existence of a minimum return guarantee, such as a GMAB, did not change the nature of the investment reward rights (pass through of actual investment performance of the referenced assets); instead, such minimum return guarantees on those contracts were viewed as being in the nature of a separate "put" that operated independent of the "basic" investment reward provisions of the contract. Some respondents to the March 2003 exposure draft commented that changes in the nature of the investment return rights and provisions (for example, changing from a contract with a fixed crediting rate to a crediting rate based on the performance of a specified pool of assets) should not drive the release of deferred acquisition costs, particularly if that

change does not materially affect future expected contract margins in reasonably possible scenarios. Other respondents commented that they did not believe that the proposed guidance was operational, as preparers could reach different conclusions. After a review of comments received and further discussion, AcSEC concluded that a change in the nature of the investment return rights (for example, between discretionary and formulaic or pass-through) is always significant, and changes in minimum guarantees for contracts subject to periodic discretionary declaration may be significant, depending on facts and circumstances. AcSEC also concluded that for pass-through contracts, the adding of a floor or a capping of the returns, such that actual returns (net of fees and charges) are not passed through to the policyholder, fundamentally changes the nature of the investment return rights and therefore is a significant change in the contract.

Additional Deposit, Premium, or Charge

A.31 AcSEC believes that the requirement of an additional deposit, premium, or charge relating to the benefit or coverage provided under the replaced contract, in excess of amounts contemplated in the replaced contract, whether explicit or implicit, indicates that the replacement contract is not a continuation of the replaced contract because of the change of the underlying economics of the replaced contract as a result of the internal replacement. For example, an increase in premiums in excess of the amount that is commensurate with an increase in the contractual benefits or coverages is an implicit additional premium for the original benefit or coverage.

Net Decrease in Balance Available to the Contract Holder

A.32 AcSEC concluded that a net decrease to the balance available to the contract holder would effectively be a surrender charge and, therefore, would be indicative of a change in the substance of the contract between the contract holder and the insurance enterprise, rather than the continuation of the replaced contract. In certain situations, an insurance enterprise may assess a surrender charge on the re-

placed contract that is offset by an immediate sales inducement on the replacement contract that is equal to or greater than the surrender charge. In these situations, the insurance enterprise should offset any immediate sales inducements against any surrender charges assessed against the contract holder's account balance under the replaced contract to determine whether there has been a net reduction in the contract holder's account balance. If the surrender charge is greater than the immediate sales inducement, the condition in paragraph 15(d) of this SOP would not be met and the internal replacement would result in substantially changed contracts. For example, if the account balance of a FASB Statement No. 97 universal life contract prior to surrender charges is $100 and a $5 surrender charge is imposed, the resulting $95 credited to the replacement contract (prior to the consideration of any new surrender charges) results in a substantial change to the contract. However, if an immediate bonus of $5 or more was credited to the replacement contract as well, there would be no net decrease to the balance available to the contract holder and the internal replacement results in a contract that is substantially unchanged, provided the other conditions of paragraph 15 are satisfied.

Change in Participation or Dividend Features

A.33 AcSEC concluded that a change in the participation, including experience refund, or dividend features of a contract indicates a substantial change to the replaced contract. For example, the addition of an experience refund rider to a LTC contract is an integrated benefit and results in a substantially changed contract. AcSEC also noted that the substance of the contract, not just its legal classification, must also be evaluated.

Change in Amortization Method or Revenue Classification

A.34 AcSEC also concluded that a modification resulting in a change to the amortization method or revenue classification of the contract indicates a substantive change in the contract because a change in amortization method or revenue classification means that the contracts should be ac-

counted for under different accounting models. Multiple accounting models exist to address the different kinds of products issued by insurance enterprises. Because "insurance-specific" accounting models are prescriptive, not elective, the use of a different accounting model implies a substantially different kind of contract. An analogy can be made to FASB Statement No. 13, *Accounting for Leases*. Paragraph 9 of FASB Statement No. 13 requires a lease agreement, whose terms have been modified, to be accounted for as a new agreement if the original classification of the lease would have been different under the modification. For example, a modification that results in either a change from amortization of deferred acquisition costs in proportion to premium revenue to amortization based on the emergence of estimated gross profits or a change in revenue classification from reporting premium as revenue to reporting deposits results in contracts that are substantially changed.

Accounting for Contracts That Are Substantially Unchanged

A.35 Paragraph 15 of FASB Statement No. 97 requires that investment contracts issued by insurance enterprises be accounted for in a manner consistent with interest-bearing instruments. EITF Issue No. 96-19 interpreted the guidance in FASB Statement No. 125, as amended by FASB Statement No. 140, to conclude that certain debt exchanges do not represent substantive modifications to existing debt. The EITF explicitly acknowledged that an exchange or modification in terms that is not substantially different does not result in an extinguishment.

A.36 AcSEC concluded that an internal replacement that is determined to result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as a continuation of the replaced contract. As such, the unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets associated with the replaced contract should continue to be deferred. Other balances associated with the replaced contract, such as any liability for MGDBs, or GMIBs, should be

handled in a similar manner, that is, as if the replacement contract is a continuation of the replaced contract.

Accounting for FASB Statements No. 91, No. 97, and No. 120 Contracts

A.37 FASB Statements No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*; No. 97; and No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, specify the treatment of revisions to the estimated cash flows and estimated gross profits of contracts accounted for under these Statements. AcSEC concluded that it would be appropriate to follow the existing authoritative accounting guidance that specifies the treatment of revisions to the estimated cash flows and estimated gross profits.

A.38 A number of respondents to the March 2003 exposure draft commented that the proposed guidance for accounting for FASB Statements No. 97 and No. 120 contracts involved in an internal replacement that is determined to result in a replacement contract that is substantially unchanged from the replaced contract, would create significant implementation and administration difficulties, as most companies would require substantial administrative system modifications to comply. In response to these concerns, AcSEC concluded that if the accounting approach described in paragraph 17 of this SOP (account for the replacement contract as a continuation of the replaced contract through revisions to future estimated gross profits) is not reasonably practicable for a contract exchange, an insurance enterprise may determine an appropriate balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract to be treated as day-one deferrable acquisition costs and amortized prospectively using estimated gross profits only of the replacement contract. Other contract-related balances that are determined based on activity over the life of the contract, such as a liability for MGDBs and deferred sales inducement assets, would be handled in a similar manner. AcSEC did note that it is expected that future administrative systems would be structured to capture

the required information and accommodate the approach described in paragraph 17 of this SOP.

Accounting for FASB Statement No. 60 Long-Duration Contracts

A.39 For long-duration contracts accounted for under FASB Statement No. 60, the continuation of the contract after an internal replacement transaction is not unlike a prospective adjustment of premiums on indeterminate premium life insurance. Although not specifically addressed in existing authoritative accounting literature, actuarial literature and practice have emerged to address that situation. Actuarial Standard of Practice No. 10, *Methods and Assumptions for Use in Life Insurance Company Financial Statements Prepared in Accordance with GAAP*, addresses the accounting for indeterminate premium policies as follows:

> *Indeterminate Premium Policies.* Provided the policy is not, in substance, a [universal life]-type policy, [FASB Statement] No. 60 is applicable to indeterminate premium policies. The premium flexibility associated with these policies may affect the application of [FASB Statement] No. 60, such as the use of a smaller provision for the risk of adverse deviation. The ability and willingness of the insurer to change premiums may be anticipated in performing loss recognition. Assumptions may be "unlocked" at gross premium change dates. If assumptions are adjusted, it should be done prospectively, without a change in the liability as of the valuation date.

In such cases, deferred acquisition costs factors also are adjusted prospectively, and there is no discontinuity in the balance of unamortized deferred acquisition costs. Such a prospective revision in this and similar situations involving guaranteed renewable health insurance products, on which premiums may be adjusted prospectively, does not violate the FASB Statement No. 60 "lock-in" concept.

Sales Inducements to Contract Holders

A.40 In the March 2003 exposure draft, AcSEC concluded that sales inducements to contract holders offered in conjunction with an internal replacement of long-duration contracts, determined to result in a replacement contract that is substan-

tially unchanged from the replaced contract and otherwise meeting the conditions of SOP 03-1, should be accounted for as if the sales inducement had been present and explicitly identified at the inception of the original contract, with a cumulative adjustment recognized as amortization in the current period to reflect accumulated amortization since inception. Several respondents to the March 2003 exposure draft noted concerns with the proposed guidance for sales inducements and perceived inconsistencies with the sales inducement guidance in SOP 03-1. The respondents were concerned that sales inducements that did not meet the conditions included in SOP 03-1, namely, explicit identification at the inception of the contract, could be added as a sales inducement and labeled an internal replacement to receive preferential accounting treatment. After review of the comments received and further discussion, AcSEC concluded that a sales inducement to a contract holder offered in conjunction with an internal replacement of a long-duration contract that is determined to result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for from the date of its addition to the replacement contract under the guidance of SOP 03-1, and should not be accounted for as if it had been present in the original contract at the inception of the contract.

Accounting for Contracts That Are Substantially Changed

A.41 AcSEC concluded that an internal replacement transaction that is determined to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as the extinguishment of the replaced contract and the issuance of a new contract. This conclusion is consistent with the analogy to guidance in EITF Issue No. 96-19 and the guidance in FASB Statement No. 97 relative to the internal replacement of a traditional life insurance contract with a universal life-type contract. AcSEC also concluded there was no compelling reason to propose any modification to the accounting results that follow from the application of current accounting guidance applicable to the termination of the replaced contract and the issuance of a new contract.

Costs Related to Internal Replacements

A.42 AcSEC concluded that an internal replacement that is determined to result in a replacement contract that is substantially unchanged from the replaced contract is, in substance, a continuation of the replaced contract; and, in the March 2003 exposure draft, concluded that any costs should be evaluated for deferral under the provisions of FASB Statements No. 60 and No. 97 applicable for nonfirst-year or renewal acquisition costs. Accordingly, in the March 2003 exposure draft, AcSEC concluded that these costs should be capitalized to the extent that they meet the criteria for deferral as renewal acquisition costs under the provisions of FASB Statements No. 60 and No. 97, in accordance with what AcSEC believed to be industry practice.

