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Accounting and reporting by insurance enterprises for certain nontraditional long-duration insurance contracts and for separate accounts; Statement of position 03-01

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

STATEMENT OF POSITION 03-1

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

July 7, 2003

Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts

Issued by the Accounting Standards Executive Committee

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) provides guidance on accounting and reporting by insurance enterprises for certain nontraditional long-duration contracts and for separate accounts. This SOP requires, among other things, the following:

- *Separate account presentation*. The portion of separate account assets representing contract holder funds should be measured at fair value and reported in the insurance enterprise's financial statements as a summary total, with an equivalent summary total for related liabilities, if the separate account arrangement meets all the criteria specified in paragraph 11 of this SOP. If a separate account arrangement does not meet the criteria, assets representing contract holder funds under the arrangement should be accounted for and recognized as general account assets. Any related liability should be accounted for as a general account liability.
- *Interest in separate accounts*. Assets underlying an insurance enterprise's proportionate interest in a separate account do not represent contract holder funds, and thus do not qualify for separate account reporting and valuation. If a separate account arrangement meets the criteria of paragraph 11 of this SOP and (*a*) the terms of the contract allow the contract holder to invest in additional units in the separate account or (*b*) the insurance enterprise is marketing contracts that permit funds to be invested in the separate account, the assets underlying the insurance enterprise's proportionate interest in the separate account should be accounted for in a manner consistent with similar assets held by the general account that the insurance enterprise may be required to sell.

  If the insurance enterprise's proportionate interest in the separate account is less than 20 percent of the separate account and all of the underlying investments of the separate account meet the definition of

securities under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, or paragraph 46 of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended by FASB Statement No. 115, or cash and cash equivalents, the insurance enterprise may report its portion of the separate account value as an investment in equity securities classified as trading under FASB Statement No. 115.

- *Gains and losses on the transfer of assets from the general account to a separate account*. Assets transferred from the general account to a separate account should be recognized at fair value to the extent of third-party contract holders' proportionate interest in the separate account if the separate account arrangement meets the criteria in paragraph 11 of this SOP. Any resulting gain related to the third-party contract holder's proportionate interest should be recognized immediately in earnings of the general account of the insurance enterprise, provided that the risks and rewards of ownership have been transferred to contract holders using the fair value of the asset at the date of the contract holders assumption of risks and rewards. A guarantee of the asset's value or minimum rate of return or a commitment to repurchase the asset would not transfer the risks of ownership, and no gain should be recognized. If the separate account arrangement does not meet the criteria in paragraph 11 of this SOP, the transfer generally should have no financial reporting effect (that is, general account classification and carrying amounts should be retained). However, in certain situations, loss recognition may be appropriate.

- *Liability valuation*. The basis for determining the balance that accrues to the contract holder for a long-duration insurance or investment contract that is subject to 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* (paragraphs 15 and 17(a)), is the accrued account balance. The accrued account balance equals:

1. Deposit(s) net of withdrawals;
2. Plus amounts credited pursuant to the contract;
3. Less fees and charges assessed;
4. Plus additional interest (for example, persistency bonus); and
5. Other adjustments (for example, appreciation or depreciation recognized in accordance with paragraph 21 of this SOP to the extent not already credited and included in item 2).

For contracts that have features that may result in more than one potential account balance, the accrued account balance should be based on the highest contractually determinable balance that will be available in cash or its equivalent at contractual maturity or the reset date, without reduction for future fees and charges. The accrued account balance should not reflect any surrender adjustments (for example, market value annuity adjustments, surrender charges, or credits). For contracts in which amounts credited as interest to the contract holder are reset periodically, the accrued balance should be based on the highest crediting rate guaranteed or declared through the reset date.

- *Return based on a contractually referenced pool of assets or index*. For a contract not accounted for under the provisions of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, that provides a return based on the total return of a contractually referenced pool of assets either through crediting rates or termination adjustments, the accrued account balance should be based on the fair value of the referenced pool of assets (or applicable index value) at the balance sheet date even if the related assets are not recognized at fair value.
- *Determining the significance of mortality and morbidity risk and classification of contracts that con-*

tain death or other insurance benefit features. To determine the accounting under FASB Statement No. 97 for a contract that contains death or other insurance benefit features, the insurance enterprise should first determine whether the contract is an investment or universal life-type contract. If the mortality or morbidity risks are other than nominal and the fees assessed or insurance benefits are not fixed and guaranteed, the contract should be classified as a FASB Statement No. 97 universal-life type contract. There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly in response to capital markets volatility. The determination of significance should be made at contract inception, other than at transition, and should be based on a comparison of the present value of expected excess payments (that is, insurance benefit amounts and related incremental claim adjustment expenses in excess of the account balance) to be made under insurance benefit features with the present value of all amounts expected to be assessed against the contract holder (revenue).

- *Accounting for contracts that contain death or other insurance benefit features.* For contracts classified as insurance contracts that have amounts assessed against contract holders each period for the insurance benefit feature that are assessed in a manner that is expected to result in profits in earlier years and subsequent losses from that insurance benefit function, a liability should be established in addition to the account balance to recognize the portion of such assessments that compensates the insurance enterprise for benefits to be provided in future periods in accordance with the guidance in paragraphs 26 through 28 of this SOP.

- *Accounting for reinsurance and other similar contracts.* If a reinsurer assumes the insurance benefit feature, the reinsurer should assess the significance of mortality and morbidity risk within the reinsurance contract according to the guidance in paragraphs 24 and 25 of this SOP, regardless of whether there is an account balance. The reinsurer should determine the classification of the reinsurance contract as an investment contract or as an insurance contract at the inception of the reinsurance contract. For reinsurance contracts, the mortality or morbidity risk could be deemed other than nominal even if the original issuer did not determine mortality or morbidity to be other than nominal. Similarly, the issuer of a contract that provides only an insurance benefit feature that wraps a noninsurance contract, for example, a guaranteed minimum death benefit related to a mutual fund balance, should evaluate its contract in the same manner. A reinsurer or issuer of the insurance benefit features of a contract should calculate a liability for the portion of premiums collected each period that represents compensation to the insurance enterprise for benefits that are assessed in a manner that is expected to result in current profits and future losses from the insurance benefit function. That liability should be calculated using the methodology described in paragraphs 26 through 28 of this SOP.

