1-1-1990

Accounting and reporting by insurance enterprises for certain long-duration contracts and for realized gains and losses from the sale of investments to insurance enterprises : application of FASB statement no. 97;Application of FASB statement no. 97; Practice bulletin, 08

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

Practice Bulletin 8

November 1990

Application of FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* to Insurance Enterprises

Insurance Companies Committee

AICPA
American Institute of Certified Public Accountants

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Practice Bulletin 8

Application of FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* to Insurance Enterprises

1. This practice bulletin provides guidance, in the form of questions and answers, for insurance enterprises regarding the application of Financial Accounting Standards Board (FASB) Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.*

Acquisition Costs

2. *Question 1:* Is the definition of capitalized acquisition costs for investment contracts and universal life-type contracts under FASB Statement No. 97 the same as the definition under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises?*

3. FASB Statement No. 60, paragraph 28, defines acquisition costs as "those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts."

4. *Answer 1:* Yes. However, FASB Statement No. 97, paragraph 24, specifies that certain acquisition costs should not be capitalized, but instead should be considered as maintenance and other period costs that are expensed as incurred, as follows:

> Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period, shall be charged to expense in the period incurred.

5. Certain acquisition costs have been excluded because, under FASB Statement No. 97, capitalized acquisition costs for universal life-type contracts and investment contracts ordinarily are amortized in relation to estimated gross profits, whereas under FASB Statement No. 60, capitalized acquisition costs are amortized in proportion to premium revenue recognized. Costs such as recurring premium taxes and ultimate level commissions, which vary with premium revenue, are effectively charged to expense in the periods incurred.

6. *Question 2:* What method should be used for amortizing deferred policy acquisition costs (DPAC) incurred on investment contracts?

7. *Answer 2:* The amortization method described in FASB Statement No. 97 for universal life-type contracts should be used for investment contracts that include significant surrender charges or that yield significant revenues from sources other than the investment of contract holders' funds. This method matches the amortization of DPAC with the recognition of gross profits. Otherwise, DPAC on investment contracts should be amortized using an accounting method that recognizes acquisition and interest costs as expenses at a constant rate applied to net policy liabilities and that is consistent with the interest method under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases* (interest method).

8. Under both the FASB Statement No. 97 amortization method and the interest method, assumptions used should be updated to be consistent with the concepts underlying the method used:

- Under the FASB Statement No. 97 amortization method, assumptions should be updated in compliance with paragraph 25 of FASB Statement No. 97, which states that "estimates of expected gross profit used as a basis for amortization shall be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised."

- Under the interest method, the incidence of surrenders (if they are probable and can be reasonably estimated) can be anticipated for purposes of determining the amortization period. The rate of DPAC amortization should be adjusted for changes in the incidence of surrenders to be consistent with the handling of principal prepayments under FASB Statement No. 91.
- DPAC related to investment contracts should be reported as an asset to be consistent with the reporting of DPAC on insurance products covered by FASB Statement No. 97. Under some reserving methods, the insurance reserve may be calculated net of DPAC. In that event, the amounts of DPAC and reserves have to be determined separately.

Limited-Payment Contracts

9. *Question 3:* Should the deferred profit liability (excess of gross premiums over net premiums), if any, on limited-payment contracts be amortized in relation to the discounted amount of insurance in force (or expected future benefit), and should interest accrue to the unamortized deferred profit liability balance?

10. *Answer 3:* Yes. The deferred profit liability should be amortized in relation to the discounted amount of the insurance in force or expected future benefit payments, and interest should accrue to the unamortized balance. The use of interest in the amortization is consistent with the determination of the deferred profit using discounting.

11. *Question 4:* Should costs related to the acquisition of new and renewal business that are not capitalized (because, for example, the costs do not vary with the acquisition of the business) be included in the calculation of net premium used in determining the profit to be deferred on limited-payment contracts?

12. *Answer 4:* No. Those costs are period costs, which should be recognized when incurred. The inclusion of such costs in the calculation of net premium would result in their deferral.

13. Costs that would be included in the determination of net premium under FASB Statement No. 97 and for purposes of determining the deferred profit for limited-payment contracts are policy-related costs that are not primarily related to the acquisition of business (such as policy administration, maintenance, and settlement costs) and acquisition costs that are capitalized under FASB Statement No. 97.

14. *Question 5:* Does the method of amortizing DPAC on limited-payment contracts under FASB Statement No. 97 differ from the method required under FASB Statement No. 60?

15. *Answer 5:* No. DPAC should continue to be amortized in proportion to premium revenue recognized, as required under FASB Statement No. 60, paragraph 29. Premium revenue used in the calculation should be the gross premium recorded, that is, the amount before adjustment for excess of gross over net premiums (the deferred profit liability).

16. *Question 6:* Does paragraph 16 of FASB Statement No. 97, which addresses limited-payment contracts, apply to limited-payment participating and limited-payment nonguaranteed-premium contracts that are not, in substance, universal life-type contracts?

17. *Answer 6:* Yes. These contracts are limited-payment contracts under paragraph 9 of FASB Statement No. 97 and are not excluded under paragraph 11 because they are not conventional forms of participating or nonguaranteed-premium contracts.

Internal Replacements

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.