A.43 Based on discussion with the FASB concerning the intention of the guidance in FASB Statements No. 60 and No. 97, AcSEC concluded that since the contract was determined to be unchanged, the purpose of the related costs would be more in the nature of contract maintenance than acquisition and should be accounted for as policy maintenance costs and charged to expense as incurred. It was also noted that one comment letter specifically made the point that it was inconsistent to analogize costs incurred in connection with an internal replacement that is in substance a continuation of the replaced contract with acquisition costs incurred in connection with contract renewals that are in substance new contracts. Some respondents to the November 2004 exposure draft questioned how renewal commissions on a replaced contract that is determined to be substantially unchanged should be accounted for in conjunction with the guidance of this SOP. AcSEC concluded that the portion of renewal commissions paid on the replacement contract that meets the criteria for deferral in accordance with the provisions of FASB Statements No. 60 and No. 97, as appropriate, limited to the amount of the future deferrable renewal commissions on the replaced contract that would have met the deferral criteria, continues to be deferrable under the provisions of FASB Statements No. 60 and No. 97.

Recoverability

A.44 AcSEC concluded there was no reason to modify the existing guidance contained in FASB Statement No. 60 as it relates to determining the recoverability of unamortized deferred acquisition costs and the present value of future profits. AcSEC did note that the separate contracts resulting from internal replacements with nonintegrated contract features should be examined independently for the recoverability of related unamortized deferred acquisition costs and the present value of future profits.

Disclosures

A.45 AcSEC concluded that existing disclosure requirements relative to the financial statement balances affected by internal replacements, such as deferred acquisition costs, unearned revenues, sales inducements, benefit liabilities, and account balances, provide adequate disclosure of information that is useful and informative to financial statement users.

Effective Date and Transition

A.46 Several respondents to the March 2003 exposure draft commented that the proposed effective date of January 1, 2004, was not reasonable. The majority of respondents to the November 2004 exposure draft also commented that the revised proposed effective date of January 1, 2006, was not reasonable given the combination of extensive time and systems modifications associated with implementation of this guidance and other guidance that insurance enterprises are currently adopting. AcSEC concluded that additional time should be allowed and, even though revisions to the proposed guidance should help alleviate some of the potential implementation issues, decided to require this SOP to be effective for internal replacements occurring in fiscal years beginning after December 15, 2006. AcSEC believed this effective date will provide insurance enterprises sufficient time to implement this SOP. AcSEC also concluded that it would allow companies the alternative of early adoption.

A.47 Upon the issuance of FASB Statement No. 154, *Accounting Changes and Error Corrections: a replacement of APB Opinion No. 20 and FASB Statement No. 3*, AcSEC evaluated the guidance in FASB Statement No. 154 and concluded that the SOP should be applied prospectively for internal replacements occurring after adoption. AcSEC concluded that it would be impracticable to apply the effects of the change in accounting principle resulting from the adoption of this SOP retrospectively because enterprises would not have accumulated the information at the level required by this new guidance to enable the companies to identify deferred acquisition costs specific to prior internal replacements.

A.48 As a result of adopting the guidance in this SOP, an insurance enterprise may need to revise lapse, surrender, or other assumptions used in the development of estimated gross profits, for previously anticipated future internal replacements. In some instances, these revisions will be necessary solely to reflect any impact of adopting the accounting guidance in this SOP. That is, the internal replacement was previously assumed to occur and the impact was already provided for in the estimated gross profits, however, the treatment of the internal replacement as either a termination or continuation of the existing contract will be different under the provisions of the SOP. Anticipated future internal replacements that, prior to the adoption of this SOP, would have been accounted for as continuations of the replaced contracts may be required to be accounted for as extinguishments of the replaced contracts, and internal replacements that, prior to the adoption of this SOP, would have been accounted for as extinguishments of the replaced contracts may be required to be accounted for as continuations of the replaced contracts. AcSEC concluded that adjustments to unamortized deferred acquisition costs, present value of future profits, unearned revenue liabilities, deferred sales inducements, and similar balances that are determined based on estimated gross profits that result from revising the lapse, surrender, or other assumptions for anticipated future internal replacements, solely as a result of changes in accounting policy to comply with this SOP and any related income tax

effects, should be reported in a manner similar to a cumulative effect of a change in accounting principle with offsetting adjustments to the opening balance of retained earnings as of the date of adoption. Changes in assumptions used in determining prospective estimated gross profits that are related to changes in the estimate of the volume or trends in contract holder behavior are changes in accounting estimates and would not be included in the cumulative effect adjustment of a change in accounting principle. Changes in assumptions used in determining prospective estimated gross profits that cannot be substantiated as solely the result of a change in accounting policy due to adoption of this SOP should be reported as a change in accounting estimate.

A.49 AcSEC recognizes the benefits of comparable financial statements but believes that because insurance enterprises are unlikely to have accumulated the information at the level required by this new guidance to enable them to identify deferred acquisition costs specific to prior internal replacements, retrospective application of this SOP in the year of adoption is not permitted and pro forma disclosures in the year of adoption are not required.

APPENDIX B

Application of Statement of Position Product and Product Feature Examples

The following are examples of contract modifications and the application of the guidance in this Statement of Position (SOP) for evaluating whether the internal replacements are substantially changed from the replaced contracts. The conclusions reached in the following examples are based on the specific facts and circumstances of the examples; the same conclusions may not be reached for other modifications because of differing facts or circumstances.

The following examples of contract modifications are included in this Appendix:

Paragraph

Increasing Death Benefit Coverage on a Life Contract...... B.1
Option to Purchase Additional Insurance Rider........... B.2
Issuance of a Second Life Insurance Policy for an Incremental Face Amount.......................... B.3
Contract Modification to Increase the Face Amount of a Traditional Life Insurance Contract................. B.6
Increase in Face Amount of Universal Life-Type Contract... B.7
Universal Life-Type Contract to Universal Life-Type Contract With a No-Lapse Guarantee................. B.9
Universal Life-Type Contract to Universal Life-Type Contract With a Second-to-Die Feature B.10
Addition of a New Car to an Automobile Contract........ B.11
Deletion of a Car From an Automobile Contract B.12
Change of Car in an Automobile Contract B.13
Addition of a New Driver to an Automobile Contract...... B.14
Deletion of a Driver From an Automobile Contract B.15
Change in Coverage of an Automobile Contract.......... B.16
Addition of a Personal Articles Floater to a Homeowner's Contract B.18
Increase in Coverage to a Homeowner's Contract B.19

Increase in Limits for an Umbrella Contract B.20
Increase in Premiums Versus Reduced Coverage B.21
Single Premium Deferred Annuity to Market
Value Adjusted Annuity. B.23
Single Premium Deferred Annuity to Equity-
Indexed Annuity B.26
Single Premium Deferred Annuity to Multi-
Bucket Annuity B.28
Fixed-Interest Rate Guaranteed Investment Contract to a
Variable-Interest Rate Guaranteed Investment Contract . . B.30
Variable Annuity With Return of Premium Death
Benefit Guarantee to Variable Annuity With Ratchet
Death Benefit Guarantee. B.32
Variable Annuity With Rollup Death Benefit Guarantee to
Variable Annuity With Ratchet Death Benefit Guarantee . . B.34
Variable Annuity to a Variable Annuity With Long-Term
Care Benefit. B.35
Variable Annuity With New Investment Alternatives
Added and Elections of Fixed Allocation Alternatives . . . B.37
Variable Annuity to Variable Annuity With Guaranteed
Minimum Accumulation Benefit B.39
Variable Annuity to Variable Annuity With Guaranteed
Minimum Income Benefit B.40
Variable Annuity to Variable Annuity With Guaranteed
Minimum Withdrawal Benefit B.41

Increasing Death Benefit Coverage on a Life Contract

B.1 There are several ways in which a contract holder can increase death benefit coverage on a traditional whole life insurance contract.

Option to Purchase Additional Insurance Rider

B.2 An option to purchase additional insurance (OPA) rider gives the contract holder the right to purchase additional insurance coverage with no additional underwriting. That is, the contract holder can increase the face value of the policy for the same type of insurance coverage and in the same form as that provided by the original contract. The

additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained. The rider could be included in the original contract or added subsequently to its issuance.

B.3 This is an example of a nonintegrated contract feature. Once purchased, the benefit under the OPA rider generally is accounted for as a separate contract.

Issuance of a Second Life Insurance Policy for an Incremental Face Amount

B.4 The contract holder obtains a second life insurance policy for an incremental face amount, with underwriting required on the new policy only. The original contract remains in force without change.

B.5 This transaction does not fall within the definition of an internal replacement in paragraph 8 of this SOP. The accounting for the original contract remains unchanged and the new contract is accounted for independently of the original contract. Any deferrable acquisition costs associated with the new contract are deferred and amortized according to the revenue or margin stream of the new contract, as applicable.

Contract Modification to Increase the Face Amount of a Traditional Life Insurance Contract

B.6 The increased face amount (death benefit) of a traditional life insurance contract effectuated through an amendment or rider to the original contract is considered a nonintegrated feature that should be accounted for separately from the existing life insurance contract, provided that the additional premium charged for that incremental insurance coverage is not in excess of an amount that is commensurate with the incremental insurance coverage and does not result in the explicit or implicit reunderwriting or repricing of other components of the contract.

Increase in Face Amount of Universal Life-Type Contract

B.7 As noted in FASB Statement No. 97, universal life-type contracts are long-duration contracts, that can provide either death or annuity benefits and are characterized by one of the following features:

a. One or more of the amounts assessed by the insurer against the policyholder are not fixed and guaranteed by the terms of the contract.

b. Amounts that accrue to the benefit of the policyholder are not fixed and guaranteed by the terms of the contract.

c. Premiums may be varied by the policyholder within contract limits without the consent of the insurer.

B.8 The increase in face amount of a universal life-type contract through an amendment to the original contract is considered an integrated feature as the death benefit under a universal life-type contract is equal to the excess of face amount over contract account value. In this example, only the additional face amount has been underwritten during the contract amendment and the additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained. This contract amendment to increase the face amount of a universal life-type contract results in the replacement contract being substantially unchanged from the replaced contract due to the following:

a. The modification does not result in a change in the insured event, as there is no significant change in the kind and degree of mortality risk. Although the face amount of the contract has increased, it is appropriate in this example to analyze the change in degree of mortality risk by comparing the relationship of the expected cost of the benefit to charges assessed for that benefit, and there was no significant change in this relationship.

b. There is no change in the nature of the investment return rights from the replaced contract.

c. There are no changes in the charges related to the original benefits; also, the additional cost of insurance is not in excess of an amount commensurate with the additional insurance coverage obtained.

d. There is no net decrease in the balance available to the contract holder, except to pay the cost of insurance charge for the increased coverage.

e. There is no change in the participation or dividend feature of the replaced contract.

f. The modification does not result in a change to either the amortization method or revenue classification of the contract.