- *Accounting for annuitization benefits*. Contracts may provide for potential benefits in addition to the account balance that are payable only upon annuitization, such as annuity purchase guarantees, guaranteed minimum income benefit (GMIBs), and two-tier annuities. Insurance enterprises should determine whether such contract features should be accounted for under the provisions of FASB Statement No. 133. If the contract feature is not accounted for under the provisions of FASB Statement No. 133, an additional liability for the contract feature should be established if the present value of expected annuitization payments at the expected annuitization date exceeds the expected account balance at the expected annuitization date in accordance with the guidance in paragraphs 31 through 35 of this SOP.

- *Sales inducements to contract holders*. 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 for 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.

Sales inducements that are recognized as part of the liability under paragraph 36 of this SOP, that are explicitly identified in the contract at inception, and that meet the criteria specified in paragraph 37 of this SOP should be deferred and amortized using the same methodology and assumptions used to amortize capitalized acquisition costs.

- *Disclosures*. The financial statements of an insurance enterprise should disclose information related to the following:

  1. Separate account assets and liabilities; the nature, extent, and timing of minimum guarantees related to variable contracts; and the amount of gains and losses recognized on assets transferred to separate accounts.
  2. An insurance enterprise's accounting policy for sales inducements, including the nature of the costs capitalized and the method of amortizing those costs; the amount of costs capitalized and amortized for each of the periods presented; and the unamortized balance as of each balance sheet date presented.
  3. The nature of the liabilities and methods and assumptions used in estimating any contract benefits recognized in excess of the account balance pursuant to paragraphs 20 and 36 of this SOP.

This SOP is effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged. This SOP should not be applied retroactively to prior years' financial statements. Initial application of this SOP should be as of the beginning of an entity's fiscal year.

At the date of initial application of this SOP, an insurance enterprise will have to make various determinations, such as qualification for separate account treatment, FASB Statement No. 115 classification of securities in separate account arrangements not meeting the criteria in paragraph 11 of this SOP, significance of mortality and morbidity risk, adjustments to contract holder liabilities, and adjustments to estimated gross profits or margins,[1] to determine the cumulative effect of a change in accounting principle from adopting this SOP. Refer to paragraphs 41 through 43 of this SOP for specific transition guidance.

1. The term *estimated gross profits or margins* relates to estimated gross profits as defined in Financial Accounting Standards Board 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*, and estimated gross margins as defined in AICPA Statement of Position 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, and will hereinafter be referred to as estimated gross profits.

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,[1] 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.

1. At the time the Accounting Standards Executive Committee (AcSEC) undertook this project, at least five of the seven Financial Accounting Standards Board members were required to not object to AcSEC undertaking this project.

Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts

Introduction and Background

Nontraditional Annuity and Life Insurance Contracts

1. At the time that Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended, and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, were issued, annuity and life insurance contracts were generally one of two basic designs: fixed or variable. Traditional fixed annuity and life insurance contracts, typically offered through an insurance enterprise's **general account**,[1] provide for a fixed rate of interest over some specified period, with the insurance enterprise bearing the investment risk associated with the invested assets. **Traditional variable annuity** and variable life insurance contracts, by contrast, offered through an insurance enterprise's **separate account**, provide that all investment risks associated with the separate account assets are passed through to the contract holder, with no guarantees of return of principal, minimum crediting rates or, for annuity contracts, minimum death benefits.

2. More recently, annuity and life products with nontraditional terms have been developed. Some of those products may combine fixed and variable features and are sold as general account or separate account products. The features of nontraditional con-

1. Terms defined in the glossary are set in boldface type the first time they appear in this Statement of Position (SOP).

tracts are many and complex, and may be offered in different combinations, such that there are numerous variations of the same basic products being sold in the marketplace. See examples of products in Appendix D of this Statement of Position (SOP).

3. A common feature in variable annuities is a **minimum guaranteed death benefit (MGDB)**, such as a death benefit equal to the total deposits made by the contract holder less any withdrawals, referred to as "return of premium" or "basic" MGDB. Although the return of premium MGDB has become increasingly common in variable annuities, the trend has been for insurers to offer MGDBs with more extensive benefit guarantees, such as:

   a. 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, often referred to as "roll up."

   b. A death benefit equal to the account balance on a specified anniversary date adjusted for deposits less partial withdrawals since the specified anniversary date, often referred to as "reset."

   c. 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, often referred to as "ratchet."

   Another example of an insurance benefit feature is a no-lapse guarantee, in which the company agrees to keep the insurance policy in force even when the account balance is not sufficient to pay the cost of insurance.

4. Some annuities may provide for potential benefits in addition to the account balance, payable only if annuitization is elected. For example, some deferred variable annuities now provide that, regardless of separate account performance, a guaranteed minimum amount is available to annuitize after a specified period, thereby providing a **guaranteed minimum income benefit (GMIB)** if the contract holder elects to annuitize. This benefit is in addition to the guaranteed minimum annuity interest rate traditionally offered. Another type of deferred annuity may provide multiple crediting rates throughout the life of the contract depending on whether the

contract holder elects to terminate or annuitize the contract. An example is a contract that applies a lower rate to funds deposited if the contract holder elects to surrender the contract for cash, and a higher rate if the contract holder elects to annuitize, often referred to as a "two-tier" annuity.