20. *Question 8:* How should insurance enterprises report changes in accounting practices for internal replacements other than replacements by universal life-type contracts?

21. *Answer 8:* If the accounting practice for internal replacements other than replacement by a universal life-type contract is changed, and if the effect is material, insurance enterprises should disclose the change in their reports to shareholders as a change in accounting principle, as described in paragraphs 18 to 26 of Accounting Principles Board Opinion No. 20, *Accounting Changes*.

Scope of FASB Statement No. 97

22. *Question 9:* According to paragraph 14 of FASB Statement No. 97, the statement does not apply to certain long-duration insurance contracts, such as those that provide benefits related only to illness, physical injury, or disability. Should FASB Statement No. 97 be applied to contracts that provide those kinds of benefits but that also have characteristics and benefits falling under FASB Statement No. 97, such as significant cash surrender benefits and limited-payment or universal-type provisions?

23. *Answer 9:* Yes. If insurance contracts have characteristics significant to the contracts that are covered by FASB Statement No. 97—for example, limited-payment or universal life-type contracts—the accounting for the contracts should be guided by the concepts of FASB Statement No. 97. For example, universal disability contracts that have many of the same characteristics as universal life-type contracts, with the exception of providing disability benefits instead of life insurance benefits, should be accounted for in a manner consistent with universal life-type contracts.

Estimated Gross Profits—Universal Life-Type Contracts

24. *Question 10:* FASB Statement No. 97, paragraph 23b, states that estimated gross profits (EGP) used to determine DPAC amortization for universal life-type contracts should

include estimates of costs expected to be incurred for contract administration, including acquisition costs not included in capitalized acquisition costs. What kinds of costs should be included in contract administration costs, and should non-policy-related costs and costs that are not capitalized under FASB Statement No. 60, paragraph 28, because they do not vary with the acquisition of new and renewal insurance contracts be included?

25. *Answer 10:* Contract administration costs included in the calculation of EGP should consist of the following:

- Policy-related costs that are not primarily related to the acquisition of business, such as policy administration, settlement, and maintenance costs
- Policy-related acquisition costs that are not capitalized under FASB Statement No. 97, paragraph 24, such as ultimate renewal commission and recurring premium taxes

26. Non-policy-related expenses, such as certain overhead costs, and costs that are related to the acquisition of business that are not capitalized under FASB Statement No. 60, such as certain advertising costs, should not be included in EGP.

27. *Question 11:* Should gains and losses from sales of investments be included in amounts expected to be earned from the investment of policyholder balances used to determine EGP?

28. *Answer 11:* Yes. Expected gains and losses from sales of investments related to universal life contracts should be included in the determination of EGP, because earned investment income should be based on the expected total yield of the investments. If the timing and amount of realized gains and losses from the sales of investments change from those expected and materially affect the expected total yield and the estimated gross profits, DPAC amortization should be reevaluated.

Transition

29. *Question 12:* Accounting changes resulting from the adoption of FASB Statement No. 97 are required to be applied retroactively through restatement of all previously issued financial statements that are being presented. FASB Statement No. 97 requires that if restatement of all years presented is not practicable, the cumulative effect of the accounting changes be reported in net income in the year the statement is adopted. If a company is adopting FASB Statement No. 97 through a cumulative-effect adjustment because restatement is not practicable, should the company nevertheless restate prior years' income statements for the change in reporting realized investment gains and losses under FASB Statement No. 97?

30. *Answer 12:* Yes. A company should adopt FASB Statement No. 97's change in reporting realized investment gains and losses through restatement of prior years' income statements even if other provisions of the standard are adopted through a cumulative-effect adjustment. A company should adopt all provisions of FASB Statement No. 97 in the same period.

31. *Question 13:* When adopting FASB Statement No. 97 retroactively through restatement of prior years' financial statements, should companies use the original accounting assumptions, such as assumptions regarding estimated gross profits, that they would have used in those prior periods, or may hindsight be used so that experience subsequent to those periods may be substituted for original assumptions?

32. *Answer 13:* Assumptions used in restating prior years' financial statements should not include significant subsequent fluctuations in experience that could not reasonably have been foreseen—for example, a significant unexpected change in lapse experience resulting from specific circumstances occurring in a subsequent period, restructuring of policy charges, or a major change in investment strategy. The effects of such changes should be included in the restated results of the period in which the changes occurred, which

may require the adjustment of total DPAC amortization recorded to date as specified in paragraph 25 of FASB Statement No. 97.

Recoverability and Loss Recognition—Investment Contracts

33. *Question 14:* Should DPAC related to investment contracts defined under FASB Statement No. 97 be written off if it is determined that the amount at which the asset is stated is probably not recoverable?

34. *Answer 14:* Yes. As stated in paragraph 87 in FASB Statement of Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* "[a]n expense or loss is recognized if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits." The DPAC asset should be reduced to the level that can be recovered. Further guidance is provided in paragraphs 35 and 36 of this practice bulletin.

35. *Question 15:* Should the provisions of FASB Statement No. 60 concerning loss recognition (premium deficiency), by which an additional liability is established for anticipated losses on contracts, apply to investment contracts defined in FASB Statement No. 97?

36. *Answer 15:* No. Such loss recognition, as described in paragraph 34 above, is not permitted for investment contracts under FASB Statement No. 97.

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