Universal Life-Type Contract to Universal Life-Type Contract With a No-Lapse Guarantee

B.9 A universal-life type contract may contain a no-lapse guarantee feature that provides for continuing coverage of the contract even if the account value drops to a level that cannot cover the contract charges. The contract exchange of a universal life-type contract for a universal life-type contract that contains a no-lapse guarantee results in the replacement contract being substantially changed from the replaced contract because the addition of the no-lapse guarantee changes both the period of coverage of the contract as well as introducing a combination of mortality and investment risk. The analysis would be the same if the change had been achieved through the addition of a no-lapse guarantee rider, as it would be considered an integrated benefit (the benefit is a function of the contract account value) and would need to meet the conditions in paragraph 15 if this SOP. If, however, the contract holder had elected to add a no-lapse guarantee feature that was included in the original contract (and met the specifications in paragraph 9 of this SOP), the modification would not be considered an internal replacement subject to the guidance of this SOP.

Universal Life-Type Contract to Universal Life-Type Contract With a Second-to-Die Feature

B.10 A second-to-die feature incorporates multiple mortality events within a single contract, as payment to the beneficiary is made, assuming the contract remains in force, only after both insured individuals die. The contract exchange of a universal life-type contract for a universal life-type contract that contains a second-to-die provision results in the replacement contract being substantially changed from the replaced contract because the addition of the second-to-die feature changes the insured event, as now two mortality events must occur for the beneficiary to obtain the proceeds. If the modification were achieved through amendment, endorsement, or rider rather than through a contract exchange, the analysis and conclusion would be the same as for the contract exchange because the second-to-die provision is an integrated feature.

Addition of a New Car to an Automobile Contract

B.11 An automobile insurance contract is a short-duration contract that generally provides coverage for personal injury and automobile damage sustained by the insured and liability to third parties for losses caused by the insured. A newly purchased car being added to an existing automobile policy with no change in the other vehicles covered or the premium related to the other vehicles under the contract results in additional nonintegrated contract coverage that should be accounted for separately from the existing automobile contract coverage, assuming the underwriting and price for coverage of the new car is determined separately and there is no change, explicit or implicit, in the pricing of the base contract.

Deletion of a Car From an Automobile Contract

B.12 If one of the existing automobiles under the contract described in paragraph B.11 of this SOP is removed from the

automobile contract, it is considered the extinguishment of nonintegrated contract coverage and should be accounted for as an extinguishment of only the balances related to that nonintegrated coverage. The amount refunded to the contract holder from the change in the coverage is determined in accordance with terms that are fixed in the contract or applicable state law or regulation and no reunderwriting is required for other coverage. The amount refunded to the contract holder reduces the related unearned revenue liability and unamortized deferred acquisition costs related to the extinguished nonintegrated contract coverage is eliminated.

Change of Car in an Automobile Contract

B.13 Assume the automobile insurance contract described in paragraph B.11 of this SOP contains one car and one driver, the existing car is sold and replaced with another car, and coverage is changed through a contract endorsement. For accounting purposes, the original automobile contract is extinguished and coverage for a new automobile contract is established for the driver and the new car. The modification is not a reduction in coverage under paragraph 10 of this SOP, as it is a termination of all coverage in the contract, not a partial termination of coverage as described in paragraph 10. It is common practice to net settle the premium and commission adjustments resulting from this contract modification. For accounting purposes, there are in substance two transactions: the extinguishment of one contract, which is accounted for as a contract extinguishment under paragraph 25 of this SOP, and establishment of a new contract.

Addition of a New Driver to an Automobile Contract

B.14 The addition of a new driver to an existing automobile contract with no other changes in the contract results in additional nonintegrated contract coverage that should be accounted for separately from the existing automobile contract coverage, as the underwriting and price for coverage for the new driver is determined separately.

Deletion of a Driver From an Automobile Contract

B.15 If one of the existing drivers under the contract described in paragraph B.14 of this SOP is removed from the automobile contract, it is the extinguishment of nonintegrated contract coverage and should be accounted for as an extinguishment of only the balances related to that nonintegrated coverage. The amount refunded to the contract holder from the change in the coverage is determined in accordance with terms that are fixed in the contract or applicable state law or regulation and no reunderwriting is required for other coverage. The amount refunded to the contract holder reduces the related unearned revenue liability and the balance of the unamortized deferred acquisition costs related to the extinguished nonintegrated contract coverage is eliminated.

Change in Coverage of an Automobile Contract

B.16 An increase in the collision deductible of an automobile contract is, in effect, a reduction in the coverage provided. It is not an internal replacement, but a reduction in coverage under paragraph 10 of this SOP, providing that all the terms that determine the amount refunded from the change in coverage are fixed in the original contract or by applicable state law or regulation and no reunderwriting is required for the continuing coverage. Contractual provisions that allow the contract holder to elect to decrease existing coverage at then-current rates (other than when required by state law or regulation), subject to a stated minimum and maximum, generally are not specific enough to satisfy this requirement.

B.17 A decrease in the collision deductible of an automobile contract is, in effect, an increase in the coverage provided. It is not an internal replacement, but an election by the contract holder of coverage that was within the original contract as noted in paragraph 9 of this SOP, providing that all the terms that determine the amount of the premium related to the additional coverage are fixed in the original contract or by ap-

plicable state law or regulation and no reunderwriting is required of the original coverage. Contractual provisions that allow the contract holder to elect to add future coverage at then-current rates (other than when required by state law or regulation), subject to a stated minimum and maximum, generally are not specific enough to satisfy this requirement.

Addition of a Personal Articles Floater to a Homeowner's Contract

B.18 A homeowner's contract is a short-duration contract that generally provides coverage for loss or damage of property and personal injury occurring on the insured's property. A personal articles floater provides coverage for losses on personal property not covered under the terms of the homeowner's contract. If multiple pieces of jewelry are added to a personal articles floater, this SOP views each separately identified and priced item to constitute a nonintegrated contract feature. Thus, the addition of a personal articles floater providing coverage for several new pieces of jewelry to an existing homeowner's contract, with no other changes in the contract, results in additional nonintegrated contract coverage that should be accounted for separately from the existing homeowner's contract, as the underwriting and price for coverage for the jewelry is determined separately from the homeowner's contract and does not result in the reunderwriting of the existing coverages provided by the contracts. This is true even though the items covered by the personal articles floater and the homeowner's contract share a deductible and limit in the event of a common loss. The sharing of a common deductible and limit in the event of loss does not determine whether the contract feature or coverage is integrated, as the deductible is a definition of the terms of coverage resulting from a single loss event.

Increase in Coverage to Homeowner's Contract

B.19 A contract holder increases the coverage of a homeowner's contract, which insures a house valued at $350,000 with $300,000 of insurance coverage, to $400,000 to include a

recently completed addition to the house worth $100,000. The additional layer of coverage results in a nonintegrated contract feature that should be accounted for separately from the existing homeowner's contract, provided that the additional premium charged for that incremental insurance coverage is not in excess of an amount that is commensurate with the incremental insurance coverage and does not result in the explicit or implicit reunderwriting or repricing of other components of the contract. If, however, there was substantive underwriting of the entire contract, including the original coverage, the contract would be considered to be substantially changed because substantive reunderwriting of existing contract coverage is an indicator that the insurance risk has changed significantly, and would probably also result in the repricing of the entire contract, which would result in failure to satisfy the criteria in paragraph 15(c) of this SOP. Additional coverage provided by a nonintegrated contract feature is considered nonintegrated even though the entire coverage provided by the contract is subject to a common deductible and limit in the event of an insured loss.

Increase in Limits for an Umbrella Contract

B.20 A contract holder currently has an umbrella contract from the same insurance enterprise as his or her homeowner's contract that provides for liability coverage with a limit of $1 million. The contract holder requests to increase the limit on the umbrella contract to $2 million. This additional layer of coverage results in additional nonintegrated contract coverage that should be accounted for separately from the existing umbrella contract, as the additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained ($1 million in excess of $1 million with no additional deductible), and there was no reunderwriting of the original coverage. If, however, there was substantive underwriting of the entire contract, including the original coverage, the contract would be considered to be substantially changed because substantive reunderwriting of existing

contract coverage is an indicator that the insurance risk has changed significantly.

Increase in Premiums Versus Reduced Coverage

B.21 A long-term care (LTC) product provides for a specified payment while the insured qualifies for benefits under the contract. For example, while in a long-term care facility or when receiving care at home. If the LTC product had an authorized rate increase, the insurance enterprise may offer the contract holder the option of reducing coverage instead of paying additional premiums (i.e., maintain the current premium rate). For example, if the original contract provided benefit coverage of $100 a day for a $2,000 annual premium and there was an authorized increase of premiums to $2,500, the contract holder could elect to pay the increased premium or, if allowed by the insurance contract, retain annual premiums of $2,000 with reduced benefit coverage of $80 a day. In this example, the increase in premiums from $2,000 to $2,500 is related to a change in the cost of the insurance that is within ranges outlined in the contract and approved by the insurance regulator, and by itself the premium increase is not considered a modification to the contract. The contract holder election of a reduction in benefits is not an internal replacement, but rather a reduction in coverage under paragraph 10 of this SOP, if all the terms for a change in coverage are fixed in the original contract or by applicable state law or regulation and no reunderwriting of the continuing coverage is required.

B.22 If the contract holder elected a reduction in benefits under which the terms related to a change in coverage were not fixed in the original contract, the contract modification results in the replacement contract being substantially unchanged from the replaced contract as a result of the following:

a. The insured event has not changed from the replaced contract.

b. The exchange does not change the nature of the contract holder's investment return rights.

c. No additional deposit or premium is required and there are no changes in the charges related to the original benefits in excess of the amounts specified or allowed in the original contract, as the reduction in benefits is not in excess of the corresponding reduction in premiums. (The original contract provided for benefits of $100 a day for $2,000 annual premium, the reduction in benefits to $80 a day is commensurate with the 20-percent reduction in premiums from the increased rate of $2,500 to $2,000.)

d. There is no net decrease in the balance available to the contract holder.

e. There is no change in the participation or dividend features of the replaced contract.

f. There is no change in the amortization method or revenue classification of the replaced contract.