5. Contracts also exist that potentially may be viewed as providing multiple account balances, for example, a contract that provides a return based on a contractually referenced pool of real estate assets owned by the insurance enterprise but also provides for minimum investment return guarantees. Other contracts may exist that provide for the return of principal and interest if held until maturity or a specified "market adjusted value" if surrendered at an earlier date.

6. **Sales inducements** to contract holders may be offered with fixed and variable life insurance and annuity contracts. Those inducements may be offered in many forms, including an immediate bonus, a persistency bonus credited to the contract holder's account after a specified period, or an enhanced crediting rate, or "bonus interest" rate, in the initial period(s) of the contract.

7. FASB Statement No. 97 provides no explicit accounting guidance for the above examples of nontraditional contract features. This SOP addresses the insurance enterprise's accounting for certain contract features not covered by other authoritative accounting literature, including asset, liability, revenue, and expense recognition. Embedded derivatives contained in nontraditional contracts should be accounted for in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and its related guidance.[2]

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2. Refer to the Financial Accounting Standards Board's (FASB's) publication *Accounting for Derivative Instruments and Hedging Activities*. As of the date of publication of this SOP, the following insurance-specific FASB Derivative Implementation Issues were available: B7—Variable Annuity Products and Policyholder Ownership of the Assets, B8—Identification of the Host Contract in a Nontraditional Variable Annuity Contract, B9—Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options, B10—Equity-Indexed Life Insurance Contracts, B25—Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period, B29—Equity-Indexed Annuity Contracts with Embedded Derivatives, B30—Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts, B34—Period Certain Plus Life-Contingent Variable Payout Annuity Contracts with a Guaranteed Minimum Level of Periodic Payments, and B36—Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments.

8. In addition, this SOP addresses the insurance enterprise's accounting for separate account assets and liabilities related to contracts for which all or a portion of the investment risk is borne by the insurer.

Applicability and Scope

9. This SOP is applicable to all entities to which FASB Statement No. 60, as amended, applies, hereinafter referred to as insurance enterprises.[3]

Conclusions

Separate Account Presentation

10. Separate account assets and liabilities should be included in the financial statements of the insurance enterprise that owns the assets and is contractually obligated to pay the liabilities.

11. The portion of separate account assets representing contract holder funds should be measured at fair value and reported in the insurance enterprise's financial statements as a summary total, with an equivalent summary total reported for related liabilities, if the **separate account arrangement** meets all of the following conditions:

   a. The separate account is legally recognized. That is, the separate account is established, approved, and regulated under special rules such as state insurance laws, federal securities laws, or similar foreign laws.

   b. The separate account assets supporting the contract liabilities are legally insulated from the general account liabilities of the insurance enterprise (that is, the contract holder is not subject to insurer default risk to the extent of the assets held in the separate account).

3. FASB Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, 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.

c. The insurer must, as a result of contractual, statutory, or regulatory requirements, invest the contract holder's funds within the separate account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies.

d. All investment performance, net of contract fees and assessments, must as a result of contractual, statutory, or regulatory requirements be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, as a ceiling would prohibit all investment performance from being passed through to the contract holder.

For the portion of separate account arrangements meeting these criteria, the related investment performance (including interest, dividends, realized gains and losses, and changes in unrealized gains and losses) and the corresponding amounts credited to the contract holder should be offset within the same statement of operations line item netting to zero. Contract fees and assessments should be reported in accordance with FASB Statement No. 97, paragraph 19. Any liabilities related to minimum guarantees and insurance benefit liabilities under the contracts in excess of the fair value of separate account assets representing contract holder funds should be recognized as general account liabilities.

12. If a separate account arrangement does not meet the criteria in paragraph 11 of this SOP, assets representing contract holder funds under the arrangement should be accounted for (measured and presented) the same as other general account assets as prescribed in paragraphs 45 through 51 of FASB Statement No. 60, as amended. Any related liability should be accounted for as a general account liability. Revenue and expenses related to such arrangements should be recognized within the respective revenue and expense lines in the statement of operations. Arrangements in which contract holders' funds are maintained in separate accounts to fund fixed account options of variable contracts, market value adjusted contracts, guaranteed investment contracts, and indexed contracts are examples of

separate account arrangements that would not meet the criteria in paragraph 11 because all of the investment performance on these investments is not passed through to the contract holder.

Accounting for an Insurance Enterprise's Interest in a Separate Account

13. Assets underlying an insurance enterprise's proportionate interest in a separate account (**seed money** or other investment as described in paragraph A12 of this SOP) do not represent contract holder funds, and thus do not qualify for separate account accounting and reporting. The insurance enterprise should "look through" the separate account[4] for purposes of accounting for its interest therein, and account for and classify the assets of the separate account underlying that interest based on their nature as if the assets of the separate account underlying the insurance enterprise's proportionate interest were held directly by the general account rather than through the separate account structure.[5]

14. If a separate account arrangement meets the criteria in paragraph 11 of this SOP, and (*a*) the terms of the contract allow the contract holder to invest in additional units in the separate account or (*b*) the insurance enterprise is marketing contracts that permit funds to be invested in the separate account, the assets of the separate account underlying the insurance enterprise's proportionate interest in the separate account should be accounted for in a manner consistent with the accounting for similar assets held by the general account that the insurance enterprise may be required to sell. For example:

    a. For a debt or equity security with an unrealized loss, the loss should be accounted for as an other than temporary impairment consistent with the guidance of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and recognized immediately in the statement of operations as a realized loss.

4. For purposes of this SOP, the term *separate accounts* includes separate accounts and subaccounts or investment divisions of separate accounts.

5. See the example in Appendix B.

b. The guidance in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, should be followed for both real estate that is held for sale and real estate that is not held for sale. For real estate that does not meet the FASB Statement No. 144 held for sale criteria, the impairment test should be performed solely using undiscounted cash flows assuming immediate disposition.