Single Premium Deferred Annuity to Market Value Adjusted Annuity

B.23 A single premium deferred annuity (SPDA) is a **general account** fixed deferred annuity with a single premium and guaranteed minimum crediting rate. The crediting rate on an SPDA may vary above the minimum guaranteed rate at the discretion of the insurance enterprise and typically is declared in advance and set for a defined period (for example, one year or three years), often as a result of a selection made by the contract holder. SPDAs typically are classified as investment contracts under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.

B.24 A market value adjusted (MVA) SPDA provides for return of principal and guaranteed interest if held until a specified date or a calculated market adjusted value if surrendered at an earlier date. The current interest rate guarantee period of the MVA annuity typically does not encompass substan-

tially all of the expected life of the contract. At the end of an interest rate declaration period, a new crediting rate is declared by the insurance enterprise and may vary above the minimum guaranteed rate. The length of the initial and subsequent interest rate guarantee periods generally is selected by the contract holder. MVA annuities typically are classified as FASB Statement No. 97 investment contracts.

B.25 In this example, there is no significant difference in the declared interest crediting rate (further, the change in interest rates is consistent with the change in declaration period), no change in the guaranteed minimum interest rate, no additional deposit or premium is required, and there are no surrender charges or front-end fees associated with the internal replacement. The contract exchange of an SPDA contract for an MVA contract results in the replacement contract being substantially unchanged from the replaced contract as a result of the following:

a. The insured event has not changed from the replaced contract.

b. The exchange does not change the nature of the contract holder's investment return rights (crediting rate declared by insurance enterprise, subject to guaranteed minimum crediting rate). The SPDA and the MVA are both contracts for which the interest rate is periodically reset by the insurer subject to a minimum interest rate guaranteed by the contract and, in this example, the current declared interest period does not represent substantially all of the expected life of the contract. The difference between the SPDA and the MVA annuity results from the manner in which the amount available to the contract holder is determined in the event the contract is terminated prematurely, not the contractual rights and provisions for the determination of the contract holder's investment return in the absence of a premature termination of the contract.

c. No additional deposit or premium is required, and there are no changes in the charges related to the original benefits.

d. There is no net decrease in the balance available to the contract holder.

e. There is no change in the participation or dividend features of the replaced contract.

f. There is no change in the amortization method or revenue classification of the replaced contract.

The SPDA and the MVA are both contracts for which the interest rate is periodically reset by the insurer subject to a minimum interest rate guaranteed by the contract; the only significant substantive difference between these two contracts is the manner in which amounts are determined in the event of a premature surrender. If the declared interest rate period of the MVA annuity constituted substantially all of the expected life of the contract, the change from a contract for which interest is set at the discretion of the insurer to one for which the rate is set by contract would result in a substantially changed contract.

Single Premium Deferred Annuity to Equity-Indexed Annuity

B.26 An SPDA has a crediting rate that is set at the discretion of the insurance enterprise. An equity-indexed annuity is a deferred fixed annuity contract with a guaranteed minimum crediting rate plus a contingent return based on a contractually specified internal or external equity index. Equity-indexed annuities typically are classified as FASB Statement No. 97 investment contracts with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, embedded derivatives that are required to be bifurcated from the contract and accounted for separately.

B.27 The contract exchange of an SPDA contract for an equity-indexed annuity results in the replacement contract being substantially changed from the replaced contract because the nature of the contract holder's investment return rights differs significantly between the two contracts. The crediting rate of the SPDA contract is declared at the discretion of

the insurance enterprise, while the crediting rate on the equity-indexed annuity is contractually determined by reference to a pool of assets, an index, or other specified formula.

Single Premium Deferred Annuity to Multi-Bucket Annuity

B.28 An SPDA has a crediting rate that is set at the discretion of the insurance enterprise. A multi-bucket annuity is a general account deferred annuity for which, subject to a contractually specified minimum crediting rate, the interest rate to be credited on the contract holder's account balance is determined based on the returns achieved on a specified category of investments or investment strategy selected by the contract holder. The contract specifies the rights and provisions for the determination of investment return to the contract holder.

B.29 The contract exchange of an SPDA contract for a multi-bucket annuity results in the replacement contract being substantially changed from the replaced contract because the nature of the investment return rights are different between the two contracts. In the case of the typical SPDA, the interest rate is declared at the discretion of the insurance enterprise whereas, in the case of the multi-bucket annuity, the interest rate is determined by reference to a specific category of assets or investment strategy selected by the contract holder as defined in the contract.

Fixed-Interest Rate Guaranteed Investment Contract to a Variable-Interest Rate Guaranteed Investment Contract

B.30 A fixed-interest rate guaranteed investment contract (GIC) has a stated fixed crediting rate guaranteed for a specified period. An example of a variable-interest rate GIC is a contract with a credited interest rate defined as London Inter Bank Offered Rate (LIBOR) plus a specified spread. Both types of GIC contracts are classified as FASB Statement No. 97 investment contracts.

B.31 The contract exchange of a fixed-rate GIC for a variable-rate GIC results in the replacement contract being substantially changed from the replaced contract because the investment return rights for the determination of the contract holder's investment return are different between the two contracts. In the case of the fixed-rate GIC, the interest rate is fixed and guaranteed whereas, in the case of the variable-interest rate GIC, the investment return to the contract holder is contractually specified to be determined based on the returns achieved on a specified category of investments or tied to a specific index.

Variable Annuity With Return of Premium Death Benefit Guarantee to Variable Annuity With Ratchet Death Benefit Guarantee

B.32 A variable annuity is a product offered by an insurance enterprise in which the contract holder's payments are used to purchase units of a **separate account**. The contract holder directs the allocation of the account value among various investment allocation alternatives and bears the investment risk. The units may be surrendered for their current value in cash (often less a surrender change) or applied to purchase annuity income contracts. The insurance enterprise periodically deducts mortality and expense charges from the account. A common feature in variable annuities is a minimum guaranteed death benefit (MGDB), with some MGDB designs providing more extensive benefits than others.

B.33 The contract exchange of a variable annuity with a return of premium death benefit guarantee, that in this example is determined to have a minimal degree of mortality risk (although sufficient to result in classification as an insurance contract under SOP 03-1), for a variable annuity that contains a ratchet death benefit guarantee, that in this example is determined to be a "rich" death benefit, results in the replacement contract being substantially changed from the replaced contract as the change in death benefits substantively changes the degree of mortality risk. The nature of a

MGDB provision is essentially a combination of mortality and investment events. Although the actual mortality event itself is the same in the return of premium and ratchet GMDBs (death of the contract holder), the risk has changed because of the combined effects of mortality and investment events. In this instance, the preparer analyzed and concluded that a significant change in the SOP 03-1 benefit ratio, as well as in the actuarially determined expected mortality costs, were indicative of a significant change in the degree of mortality risk. It should be noted that other methods and approaches could have been used to evaluate the change in degree of mortality.

Variable Annuity With Rollup Death Benefit Guarantee to Variable Annuity With Ratchet Death Benefit Guarantee

B.34 In this example, it is assumed that both the variable annuity with the rollup death benefit guarantee and the variable annuity with the ratchet death benefit guarantee offered as an internal replacement are determined to have similar degrees of mortality risk. In this instance, the preparer compared actuarially determined expected mortality costs, and since the costs were similar, it was indicative that the degree of mortality risk was also similar. It should be noted that other methods and approaches could have been used to evaluate the change in degree of mortality. It is also assumed that there is no reunderwriting required for the transaction, no additional deposit required to effect the transaction, and no net decrease in the balance available to the contract holder prior to surrender charges. In this example, the replacement results in additional mortality and expense charges due to the enhanced death benefit guarantee not in excess of an amount commensurate with the added benefit. A contract exchange of a variable annuity contract that contains an MGDB that is determined to have significant mortality risk with a variable annuity contract that contains another kind of MGDB that is determined to have a comparable degree of mortality risk, results in the replacement contract being substantially unchanged from the replaced contract as a result of the following:

a. The exchange does not result in a significant change in the kind and degree of mortality risk.

b. The exchange does not change the nature of the contract holder's investment return rights.

c. No additional deposit or premium is required relating to the variable annuity (the original benefit) and the additional charges for the ratchet death benefit guarantee are not in excess of an amount commensurate with the benefit.

d. There is no net decrease in the balance available to the contract holder.

e. There is no change in the participation or dividend features of the contracts.

f. There is no change to the amortization method or revenue classification of the replaced contract.

If the modification were achieved through amendment, endorsement, or rider rather than through a contract exchange, the analysis and conclusion would be the same as for the contract exchange because the MGDB is an integrated feature.

Variable Annuity to a Variable Annuity with Long-Term Care Benefit

B.35 A long-term care (LTC) rider provides that in the event the insured enters a LTC facility, the feature will provide a specified fixed payment while the insured is being treated at a LTC facility.

B.36 In this example, the contract holder exchanges the original variable annuity contract for a new variable annuity contract that contains an LTC rider. This is a contract exchange in which the replacement contract contains a nonintegrated contract feature, as the LTC rider is not related to the provisions of the replacement variable annuity contract. This contract exchange results in the base annuity contract being substantially unchanged from the replaced contract as a result of the following:

a. The modification does not result in a change in the insured event, as there is no significant change in the kind and degree of mortality risk from the replaced contract.

b. There is no change in the nature of the investment return rights from the replaced contract.

c. There are no changes in the charges related to the variable annuity (the original benefit), and the additional premium for the long-term care benefit is not in excess of an amount commensurate with the additional insurance coverage obtained.

d. There is no net decrease in the balance available to the contract holder.

e. There is no change in the participation or dividend features of the replaced contract.

f. The modification does not result in a change to either the amortization method or revenue classification of the contract.

The LTC rider should be accounted for as a separate contract, as it is a nonintegrated contract feature. This accounting would be the same if the modification had been achieved through the addition of a LTC rider to the original annuity contract rather than through an exchange.

Variable Annuity With New Investment Alternatives Added and Elections of Fixed Allocation Alternatives

B.37 Variable annuities generally have a number of investment allocation alternatives from which the contract holder may select. In the normal course of business, companies modify these elections for a number of reasons, including competition and changes in investment management and distribution relationships. Throughout the life of the contract, the contract holder has the option to select new allocations for the investment of his or her annuity account balance. Generally, the addition of new investment allocation alternatives to variable life insurance or annuity contracts does not result in a substantive change to the original contract

because the contractual rights and provisions for the determination of the contract holder's investment return have not changed.

B.38 It is possible that one of the investment allocation alternatives added or elected could be a fixed return option. As long as the contract remains a variable annuity contract and the contract holder retains the right to reallocate amounts to other investment alternatives, neither the addition of the investment alternative nor the contract holder's utilization of that investment alternative would constitute an internal replacement that results in a substantially changed contract. If, however, the contract holder's election of a fixed allocation alternative results in a conversion or partial conversion to a fixed annuity contract or the contract remains a variable annuity contract but the transfer is effectively a conversion or partial conversion because there are substantive restrictions on the contract holder's ability to reallocate amounts to other investment alternatives, the modification would result in a substantially changed contract to the extent of the conversion or substantially restricted balance.

Variable Annuity to Variable Annuity With Guaranteed Minimum Accumulation Benefit

B.39 A variable annuity contract is replaced with a variable annuity contract that also provides a guaranteed minimum accumulation benefit (GMAB); in this example, a 5-percent annual rollup of contract value in 10 years. The contract exchange of a variable annuity for a variable annuity that contains a GMAB results in the replacement contract being substantially changed from the replaced contract because the addition of a GMAB, an integrated benefit feature, changes the investment return rights of the contract holder by providing a minimum investment return guarantee. The analysis would be the same if the change had been achieved through the addition of a GMAB rider. If, however, the contract holder had elected to add a GMAB feature that was included in the original contract (and met the specifi-

cations in paragraph 9 of this SOP), the modification would not be considered an internal replacement subject to the guidance in this SOP.

Variable Annuity to Variable Annuity With Guaranteed Minimum Income Benefit

B.40 A variable annuity contract is replaced with a variable annuity contract that also provides a guaranteed minimum income benefit (GMIB); in this example, a 5-percent annual rollup of contract value. A GMIB, an integrated contract feature, specifies a manner in which an annuitization benefit is determined if the contract holder elects to annuitize. The GMIB benefit cannot be withdrawn or net settled. The contract exchange of a variable annuity for a variable annuity that contains a GMIB results in the replacement contract being substantially changed from the replaced contract because the addition of a GMIB changes the investment return rights of the contract holder, as a minimum investment return provision, via the guaranteed amount for annuitization, has been added to the variable annuity. The analysis would be the same if the change had been achieved through the addition of a GMIB rider. If, however, the contract holder had elected to add a GMIB feature that was included in the original contract (and met the specifications in paragraph 9 of this SOP), the modification would not be considered an internal replacement subject to the guidance in this SOP.

Variable Annuity to Variable Annuity With Guaranteed Minimum Withdrawal Benefit

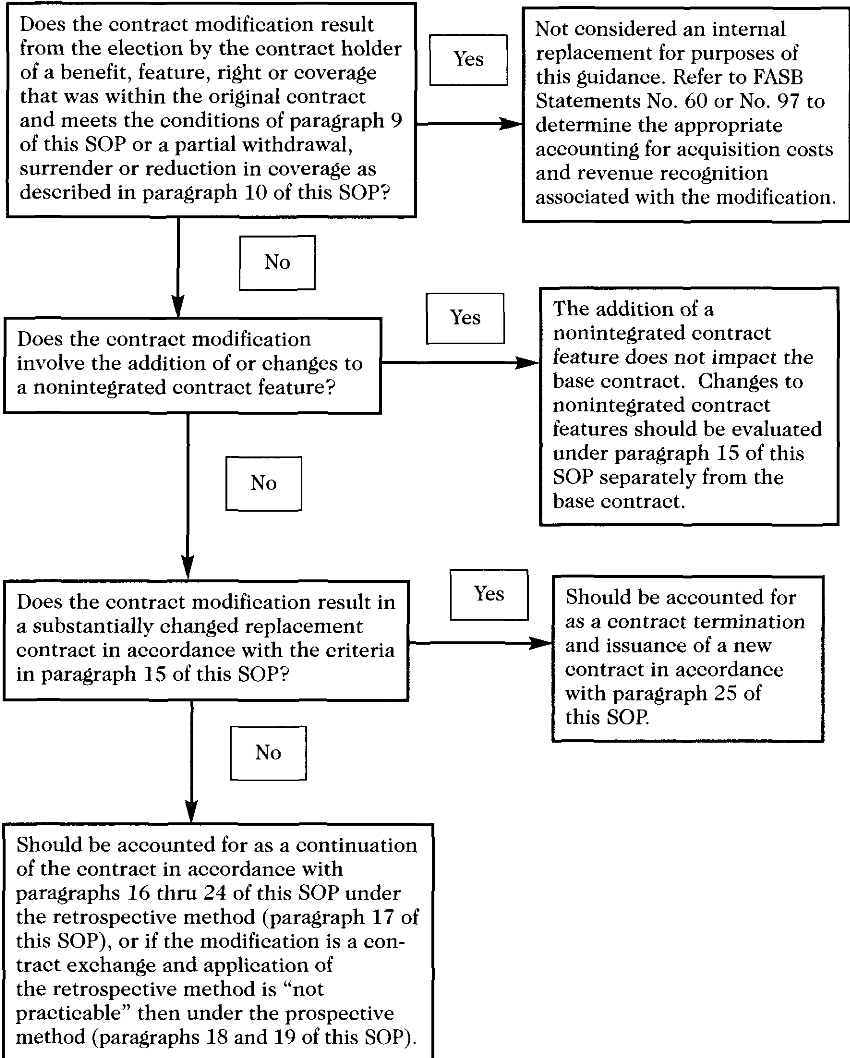
B.41 A guaranteed minimum withdrawal benefit (GMWB) provides a contract holder a guarantee that a minimum amount (usually stated as a percentage of premiums) will be available for withdrawal over a specific period. Regardless of the contract value, the contract holder is guaranteed the right to periodic withdrawals from the contract until the amount of premiums deposited into the contract is withdrawn. The insurance enterprise either replaces de-

ferred annuity contracts with annuity contracts that contain the GMWB feature or the insurance enterprise adds a GMWB rider to existing inforce business (that is, deferred annuity contracts).

B.42 A variable annuity with a GMWB is classified as an FASB Statement No. 97 investment contract with an embedded derivative. The contract exchange of a variable annuity for a variable annuity that contains a GMWB results in the replacement contract being substantially changed from the replaced contract because the addition of a GMWB, an integrated contract feature, changes the investment return rights of the contract holder, as a minimum investment return provision, via the guaranteed withdrawal amount, to the variable annuity. The analysis would be the same if the change had been achieved through the addition of a GMWB rider. If, however, the contract holder had elected to add a GMWB feature that was included in the original contract (and met the specifications in paragraph 9 of this SOP), the modification would not be considered an internal replacement subject to the guidance in this SOP.

APPENDIX C

Flowchart—Application of SOP 05-1 Accounting Model



APPENDIX D

Illustration of Deferred Acquisition Costs and Unearned Revenue Liability Amortization for a FASB Statement No. 97 Internal Replacement That Is Determined to Result in a Substantially Unchanged Contract

D.1 The schedules in Illustrations D-1 and D-2 that follow are based on the same example and use the same assumptions. In the illustrative examples, an insurance enterprise is offering to replace its general account single premium deferred annuity (SPDA) contracts with newer general account SPDA contracts, and assumes that 50 percent of the existing contract holders choose the internal replacement at the end of year 5. No surrender charges from the original contract will be imposed on contract holders who elect to have their contracts replaced. The contract holder who elects the new contract will receive a higher interest crediting rate than under the older contract but must accept a new surrender charge period. The insurance enterprise expects that persistency rates will improve under the replacement contracts as a result of the new surrender charge period and the higher credited interest.

D.2 The exchange of an SPDA contract for a newer SPDA contract in this example results in the replacement contract being substantially unchanged from the replaced contract, due to the following:

a. The insured event or risk, type, or period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.

b. The nature of the investment return rights, if any, has not changed.

c. No additional deposit, premium, or charge relating to the original benefit, in excess of amounts contemplated in the original contract, is required to effect the transaction.

d. Other than distributions to the contract holder or contract designee, there is no net reduction in the contract holder's account value or, for contracts not having an explicit or implicit account value, the cash surrender value, if any.

e. There is no change in the participation or dividend features of the contract, if any.

f. There is no change to the amortization method or revenue classification of the contract.

D.3 Illustration D-1 presents an example of the application of the guidance in paragraph 17 of this Statement of Position (SOP), whereby the estimated gross profits (EGPs) of the replacement contract are accounted for as revisions to the EGPs of the replaced contract in the determination of the amortization of deferred acquisition costs and deferred sales inducement assets and the recognition of unearned revenues.

D.4 An alternative allocation approach may be used if it is not reasonably practicable for an insurance enterprise to account for, in the manner described in paragraph 17 of this SOP, a contract exchange that has resulted in a replacement contract that is substantially unchanged from the replaced contract. The insurance enterprise may then determine an appropriate balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract, and utilize only EGPs of the replacement contract to determine future amortization. Illustration D-2 is an example of such an alternative allocation approach.

D.5 In the illustrations, the insurance enterprise's accounting policy is to let the discount rate fluctuate with changes in interest crediting rates.[1]

Illustration D-1

D.6 Illustration D-1, which follows, presents an example of the guidance in paragraph 17 of this SOP, whereby the EGPs or margins of the replacement contract are accounted for as revisions to the EGPs or margins of the replaced contract in the determination of the amortization of DAC and deferred sales inducement assets and the recognition of unearned revenues.

D.7 The following schedules are included in Illustration D-1:

- Schedule 1, "Original Contracts Deferred Acquisition Costs and URL Amortization Before Replacement"
- Schedule 2, "Account Value and EGPs, of.Replacement Contracts" (This schedule illustrates the account balances for contracts that have elected to participate in the internal replacement transaction at the end of year 5.)
- Schedule 3, "Account Value and Crediting Rates of Original and Replacement Contracts" (This schedule illustrates the account balances and interest crediting rates for both the replacement contracts and the contracts not electing to participate in the internal replacement transaction.)
- Schedule 4, "Combined EGPs, Deferred Acquisition Costs, and URL" (This schedule summarizes the EGPs, deferred acquisition costs, and front-end fees for both the replacement contracts and the contracts not electing to participate in the internal replacement transaction.)