Transfers to Separate Accounts

15. Assets transferred from the general account to a separate account should be recognized at fair value to the extent of the third-party contract holders' proportionate interests in the separate account if the separate account arrangement meets the criteria in paragraph 11 of this SOP. Any resulting gain related to the third-party contract holders' proportionate interest should be recognized immediately in earnings of the general account of the insurance enterprise provided that the risks and rewards of ownership have been transferred to contract holders using the fair value of the asset at the date of the contract holders' assumption of risks and rewards.[6] A guarantee of the asset's value or minimum rate of return or a commitment to repurchase the asset would not transfer the risks of ownership, and no gain should be recognized. If the separate account arrangement does not meet the criteria in paragraph 11 of this SOP, the transfer generally should have no financial reporting effect (that is, general account classification and carrying amounts should be retained). Consistent with the guidance in footnote 9 of this SOP, the insurance enterprise should recognize an impairment loss on an asset transferred from the general account to a separate account not meeting the criteria in paragraph 11 of this SOP if the terms of the arrangement with the contract holder are such that the insurance enterprise will not be able to recover the asset's carrying value. The insurance enterprise should recognize an impairment loss on its proportionate interest in a separate account arrangement meeting the criteria in para-

6. If the asset transferred is real estate, no gain may be recognized if recognition is inconsistent with FASB Statement No. 66, *Accounting for Sales of Real Estate*.

graph 11, in a situation where the current fair value of the insurance enterprise's proportionate interest in the separate account assets is less than its carrying amount.

16. If the transferred asset is subsequently sold by the separate account, any remaining unrecognized gain related to the insurance enterprise's proportionate interest should be recognized immediately in the earnings of the general account of the insurance enterprise. If third-party contract holders' proportionate interests in the separate account are subsequently increased, or the insurance enterprise otherwise reduces its proportionate interest in the separate account arrangement that meets the criteria in paragraph 11 of this SOP, the reduction in the insurance enterprise's proportionate interest may result in additional gain. If an insurance enterprise's proportionate interest subsequently increases as a result of transactions executed at fair value (for example, at net asset value), the increase is considered a purchase from the contract holder and should be recognized at fair value.

17. For example, the general account transfers to the separate account arrangement, as seed money, a debt security with a book value of $60 and a fair value of $100. No gain is recognized on the initial transfer to the separate account arrangement. Contract holders subsequently direct $100 to the separate account arrangement, reducing the general account's proportionate interest to 50 percent. Assuming the fair value of the debt security is still $100, the general account recognizes a gain of $20, as a result of the contract holder investment into the separate account arrangement. In subsequent years, if the insurance enterprise reduces its interest in the separate account arrangement through withdrawal of cash or additional investment by contract holders, additional gains would be recognized if the fair value of the security continues to exceed the general account's basis in the security.

18. If the insurance enterprise's proportionate interest in the separate account is less than 20 percent of the separate account and all of the underlying investments of the separate account meet the definition of securities under FASB Statement No. 115 or paragraph 46 of FASB Statement No. 60, as amended

by FASB Statement No. 115, or cash and cash equivalents, the insurance enterprise may report its portion of the separate account value as an investment in equity securities under FASB Statement No. 115. This investment should be classified as trading and accounted for under the guidance in FASB Statement No. 115. The guidance in paragraphs 13 through 17 of this SOP should be applied when an insurance enterprise's proportionate interest in the separate account represents 20 percent or greater of the separate account interest, or when the underlying investments are other than those that meet the definition of securities under FASB Statement No. 115 or paragraph 46 of FASB Statement No. 60, as amended by Statement No. 115, or cash and cash equivalents.

Valuation of Liabilities

19. Paragraphs 20 through 23 of this SOP provide guidance for determining the balance that accrues to the benefit of contract holders under paragraphs 15 and 17(a) of FASB Statement No. 97. Paragraphs 24 through 30 of this SOP provide guidance for determining any additional liability for death or other insurance benefit features under paragraph 17(b) of FASB Statement No. 97. Paragraphs 31 through 35 of this SOP provide guidance for determining any additional liability for potential benefits available only upon annuitization. Paragraph 36 of this SOP provides guidance for determining any additional liability for sales inducements.

20. The balance that accrues to the benefit of the contract holder for a long-duration insurance or investment contract that is subject to FASB Statement No. 97 (paragraphs 15 and 17(a)) is the accrued account balance. The accrued account balance[7] equals:

    a. Deposit(s) net of withdrawals;

    b. Plus amounts credited pursuant to the contract;

    c. Less fees and charges assessed;

    d. Plus additional interest (for example, persistency bonus); and

7. The liability for the contract is the combination of amounts recorded in separate account liabilities and general account policyholder liabilities.

e. Other adjustments (for example, appreciation or depreciation recognized in accordance with paragraph 21 of this SOP to the extent not already credited and included in b above).

For purposes of item d above, additional interest is an amount that is required to be accrued under the liability valuation model that has not yet been credited to the contract holder's account. Additional interest, if any, should be accrued through the balance sheet date at the rate that would accrue to the balance available in cash, or its equivalent,[8] before reduction for future fees and charges, at the earlier of the date that the interest rate credited to the contract is reset or contractual maturity. The reset date is the date at which the existing contractually declared investment return expires.

21. Some contracts, such as variable life and annuity and certain group pension participating and other experience-rated contracts, provide for a return through periodic crediting rates, surrender adjustments, or termination adjustments based on the total return of a contractually referenced pool of assets owned by the insurance enterprise. Insurance enterprises should determine whether such contracts will be accounted for under the provisions of FASB Statement No. 133.[9] To the extent the contract is not accounted for under the provisions of FASB Statement No. 133, the amount of other adjustments described in paragraph 20 of this SOP should be based on the fair value of the referenced pool of assets at the balance sheet date, even if the related assets are not recognized at fair value, to the extent not already credited to the accrued account balance and included in paragraph 20(b) of this SOP. Amounts determined for other adjustments are not reduced for future fees and charges.[10]

8. For this purpose, an asset or contract is the equivalent of cash if it has a readily determinable fair value and can be converted to cash without incurring significant transaction costs.