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1. In accordance with the guidance in paragraph 25 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.*

- Schedule 5, "Revised Amortization of Deferred Acquisition Costs and URL After Replacement" (This schedule illustrates the determination of the revised deferred acquisition costs and URL balances for the combination of both replacement contracts and the contracts not electing to participate in the internal replacement transaction.)
- Schedule 6, "Summary of Deferred Acquisition Costs and URL as a Result of Internal Replacement That Is Not Substantially Different"

D-1: Schedule 1: Original Contracts Deferred Acquisition Costs and URL Amortization Before Replacement

Contract Year	Discount Rate	Account Value End of Year	Deposits	Acquisition Costs	Front-End Fees	EGPs	Deferred Acquisition Costs Balance End of Year	URL Balance End of Year
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
1(Act.)	6.00%	$30,694,950	$30,000,000	$1,925,000	$300,000	$302,094	$1,775,253	$276,663
2(Act.)	7.00	31,201,417	—	—	—	356,730	1,586,302	247,216
3 (Act.)	7.50	28,510,294	—	—	—	517,263	1,251,103	194,977
4 (Act.)	6.50	22,772,598	—	—	—	549,372	850,060	132,477
5 (Act.)	5.50	16,817,563	—	—	—	414,428	532,934	83,055
6 (Proj.)	5.50	12,419,771	—	—	—	253,964	339,258	52,871
7 (Proj.)	5.50	9,172,001	—	—	—	149,039	227,057	35,385
8 (Proj.)	5.50	6,773,522	—	—	—	81,593	167,904	26,167
9 (Proj.)	5.50	5,002,246	—	—	—	60,646	123,889	19,307
10 (Proj.)	5.50	3,694,159	—	—	—	45,060	91,139	14,203
11 (Proj.)	5.50	2,728,136	—	—	—	33,468	66,765	10,405
12 (Proj.)	5.50	2,014,729	—	—	—	24,850	48,619	7,577
13 (Proj.)	5.50	1,487,877	—	—	—	18,445	35,097	5,470
14 (Proj.)	5.50	1,098,797	—	—	—	13,687	25,010	3,898
15 (Proj.)	5.50	811,462	—	—	—	10,154	17,470	2,723
16 (Proj.)	5.50	599,265	—	—	—	7,531	11,818	1,842
17 (Proj.)	5.50	442,557	—	—	—	5,584	7,565	1,179
18 (Proj.)	5.50	326,828	—	—	—	4,140	4,347	677

Year	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
19 (Proj.)	5.50	241,363	—	—	—	3,068	1,892	295
20 (Proj.)	5.50	—	—	—	—	2,273	0	0
Present values				1,925,000	300,000	2,192,412		
k factor				0.87803	0.13684			

Explanation of columns:

(a) Discount rate for FASB Statement No. 97 product, which is the rate that accrues to contract holder balances.
(b) Prior year-end account value plus interest credited less fees less withdrawals.
(c) Premium deposits at beginning of contract year.
(d) Deferrable acquisition costs as defined in FASB Statement No. 60, assumed to be incurred as of the beginning of the year.
(e) Front-end fees charged to contract holders at beginning of year for services to be provided over life of contract.
(f) EGPs as defined in FASB Statement No. 97.
(g) Ending deferred acquisition costs balance as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY DAC = BOY DAC + Acquisition Costs + Interest – Amortization (f * 0.87803).
(h) Ending URL as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY URL = BOY URL + Front-End Fees + Interest – Amortization (f * 0.13684).

D-1: Schedule 2 Account Value and EGPs of Replacement Contracts

Contract Year	Account Value End of Year	EGPs	Discount Rate
	(a)	(b)	(c)
At Replacement	$8,408,782		
6 (Proj.)	8,669,979	$ 5,228	5.75%
7 (Proj.)	8,710,078	82,455	5.75%
8 (Proj.)	8,520,090	90,295	5.75%
9 (Proj.)	8,108,995	91,087	5.75%
10 (Proj.)	7,503,355	85,007	5.75%
11 (Proj.)	6,744,578	73,107	5.75%
12 (Proj.)	5,884,223	57,140	5.75%
13 (Proj.)	4,978,052	39,242	5.75%
14 (Proj.)	4,211,432	33,424	5.75%
15 (Proj.)	3,562,872	28,457	5.75%
16 (Proj.)	3,014,190	24,218	5.75%
17 (Proj.)	2,550,004	20,604	5.75%
18 (Proj.)	2,157,304	17,523	5.75%
19 (Proj.)	1,825,079	14,898	5.75%
20 (Proj.)	0	12,663	5.75%

Explanation of columns:

(a) 50 percent of original contracts account value at replacement; thereafter, prior year-end account value plus interest credited less fees less withdrawals.

(b) Estimated gross profits as defined in FASB Statement No. 97. EGP in year 6 reflects commissions of 0.75 percent of account value paid at time of replacement that is not deferrable under the SOP.

(c) Discount rate for FASB Statement No. 97 product, which is the rate at which contract holder's funds accumulate.

D-1: Schedule 3: Account Value and Crediting Rates of Original and Replacement Contracts

50 Percent of Original Contracts' Account Value Replaced With New Contracts

Contract Year	Account Value End of Year Original Contracts	Account Value End of Year Replacement Contracts	Interest Crediting Rate Original Contracts	Interest Crediting Rate Replacement Contracts	Interest Crediting Rate Weighted Average
	(a)	(b)	(c)	(d)	(e)
At Issue	$29,700,000	—	6.00%	—	6.00%
1	30,694,950	—	7.00	—	7.00
2	31,201,417	—	7.50	—	7.50
3	28,510,294	—	6.50	—	6.50
4	22,772,598	—	5.50	—	5.50
5	16,817,563				
At Replacement	8,408,782	$8,408,782	5.50	5.75%	5.63
6	6,209,885	8,669,979	5.50	5.75	5.65
7	4,586,000	8,710,078	5.50	5.75	5.66
8	3,386,761	8,520,090	5.50	5.75	5.68
9	2,501,123	8,108,995	5.50	5.75	5.69
10	1,847,079	7,503,355	5.50	5.75	5.70
11	1,364,068	6,744,578	5.50	5.75	5.71
12	1,007,364	5,884,223	5.50	5.75	5.71
13	743,939	4,978,052	5.50	5.75	5.72
14	549,399	4,211,432	5.50	5.75	5.72
15	405,731	3,562,872	5.50	5.75	5.72
16	299,632	3,014,190	5.50	5.75	5.73
17	221,278	2,550,004	5.50	5.75	5.73
18	163,414	2,157,304	5.50	5.75	5.73
19	120,681	1,825,079	5.50	5.75	5.73
20	—	—	—	—	—

Explanation of columns:

(a) Account value at the end of the contract year for original contracts (beginning in year 6, this represents account value related to those contracts not electing the replacement).
(b) Account value at the end of the contract year for replacement contracts (per Schedule 2 Column a).
(c) Interest crediting rate on original contracts; beginning in year 6 this represents the interest crediting rate on those contracts not electing the replacement.
(d) Interest crediting rate on replacement contracts.
(e) Interest crediting rate weighted by account value.

D-1: Schedule 4: Combined EGPs, Deferred Acquisition Costs, and URL (Contracts that have not elected the replacement plus contracts that have elected the replacement)

50 Percent of Original Contracts' Account Value Replaced With New Policies

Contract Year	EGPs Original Contracts	EGPs Replacement Contracts	Combined EGPs	Deferred Acquisition Costs	Front-End Fees
	(a)	(b)	(c)	(d)	(e)
1 (Act.)	$302,094	—	$302,094	$1,925,000	$300,000
2 (Act.)	356,730	—	356,730	—	—
3 (Act.)	517,263	—	517,263	—	—
4 (Act.)	549,372	—	549,372	—	—
5 (Act.)	414,428	—	414,428	—	—
6 (Proj.)	126,982	5,228	132,210	—	—
7 (Proj.)	74,520	82,455	156,975	—	—
8 (Proj.)	40,797	90,295	131,092	—	—
9 (Proj.)	30,323	91,087	121,410	—	—
10 (Proj.)	22,530	85,007	107,537	—	—
11 (Proj.)	16,734	73,107	89,841	—	—
12 (Proj.)	12,425	57,140	69,565	—	—
13 (Proj.)	9,223	39,242	48,465	—	—
14 (Proj.)	6,844	33,424	40,268	—	—
15 (Proj.)	5,077	28,457	33,534	—	—
16 (Proj.)	3,765	24,218	27,984	—	—
17 (Proj.)	2,792	20,604	23,396	—	—
18 (Proj.)	2,070	17,523	19,593	—	—
19 (Proj.)	1,534	14,898	16,432	—	—
20 (Proj.)	1,137	12,663	13,799	—	—
	Present values			$1,925,000	$300,000
			2,328,377		00
	k factor			0.8268	0.1288

Explanation of columns:

(a) EGPs from original policies (beginning in year 6, this represents EGPs related to those contracts not electing the replacement).
(b) EGPs from replacement policies.
(c) Combined EGPs.
(d) Deferrable acquisition costs from original policies.
(e) Front-end fees from original policies.

D-1: Schedule 5: Revised Amortization of Deferred Acquisition Costs and URL After Replacement

	Deferred Acquisition Cost Amortization				Unearned Revenue Amortization			
Contract Year	Acquisition Costs	Interest Added	Amortization	DAC (End of Year)	Front-End Fees	Interest Added	Amortization	URL (End of Year)
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
1 (Act.)	$1,925,000	$115,500	$(249,758)	$1,790,742	$300,000	$18,000	$(38,923)	$279,077
2 (Act.)	—	125,352	(294,929)	1,621,165	—	19,535	(45,963)	252,649
3 (Act.)	—	121,587	(427,650)	1,315,102	—	18,949	(66,647)	204,951
4 (Act.)	—	85,482	(454,197)	946,387	—	13,322	(70,784)	147,489
5 (Act.)	—	52,052	(342,631)	655,808	—	8,112	(53,397)	102,204
6 (Proj.)		36,889	(109,305)	583,392	—	5,749	(17,035)	90,918
7 (Proj.)	—	32,936	(129,780)	486,548	—	5,133	(20,225)	75,826
8 (Proj.)	—	27,557	(108,381)	405,724	—	4,295	(16,891)	63,230
9 (Proj.)	—	23,041	(100,377)	328,388	—	3,590	(15,643)	51,177
10 (Proj.)	—	18,689	(88,907)	258,170	—	2,913	(13,856)	40,234
11 (Proj.)	—	14,717	(74,277)	198,610	—	2,294	(11,576)	30,952
12 (Proj.)	—	11,337	(57,513)	152,434	—	1,767	(8,963)	23,756
13 (Proj.)	—	8,710	(40,069)	121,075	—	1,357	(6,244)	18,869
14 (Proj.)	—	6,923	(33,292)	94,706	—	1,079	(5,188)	14,760
15 (Proj.)	—	5,418	(27,724)	72,400	—	844	(4,321)	11,283
16 (Proj.)	—	4,144	(23,136)	53,408	—	646	(3,606)	8,323

(continued)

D-1: Schedule 5: Revised Amortization of Deferred Acquisition Costs and URL After Replacement *(continued)*

	Deferred Acquisition Cost Amortization				Unearned Revenue Amortization			
Contract Year	Acquisition Costs	Interest Added	Amortization	DAC (End of Year)	Front-End Fees	Interest Added	Amortization	URL (End of Year)
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
17 (Proj.)	–	3,059	(19,343)	37,124	—	477	(3,014)	5,786
18 (Proj.)	–	2,127	(16,198)	23,053	—	331	(2,524)	3,593
19 (Proj.)	–	1,322	(13,585)	10,790	—	206	(2,117)	1,682
20 (Proj.)	–	619	(11,409)	0	—	96	(1,778)	(0)

Explanation of columns:

(a) Total deferrable acquisition costs from original policies.
(b) Interest on deferred acquisition costs.
(c) Deferred acquisition cost amortization (k-factor per Schedule 4, column f * total revised EGP per Schedule 4, column c).
(d) Ending DAC = BOY DAC + (a) + (b) +(c).
(e) Total front-end fees from original policies.
(f) Interest on URL.
(g) URL amortization (k-factor per Schedule 4, column I * total revised EGP per Schedule 4, column c).
(h) Ending URL = BOY URL + (e) + (f) + (g).

D-1: Schedule 6: Summary of Deferred Acquisition Cost and URL As a Result of Internal Replacement That Is Not Substantially Different

	Deferred Acquisition Costs	URL
Original contracts before replacement (year 5 balances, per Schedule 1, columns g and h)	$ 532,934	$ 83,055
Combined contracts after replacement (year 5 balances, per Schedule 5, columns d and h)	655,808	102,204
	(122,874)	(19,149)
Summary of Accounting Entries		
Deferred acquisition costs	$122,874	
Amortization		$122,874
Change in Unearned Revenue	$19,149	
URL		$19,149

Illustration D-2

D.8 An alternative allocation approach may be used if it is not reasonably practicable for an insurance enterprise to account for, in the manner described in paragraph 17 of this SOP, a contract exchange that has resulted in a replacement contract that is substantially unchanged from the replaced contract. The insurance enterprise may then determine the balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract, and utilize estimated gross profits or margins only of the replacement contract to determine future amortization. Illustration D-2 is an example of such an alternative allocation approach.

D.9 The following schedules are included in Illustration D-2:

- Schedule 1, "Original Contracts Deferred Acquisition Costs and URL Amortization Before Replacement"
- Schedule 2, "Original Contracts Deferred Acquisition Costs and URL Amortization After Replacement" (This schedule calculates the revised balances for deferred acquisition costs and URL for contracts not electing to participate in the internal replacement transaction. Account value and balances on EGPs related to replacement contracts are eliminated prospectively from the end of year 5, when contracts are assumed to be replaced for purposes of this illustration. The differences in the balances for deferred acquisition costs and URL are allocated to replacement contracts and treated as if they were deferrable acquisition costs and front-end fees, respectively, incurred at the inception of the replacement contracts.)
- Schedule 3, "Calculation of Carryover Amounts" (This schedule calculates the balances for deferred acquisition costs and URL to be allocated to the replacement contracts.)
- Schedule 4, "Account Value, Deferred Acquisition Costs, Front-End Fees, and EGPs of Replacement Contracts" (This schedule calculates the account

value, deferred acquisition costs, front-end fees, and EGPs of contracts that have elected the internal replacement transaction at the end of year 5.)

- Schedule 5, "Deferred Acquisition Costs and URL Amortization for Replacement Contracts" (This schedule calculates the deferred acquisition costs and URL amortization of contracts that have elected the internal replacement transaction at the end of year 5.)
- Schedule 6, "Combined Deferred Acquisition Costs and URL After the Internal Replacement Transaction" (This schedule calculates the total deferred acquisition costs and URL balances for contracts that have not elected the internal replacement transaction and replacement contracts.)
- Schedule 7 "Summary of Deferred Acquisition Costs and URL as a Result of an Internal Replacement That Is Not Substantially Different"

D-2: Schedule 1: Original Contracts Deferred Acquisition Costs and URL Amortization Before Replacement

Contract Year	Discount Rate	Account Value End of Year	Deposits	Acquisition Costs	Front-End Fees	EGPs	Deferred Acquisition Costs Balance End of Year	URL Balance End of Year
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
1 (Act.)	6.00%	$30,694,950	$30,000,000	$1,925,000	$300,000	$302,094	$1,775,253	$276,663
2 (Act.)	7.00%	31,201,417	—	—	—	356,730	1,586,302	247,216
3 (Act.)	7.50%	28,510,294	—	—	—	517,263	1,251,103	194,977
4 (Act.)	6.50%	22,772,598	—	—	—	549,372	850,060	132,477
5 (Act.)	5.50%	16,817,563	—	—	—	414,428	532,934	83,055
6 (Proj.)	5.50%	12,419,771	—	—	—	253,964	339,258	52,871
7 (Proj.)	5.50%	9,172,001	—	—	—	149,039	227,057	35,385
8 (Proj.)	5.50%	6,773,522	—	—	—	81,593	167,904	26,167
9 (Proj.)	5.50%	5,002,246	—	—	—	60,646	123,889	19,307
10 (Proj.)	5.50%	3,694,159	—	—	—	45,060	91,139	14,203
11 (Proj.)	5.50%	2,728,136	—	—	—	33,468	66,765	10,405
12 (Proj.)	5.50%	2,014,729	—	—	—	24,850	48,619	7,577
13 (Proj.)	5.50%	1,487,877	—	—	—	18,445	35,097	5,470
14 (Proj.)	5.50%	1,098,797	—	—	—	13,687	25,010	3,898
15 (Proj.)	5.50%	811,462	—	—	—	10,154	17,470	2,723
16 (Proj.)	5.50%	599,265	—	—	—	7,531	11,818	1,842
17 (Proj.)	5.50%	442,557	—	—	—	5,584	7,565	1,179

18 (Proj.)	5.50%	326,828	—	—	—	4,140	4,347	677
19 (Proj.)	5.50%	241,363	—	—	—	3,068	1,892	295
20 (Proj.)	5.50%	—	—	—	—	2,273	0	0
Present Values			$1,925,000	$300,000	$2,192,412			
k-factor			0.87803	0.13684				

Explanation of columns:

(a) Discount rate for FASB Statement No. 97 product, which is the rate that accrues to contract holder balances.
(b) Prior year-end account value plus premiums plus interest credited less fees less withdrawals.
(c) Premium deposits at beginning of contract year.
(d) DAC as defined in FASB Statement No. 60, assumed to be incurred as of the beginning of the year.
(e) Front-end fees charged to contract holders at beginning of year for services to be provided over life of contract.
(f) EGPs as defined in FASB Statement No. 97.
(g) Ending deferred acquisition costs balance as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY DAC = BOY DAC + Acquisition Costs+ Interest – Amortization (f * 0.87803).
(h) Ending URL balance as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY URL = BOY URL + Front-End Fees + Interest – Amortization (f * 0.13684).

D-2: Schedule 2: Original Contracts Deferred Acquisition Costs and URL Amortization After Replacement

Contract Year	Discount Rate	Account Value End of Year	Deposits	Acquisition Costs	Front-End Fees	EGPs	Deferred Acquisition Costs Balance End of Year	URL Balance End of Year
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
1 (Act.)	6.00%	$30,694,950	$30,000,000	$1,925,000	$300,000	$302,094	$1,745,439	$272,016
2 (Act.)	7.00%	31,201,417	—	—	—	356,730	1,519,194	236,757
3 (Act.)	7.50%	28,510,294	—	—	—	517,263	1,127,912	175,778
4 (Act.)	6.50%	22,772,598	—	—	—	549,372	664,643	103,581
5 (Act.)	5.50%	8,408,782	—	—	—	414,428	296,419	46,195
6 (Proj.)	5.50%	6,209,885	—	—	—	126,982	188,696	29,407
7 (Proj.)	5.50%	4,586,000	—	—	—	74,520	126,289	19,681
8 (Proj.)	5.50%	3,386,761	—	—	—	40,797	93,388	14,554
9 (Proj.)	5.50%	2,501,123	—	—	—	30,323	68,907	10,739
10 (Proj.)	5.50%	1,847,079	—	—	—	22,530	50,691	7,900
11 (Proj.)	5.50%	1,364,068	—	—	—	16,734	37,135	5,787
12 (Proj.)	5.50%	1,007,364	—	—	—	12,425	27,042	4,214
13 (Proj.)	5.50%	743,939	—	—	—	9,223	19,521	3,042
14 (Proj.)	5.50%	549,399	—	—	—	6,844	13,910	2,168
15 (Proj.)	5.50%	405,731	—	—	—	5,077	9,717	1,514
16 (Proj.)	5.50%	299,632	—	—	—	3,765	6,573	1,024
17 (Proj.)	5.50%	221,278	—	—	—	2,792	4,208	656

Year	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
18 (Proj.)	5.50%	163,414	—	—	—	2,070	2,418	377
19 (Proj.)	5.50%	120,681	—	—	—	1,534	1,052	164
20 (Proj.)	5.50%	—	—	—	—	1,137	—	—
Present Values				$1,925,000	$300,000	$1,970,881		
k-factor				0.97672	0.15222			

Explanation of columns:

(a) Discount rate for FASB Statement No. 97 product, which is the rate that accrues to contract holder balances.
(b) Prior year-end account value plus premiums plus interest credited less fees less withdrawals (including "replacements").
(c) Premium deposits at beginning of contract year.
(d) Deferred acquisition costs as defined in FASB Statement No. 60 assumed to be incurred as of the beginning of the year.
(e) Front-end fees charged to contract holders at beginning of year for services to be provided over life of contract.
(f) EGPs as defined in FASB Statement No. 97.
(g) Ending deferred acquisition costs balance as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY DAC = BOY DAC + Acquisition Costs + Interest – Amortization (f * 0.97672).
(h) Ending URL balance as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY URL = BOY URL + Front-End Fees + Interest – Amortization (f * 0.15222).