9. Contracts that have been grandfathered under the provisions of paragraph 50 of FASB Statement No. 133 would need to follow the accounting guidance that is specified in paragraph 21 of this SOP.

10. A loss should be recognized in the statement of operations to the extent an asset reported in the general account is designated as part of a contractually referenced pool of assets and on that designation date has an unrealized loss.

22. For contracts that have features that may result in more than one potential account balance (for example, a contract that provides a return based on a contractually referenced pool of real estate assets owned by the insurance enterprise but also provides for minimum investment return guarantees), the accrued account balance should be based on the highest contractually determinable balance that will be available in cash or its equivalent at contractual maturity or the reset date, before reduction for future fees and charges. For contracts in which amounts credited as interest to the contract holder are reset periodically, the accrued balance should be based on the highest crediting rate guaranteed or declared through the reset date.

23. The accrued account balance should not reflect surrender adjustments (for example, market value annuity adjustments,[11] surrender charges, or credits). Any changes in the accrued account balance resulting from the application of the guidance in paragraphs 20 through 22 of this SOP should be reflected in net income in the period of the changes.

Contracts With Death or Other Insurance Benefit Features

Determining the Significance of Mortality and Morbidity Risk and Classification of Contracts That Contain Death or Other Insurance Benefit Features

24. To determine the accounting under FASB Statement No. 60 or No. 97 for a contract that contains death or other insurance benefit features, the insurance enterprise should first determine whether the contract is an investment or insurance contract. Classification of a contract as an investment contract or as an insurance contract should be made at contract inception, and the classification should not be reassessed during the **accumulation phase** of the contract. If the **mortality** and **morbidity** risk associated with insurance benefit features offered in a

11. For a description of a market value annuity and market value annuity adjustments refer to Appendix D, paragraph D1.

contract is deemed to be nominal, that is, a risk of insignificant[12] amount or remote[13] probability, the contract should be classified as an investment contract; otherwise, it should be considered an insurance contract. There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly in response to capital markets volatility. If the mortality or morbidity risk is other than nominal and the fees assessed or insurance benefits are not fixed and guaranteed, the contract should be classified as an FASB Statement No. 97 universal life-type contract by the insurance enterprise. If the fees assessed on a contract and insurance benefits provided by the contract are fixed and guaranteed or if the contract is short duration, the contract should be classified under FASB Statement No. 60, as amended.

25. The determination of significance of mortality or morbidity risk should be based on a comparison of the present value of expected excess payments to be made under insurance benefit features (that is, insurance benefit amounts and related incremental claim adjustment expenses in excess of the account balance, herein referred to as the "excess payments") with the present value of all amounts expected to be assessed against the contract holder (revenue). For contracts that include investment margin[14] in their estimated gross profits,[15] the investment margin should be included with any other assessments for purposes of determining significance. In performing the analysis, an insurance enterprise should consider both frequency and severity under a full range of scenarios that considers the volatility inherent in the assumptions, rather than making a best estimate using one set of assumptions. For example, if the annuity contract is a variable annuity contract, the insurance enterprise should consider a range of fund return scenarios. When considering a range of scenarios, the insurance enterprise should consider historical investment returns, the volatility of those returns, and expected future returns, as applicable.

12. The terms *nominal* and *insignificant* are as used in 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*, paragraph 40.

13. The term *remote* is as defined in FASB Statement No. 5, *Accounting for Contingencies*.

14. The term *investment margin* is as defin in FASB Statement No. 97, paragraph 23(c).

15. The term *estimated gross profit* is as defined in FASB Statement No. 97, paragraph 23.

Accounting for a FASB Statement No. 97 Universal Life-Type Contract With Death or Other Insurance Benefit Features

26. For a contract determined to meet the definition of an insurance contract as described in paragraphs 24 and 25, if the amounts assessed against the contract holder each period for the insurance benefit feature are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function, a liability should be established in addition to the account balance to recognize the portion of such assessments that compensates the insurance enterprise for benefits to be provided in future periods. Insurance coverage encompasses the concepts of amounts at risk and the relative probability of mortality and morbidity events. The amount of the additional liability should be determined based on the ratio (benefit ratio) of (*a*) the present value of total expected excess payments over the life of the contract, divided by (*b*) the present value of total expected assessments over the life of the contract. The benefit ratio may exceed 100 percent, resulting in a liability that exceeds cumulative assessments. Total expected assessments are the aggregate of all charges, including those for administration, mortality, expense, and surrender, regardless of how characterized. For contracts in which the assets are reported in the general account and that include investment margin in their estimated gross profits, the investment margin should be included with any other assessments for purposes of determining total expected assessments. The insurance enterprise should calculate the present value of total expected excess payments and total assessments and investment margins, as applicable, based on expected experience. Expected experience should be based on a range of scenarios rather than a single set of best estimate assumptions. In calculating the additional liability for the insurance benefit feature, assumptions used, such as the interest rate, discount rate, lapse rate, and mortality, should be consistent with assumptions used in estimating gross profits for purposes of amortizing capitalized acquisition costs. For contracts in which assessments are collected over a period significantly shorter than the

period for which the contract is subject to mortality and morbidity risks, the assessment would be considered a front-end fee under FASB Statement No. 97 and accounted for under paragraph 20 of that Statement. The amounts recognized in income should be considered assessments for purposes of this paragraph.