D-2: Schedule 3: Calculation of Carryover Amounts

	Deferred Acquisition Costs Balance	URL Balance
	(a)	(b)
Balances just prior to replacement	$532,934	$83,055
Balances just after replacement, for contracts not electing to participate in the internal replacement transaction at the end of year 5	296,419	46,195
Carryover Amounts, allocated to contracts choosing the internal replacement at end of year 5	$236,515	$36,860

Explanation of columns:

(a) Deferred acquisition costs balances end of year 5 from Schedules 1 and 2.
(b) URL balances end of year 5 from Schedules 1 and 2.

D-2: Schedule 4: Account Value, Deferred Acquisition Costs, Front-End Fees, and EGPs of Replacement Contracts

Contract Year	Account Value End of Year	Acquisition Costs	Front-End Fees	EGPs	Discount Rate
	(a)	(b)	(c)	(d)	(e)
At Replacement	$8,408,782	$236,515	$36,860		
6 (Proj.)	8,669,979	—	—	$ 5,228	5.75%
7 (Proj.)	8,710,078	—	—	82,455	5.75%
8 (Proj.)	8,520,090	—	—	90,295	5.75%
9 (Proj.)	8,108,995	—	—	91,087	5.75%
10 (Proj.)	7,503,355	—	—	85,007	5.75%
11 (Proj.)	6,744,578	—	—	73,107	5.75%
12 (Proj.)	5,884,223	—	—	57,140	5.75%
13 (Proj.)	4,978,052	—	—	39,242	5.75%
14 (Proj.)	4,211,432	—	—	33,424	5.75%
15 (Proj.)	3,562,872	—	—	28,457	5.75%
16 (Proj.)	3,014,190	—	—	24,218	5.75%
17 (Proj.)	2,550,004	—	—	20,604	5.75%
18 (Proj.)	2,157,304	—	—	17,523	5.75%
19 (Proj.)	1,825,079	—	—	14,898	5.75%
20 (Proj.)	—	—	—	12,663	5.75%
Present Values		$236,515	$36,860	$489,000	
k-factor		0.4837	0.0754		

Explanation of columns:

(a) Prior year-end account value plus premiums plus interest credited less fees less withdrawals (per Appendix D1, Schedule 3, column b).
(b) Carryover deferred acquisition costs as defined in FASB Statement No. 60, assumed to be incurred as of the beginning of the year (carryover amount calculated per Schedule 3).
(c) Carryover front-end fees charged to contract holders at beginning of year for services to be provided over life of contract (carryover amount calculated per Schedule 3).
(d) EGPs as defined in FASB Statement No. 97 (per Appendix D1, Schedule 4, column b).
(e) Discount rate for FASB Statement No. 97 product, which is the rate at which contract holder's funds accumulate.

D-2: Schedule 5: Deferred Acquisition Costs and URL Amortization for Replacement Contracts

	Deferred Acquisition Cost Amortization				Unearned Revenue Amortization			
Contract Year	Acquisition Costs	Interest Added	Amortization	Deferred Acquisition Costs (End of Year)	Front-End Fees	Interest Added	Amortization	URL (End of Year)
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
6 (Proj.)	$236,515	$13,599	$ (2,529)	$247,585	$36,860	$ 2,119	$ (394)	$38,585
7 (Proj.)	—	14,236	(39,881)	221,940	—	2,219	(6,215)	34,589
8 (Proj.)	—	12,762	(43,673)	191,029	—	1,989	(6,806)	29,772
9 (Proj.)	—	10,984	(44,056)	157,957	—	1,712	(6,866)	24,618
10 (Proj.)	—	9,083	(41,115)	125,925	—	1,415	(6,408)	19,625
11 (Proj.)	—	7,241	(35,360)	97,806	—	1,128	(5,511)	15,242
12 (Proj.)	—	5,624	(27,637)	75,793	—	877	(4,307)	11,812
13 (Proj.)	—	4,357	(18,980)	61,170	—	679	(2,958)	9,533
14 (Proj.)	—	3,517	(16,166)	48,521	—	548	(2,519)	7,562
15 (Proj.)	—	2,790	(13,764)	37,547	—	435	(2,145)	5,852
16 (Proj.)	—	2,159	(11,714)	27,992	—	336	(1,826)	4,362
17 (Proj.)	—	1,610	(9,965)	19,637	—	251	(1,553)	3,060
18 (Proj.)	—	1,129	(8,475)	12,291	—	176	(1,321)	1,915
19 (Proj.)	—	707	(7,206)	5,792	—	110	(1,123)	902
20 (Proj.)	—	333	(6,125)	(0)	—	52	(954)	(0)

Explanation of columns:

(a) Carryover deferred acquisition costs.
(b) Interest on deferred acquisition costs.
(c) Deferred acquisition costs amortization (k-factor x EGP, per Schedule 4).
(d) Ending DAC = BOY DAC + (a) + (b) +(c).
(e) Total front-end fees from original and replacement policies.
(f) Interest on URL.
(g) URL amortization (k-factor x EGP, per Schedule 4).
(h) Ending URL = BOY URL + (e) + (f) + (g).

D-2: Schedule 6: Combined Deferred Acquisition Costs and URL After the Internal Replacement Transaction

Contract Year	Deferred Acquisition Costs Original Contracts	Deferred Acquisition Costs Replaced Contracts	Total Deferred Acquisition Costs	URL Original Contracts	URL Replaced Contracts	Total URL
	(a)	(b)	(c)	(d)	(e)	(f)
1 (Act.)	$1,745,439		$1,745,439	$272,016		$272,016
2 (Act.)	1,519,194		1,519,194	236,757		236,757
3 (Act.)	1,127,912		1,127,912	175,778		175,778
4 (Act.)	664,643		664,643	103,581		103,581
5 (Act.)	296,419	236,515	532,934	46,195	36,860	83,055
6 (Proj.)	188,696	247,585	436,281	29,407	38,585	67,992
7 (Proj.)	126,289	221,940	348,229	19,681	34,589	54,270
8 (Proj.)	93,388	191,029	284,417	14,554	29,772	44,326
9 (Proj.)	68,907	157,957	226,864	10,739	24,618	35,357
10 (Proj.)	50,691	125,925	176,616	7,900	19,625	27,525
11 (Proj.)	37,135	97,806	134,941	5,787	15,242	21,029
12 (Proj.)	27,042	75,793	102,835	4,214	11,812	16,026
13 (Proj.)	19,521	61,170	80,691	3,042	9,533	12,575
14 (Proj.)	13,910	48,521	62,431	2,168	7,562	9,730
15 (Proj.)	9,717	37,547	47,264	1,514	5,852	7,366
16 (Proj.)	6,573	27,992	34,565	1,024	4,362	5,386
17 (Proj.)	4,208	19,637	23,845	656	3,060	3,716
18 (Proj.)	2,418	12,291	14,709	377	1,915	2,292
19 (Proj.)	1,052	5,792	6,844	164	902	1,066
20 (Proj.)	0	(0)	0	0	(0)	0

Explanation of columns:

(a) EOY DAC for original contracts. After year 6, DAC related to contracts not electing the internal replacement transaction (per Schedule 2, column g).
(b) EOY DAC for contracts electing the internal replacement transaction at the end of year 5 (per Schedule 5, column d).
(c) Combined EOY DAC.
(d) EOY URL for original contracts. After year 6, URL related to contracts not electing the internal replacement transaction (per Schedule 2, column h).
(e) EOY URL for contracts electing the internal replacement transaction at the end of year 5 (per Schedule 5, column h).
(f) Combined EOY URL.

D-2: Schedule 7: Summary of Deferred Acquisition Costs and URL as a Result of Internal Replacement That Is Not Substantially Different

	Deferred Acquisition Costs	URL
Original (Year 5 balances)	$532,934	$83,055
Nonreplaced Contracts (Year 5 balances)	296,419	46,195
After Replacement (Year 5 balances)	236,515	36,860
	532,934	83,055
Difference	$ —	$ —

Summary of Accounting Entries

Deferred Acquisition Costs	$0	
Deferred Acquisition Costs Amortization		$0
Change in Unearned Revenue	$0	
URL		$0

GLOSSARY

Base contract. The type of contract specified in the policy form prior to the addition or election of riders or other contract features. For example, for an annuity with a guaranteed minimum income benefit (GMIB) rider, the annuity would be considered the base contract.

Contract exchange. The legal extinguishment of one contract and the issuance of another.

Coverage. An insurance enterprise's exposure to loss. The concept of coverage would typically include policy limits, deductible, insured, and covered property or insured event.

Existing contract. The contract that is currently held by the contract holder and excludes nonintegrated contract features.

General account. All operations of an insurance enterprise that are not reported in a separate account.

Integrated contract feature. A contract feature in which the benefits provided by the feature can be determined only in conjunction with the base contract.

Internal replacement. A modification in product benefits, features, rights, or coverages that occurs by the legal extinguishment of one contract and the issuance of another contract (a contract exchange); or by amendment, endorsement, or rider to a contract; or by the election of a benefit, feature, right, or coverage within the contract.

Nonintegrated contract feature. A contract feature in which the benefits provided are not related or dependent on the provisions of the base contract.

Original contract. The contract that was initially entered into by the contract holder prior to any potential internal replacement activity.

Ratchet death benefit. A death benefit equal to the highest account balance among prior specified anniversary dates adjusted for deposits less partial withdrawals since the specified anniversary date.

Replaced contract. The contract that currently is held by the contract holder, and is exchanged or modified in an internal replacement transaction.

Replacement contract. The new or modified contract in an internal replacement transaction.

Return of premium death benefit. *A death benefit equal to the total de*posits made by the contract holder less any withdrawals.

Reunderwriting. The reexamination of the insurance risk of the entire contract for purposes of acceptance or rejection or for rating the risk for pricing purposes.

Roll-up death benefit. A death benefit equal to the total of deposits made to the contract less an adjustment for partial withdrawals, accumulated at a specified interest rate.

Sales inducement to a contract holder. A product feature that enhances the investment yield to the contract holder. The three main types of sales inducements are (1) day one bonus, which increases the account value at inception, also called immediate bonus; (2) persistency bonus, which increases the account value at the end of a specified period; and (3) enhanced yield, which credits interest for a specified period in excess of rates currently being offered for other similar contracts. Sales inducements are defined as contractually obligated inducements that are explicitly identified in the contract and are in excess of current market conditions.

Separate account. 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.

Surrender charge. Charges assessed at contract redemption, whole or partial, regardless of how the charges are labeled, such as contingent deferred sales charges.

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