27. The insurance enterprise should regularly evaluate estimates used and adjust the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. In making such revised estimates, both the present value of total excess payments and the present value of total expected assessments and investment margins, should be calculated as of the balance sheet date using historical experience from the issue date to the balance sheet date and estimated experience thereafter.

28. The additional liability at the balance sheet date should be equal to:

   a. The current benefit ratio multiplied by the cumulative assessments[16]

   b. Less the cumulative excess payments (including amounts reflected in claims payable liabilities)

   c. Plus accreted interest

   However, in no event should the additional liability balance be less than zero. The change in the additional liability should be recognized as a component of benefit expense in the statement of operations.

29. The estimated gross profits used for the amortization of deferred acquisition costs should be adjusted to reflect the recognition of the liability in accordance with paragraph 28 of this SOP.

16. The term *cumulative assessments* refers to actual cumulative assessments, including investment margins, if applicable, recorded from contract inception through the balance sheet date.

Accounting for Reinsurance and Other Similar Contracts

30. If a reinsurer assumes the insurance benefit feature, the reinsurer should assess the significance of mortality and morbidity risk within the reinsurance contract according to the guidance in paragraphs 24 and 25 of this SOP, regardless of whether there is an account balance. The reinsurer should determine the classification of the reinsurance contract as an investment contract or as an insurance contract at the inception of the reinsurance contract. For reinsurance contracts, the mortality or morbidity risk could be deemed other than nominal even if the original issuer did not determine mortality or morbidity to be other than nominal. There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly in response to capital markets volatility. Similarly, the issuer of a contract that provides only an insurance benefit feature that wraps[17] a noninsurance contract, for example, a guaranteed minimum death benefit related to a mutual fund balance, should evaluate its contract in the same manner. A reinsurer or issuer of the insurance benefit features of a contract should calculate a liability for the portion of premiums collected each period that represents compensation to the insurance enterprise for benefits that are assessed in a manner that is expected to result in current profits and future losses from the insurance benefit function. That liability should be calculated using the methodology described in paragraphs 26 through 28 of this SOP. For example, a reinsurance contract that assumes only the risk related to the MGDB feature for a fee that varies with the account balance rather than with the insurance coverage provided would be a FASB Statement No. 97 universal life-type contract and the contract should be accounted for in accordance with paragraphs 26 through 28 of this SOP.

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17. The term *wrap* refers to the practice of adding an insurance benefit feature to a separate noninsurance contract generally from a different issuer.

Accounting for Contracts That Provide Annuitization Benefits

31. Contracts may provide for potential benefits in addition to the account balance that are payable only upon annuitization, such as annuity purchase guarantees, GMIBs and two-tier annuities. Insurance enterprises should determine whether such contract features should be accounted for under the provisions of FASB Statement No. 133.[18] If the contract feature is not accounted for under the provisions of FASB Statement No. 133, an additional liability for the contract feature should be established if the present value of expected annuitization payments at the expected annuitization date exceeds the expected account balance at the expected annuitization date. The amount of the additional liability should be determined based on the ratio (benefit ratio) of (*a*) the present value of expected annuitization payments to be made and related incremental claim adjustment expenses, discounted at estimated investment yields expected to be earned during the **annuitization phase** of the contract, minus the expected accrued account balance at the expected annuitization date (the "excess payments"), divided by (*b*) the present value of total expected assessments during the accumulation phase of the contract. Total expected assessments are the aggregate of all charges, including those for administration, mortality, expense, and surrender, regardless of how characterized. For contracts whose assets are reported in the general account and that include investment margin in their estimated gross profits, the investment margin should be included with any other assessments for purposes of determining total expected assessments. The insurance enterprise should calculate the present value of total expected excess payments and total assessments and investment margins, as applicable, based on expected experience. Expected experience should be based on a range of scenarios that considers the volatility inherent in the assumptions rather than a single set of best estimate assumptions. In

18. Refer to FASB Derivative Implementation Issue: B25—Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period, Questions 1 and 2, for discussion of these products.

calculating the additional liability for the additional benefit feature, assumptions used, such as the interest rate, discount rate, lapse rate, and mortality, should be consistent with assumptions used in estimating gross profits for purposes of amortizing capitalized acquisition costs. When determining expected excess payments, the expected annuitization rate is one of the assumptions that needs to be estimated.

32. The insurance enterprise should regularly evaluate estimates used and adjust the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. In making such revised estimates, both the present value of total excess payments and the present value of total expected assessments or investment margins should be calculated as of the balance sheet date using historical experience from the issue date to the balance sheet date and estimated experience thereafter.

33. The additional liability at the balance sheet date should be equal to:

    a. The current benefit ratio multiplied by the cumulative assessments

    b. Plus accreted interest

    c. Less, at time of annuitization, the cumulative excess payments determined at annuitization

However, in no event should the additional liability balance be less than zero. The change in the additional liability should be recognized as a component of benefit expense in the statement of operations. "Cumulative excess payments determined at annuitization" represent the amount that should be deducted at the actual date of annuitization. That amount should be calculated as the present value of expected annuity payments and related claim adjustment expenses discounted at expected investment yields minus the accrued account balance at the actual annuitization date. On the date of annuitization, the additional liability related to the cumulative excess benefits will be zero and the amount deducted will be used in the calculation of the liability for the payout annuity.

34. The estimated gross profits used for the amortization of deferred acquisition costs should be adjusted to reflect the recognition of the liability determined in accordance with paragraph 32 of this SOP. Capitalized acquisition costs should continue to be amortized over the present value of estimated gross profits (as adjusted above) over the expected life of the book of contracts. For purposes of amortization of deferred acquisition costs, the life of the book of contracts excludes the annuitization phase.

35. A reinsurer may agree to reinsure all or a portion of the additional benefits described in paragraph 31 of this SOP. Both the ceding company and the reinsurer should determine whether such a reinsurance contract should be accounted for under the provisions of FASB Statement No. 133. For example, unlike many of the direct contracts that contain GMIB benefits, contracts to reinsure GMIB benefits often meet the definition of a derivative under FASB Statement No. 133. If the reinsurance contract should not be accounted for under the provisions of FASB Statement No. 133, the guidance in paragraphs 31 through 34 of this SOP should be followed.

Sales Inducements to Contract Holders

36. 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.

37. Sales inducements that (*a*) are recognized as part of the liability under paragraph 36 of this SOP, (*b*) are explicitly identified in the contract at inception, and (c) meet the criteria in the following sentence should be deferred and amortized using the same methodology and assumptions used to amortize capitalized acquisition costs. The insurance enterprise should demonstrate that such amounts are

(*a*) incremental to amounts the enterprise credits on similar contracts without sales inducements and (*b*) higher than the contract's expected ongoing crediting rates for periods after the inducement, as applicable; that is, the crediting rate excluding the inducement should be consistent with assumptions used in estimated gross profits, contract illustrations, and interest-crediting strategies. Due to the nature of day-one and persistency bonuses, the criteria in the preceding sentence are generally met. The deferred amount should be recognized on the statement of financial position as an asset, and amortization should be recognized as a component of benefit expense. The annuitization phase is viewed as a separate contract under FASB Statement No. 97, and should not be combined with the accumulation phase for amortization of deferred sales inducements.

Disclosures

38. The following information should be disclosed in the financial statements of the insurance enterprise:

    a. The general nature of the contracts reported in separate accounts, including the extent and terms of minimum guarantees.

    b. The basis of presentation for separate account assets and liabilities and related separate account activity.

    c. A description of the liability valuation methods and assumptions used in estimating the liabilities for additional insurance benefits and minimum guarantees.

    d. Disclosures should include the following amounts related to minimum guarantees:

        (1) The separate account liability balances subject to various types of benefits (for example, guaranteed minimum death benefit, guaranteed minimum income benefit, guaranteed minimum accumulation benefit). Disclosures within these categories of benefits for the types of guarantees provided may also be appropriate (for example, return of net deposits, return of net deposits accrued at a stated rate, return of highest anniversary value).

(2) The amount of liability reported for additional insurance benefits, annuitization benefits and other minimum guarantees, by type of benefit, for the most recent balance sheet date and the incurred and paid amounts for all periods presented.

(3) For contracts for which an additional liability is disclosed in paragraph 38(d)(2), **net amount at risk** and weighted average attained age of contract holders.

e. The aggregate fair value of assets, by major investment asset category, supporting separate accounts with additional insurance benefits and minimum investment return guarantees as of each date for which a statement of financial position is presented.

f. The amount of gains and losses recognized on assets transferred to separate accounts for the periods presented.

39. An insurance enterprise should disclose its accounting policy for sales inducements, including the nature of the costs deferred and the method of amortizing those costs. The amount of costs deferred and amortized for each of the periods presented and the unamortized balance as of each balance sheet date also should be disclosed.

Effective Date and Transition

40. The provisions of this SOP are effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged. Restatement of previously issued annual financial statements or reclassification between separate account and general account balances 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 and during an interim period, all prior interim periods should be restated). Disclosure of the pro forma effects of retroactive application (discussed in paragraph 21 of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*) or the pro forma effect on the year of adoption is not required.

41. At the date of initial application:

a. For assets that no longer qualify for separate account treatment:

(1) Debt or equity securities previously classified as separate account assets but valued in accordance with FASB Statement No. 115 should maintain their designations as held-to-maturity, available-for-sale, or trading upon reclassification to the general account.

(2) The provisions of FASB Statement No. 115 should be adopted for any debt or equity securities previously recognized at fair value in accordance with paragraph 54 of FASB Statement No. 60, as amended. Any adjustment for FASB Statement No. 115 designation resulting from initial adoption should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20 and paragraph 25 of FASB Statement No. 115:

(a) If designated as held-to-maturity, the adjustment should be reported through income.

(b) If designated as available-for-sale, the adjustment should be reported in income, with a corresponding cumulative effect adjustment for the unrealized holding gains and losses reported in other comprehensive income.

(c) If designated as trading, there should be no adjustment.

(3) Any revaluation adjustments related to assets that are not subject to FASB Statement No. 115 should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20.

b. The guidance in paragraph 41(a) of this SOP should be applied in accounting for an insurance enterprise's proportionate interest in the separate account assets regardless of whether the interest was previously reported in the separate account or the general account.

If the insurance enterprise considered its portion of separate account units to be equity securities under FASB Statement No. 115, the guidance in paragraph 41(a)(1) or (3) should be applied as appropriate.

c. To the extent a debt or equity security subject to FASB Statement No. 115 and previously classified as available-for-sale is part of a contractually referenced pool of assets in which total return will be accrued to the account balance (in accordance with paragraph 21 of this SOP), and a transition adjustment for the liability valuation is reported in accordance with 41(e), that security may be reclassified to trading with the revaluation adjustment recognized as a cumulative effect similar to the liability transition adjustment.

d. For contracts that are in force on the date of initial application of this SOP, the determination of significance of mortality and morbidity risk resulting from insurance benefit features, in accordance with paragraphs 24 through 25 of this SOP, should be performed as of the date of initial application of this SOP using both actual results from inception of the contract through the date of initial application and expected future results thereafter.

e. Any adjustment in contract holder liabilities from adopting this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20, through income or, for amounts previously accrued under Emerging Issues Task Force (EITF) Topic No. D-41, *Adjustments in Assets and Liabilities for Holding Gains and Losses as Related to the Implementation of FASB Statement No. 115*, accumulated other comprehensive income.

f. If the adoption of this SOP results in changes in estimated gross profits, any adjustments to unamortized deferred acquisition costs or present value of future profits[19] should be reported in a manner similar to

19. Adjustments are as discussed in 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.*

the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20, through income or, for amounts previously accrued under EITF Topic No. D-41, accumulated other comprehensive income.

42. This SOP should be applied prospectively with respect to the deferral of sales inducements meeting the criteria in paragraph 37 of this SOP. Sales inducements deferred subsequent to the initial application of this SOP on policies in force at that date should be accounted for in accordance with paragraph 37 of this SOP. Costs recognized for sales inducements prior to initial application of this SOP other than for those referred to in paragraph 43 of this SOP, whether capitalized or not, should not be adjusted to the amounts that would have been deferred had this SOP been in effect when those costs were incurred. Costs capitalized for sales inducements prior to initial application of this SOP that were previously reported with unamortized deferred acquisition costs should be reported separately.

43. Insurance enterprises that were previously amortizing sales inducements using the same methodology and assumptions used for amortizing deferred acquisition costs (the approach required by the guidance in this SOP) should continue using that approach and should consider the entire life of the contracts. Any cumulative adjustment to unamortized sales inducements resulting from changes in estimated gross profits, made as a result of the initial adoption of this SOP, should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20, through net income or, for amounts previously accrued under EITF Topic No. D-41, accumulated other comprehensive income. However, if an insurance enterprise had been amortizing sales inducements using a methodology or assumptions other than those used for amortizing deferred acquisition costs, the amortization of deferred sales inducements after implementation of this SOP should consider only estimated gross profits or interest, as applicable, depending on the amortization methodology, from the date of initial application forward.

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

APPENDIX A

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 July 2002, AcSEC issued for public comment an exposure draft of a proposed SOP, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*. During the 90-day comment period, 20 comment letters were received by AcSEC.

Separate Account Presentation

A.2 Existing authoritative accounting guidance for separate accounts is limited to paragraphs 53 and 54 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, and was written when contracts underlying the separate accounts generally were either fixed (having guaranteed returns) or variable (wherein the performance of the assets was the sole determinant of the return to the contract holder):

> 53. Separate accounts represent assets and liabilities that are maintained by an insurance enterprise for purposes of funding fixed-benefit or variable annuity contracts, pension plans, and similar activities. The contract holder generally assumes the investment risk, and the insurance enterprise receives a fee for investment management, certain administrative expenses, and mortality and expense risks assumed.
>
> 54. Investments in separate accounts shall be reported at market except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets shall be reported in accordance

> with paragraphs 45-51. Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance enterprise.

Paragraphs 45 through 51 of Financial Accounting Standards Board (FASB) Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, provide guidance for valuing assets of the insurance enterprise's general account (for example, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, for securities, and FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, for mortgage loans), which for the remainder of this discussion will be referred to as "general account assets."

A.3 Paragraph 54 of FASB Statement No. 60 has not been applied consistently in practice in terms of *valuing* assets maintained in separate accounts that have been determined to require valuation as general account assets, and in classifying the assets in the insurer's statement of financial position. It is unclear whether the phrase "reported in accordance with paragraphs 45-51," as used in paragraph 54 of FASB Statement No. 60, refers only to valuation or whether it refers to statement of financial position single line presentation as well. Paragraph 54 of FASB Statement No. 60 states, "Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance enterprise." Because separate account liabilities are classified consistent with the related asset classification, the issue of classification also affects separate account liabilities.

A.4 Although FASB Statement No. 60, as amended, requires separate account assets and liabilities to be reported in the financial statements of the insurance enterprise, AcSEC considered whether that guidance is consistent with recent standards addressing both asset and liability recognition and derecognition, such as FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. AcSEC also considered potential analogies to similar trust fund and mutual fund products offered by the financial services industry. AcSEC noted that, unlike a financial institution trust fund account or mutual fund, the assets of the separate account are legally owned by the insurance enterprise. Additionally, a separate account is not a separate legal entity under general corporate statutes. As noted in the AICPA Audit and Accounting Guide *Life and Health Insurance Entities*, "a separate account is a legally restricted fund that is segregated from the life insurance entity. State insurance laws provide that assets in separate accounts may be invested without regard to restrictions covering general investments of life insurance entities. Separate account assets are generally not available to cover liabilities except those of the separate account."

A.5 Thus, separate account assets may be isolated from the general creditors of the insurance enterprise, but not from the insurance enterprise itself, which still legally owns the assets. In a variable annuity or similar arrangement, there is no relinquishment of ownership of assets but rather the execution of a contract pursuant to which the insurance enterprise agrees to pass through the separate account investment results to the contract holder. Furthermore, the contract executed between the contract holder and the insurance enterprise creates an obligation of the insurance enterprise that is not defeased by the segregation of funds in the separate account. Based on the above, AcSEC concluded that separate account assets and separate account liabilities should be reported in the statement of financial position of the insurance enterprise that owns the assets and is contractually obligated to settle the liabilities.

A.6 AcSEC considered whether it should ask FASB to reconsider the separate account asset and liability reporting requirements of FASB Statement No. 60, as amended, in light of AcSEC's conclusion in the SOP 00-3, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*, that closed block assets, liabilities, and related statement of operations activity should be displayed with the remainder of an insurance enterprise's assets, liabilities, and statement of operations activity. AcSEC concluded that separate account structures differ in several significant respects from closed block structures: closed blocks do not legally insulate the assets supporting contract liabilities, closed block contract holders do not direct the investment of supporting assets, and individual closed block contract holders do not receive the direct pass-through of investment performance.

A.7 Collectively, the unique features of separate account arrangements warrant presentation distinct from an insurance enterprise's other assets and liabilities. AcSEC concluded that summary account totals in the statement of financial condition and the offsetting of investment performance and corresponding amounts credited to the contract holder provide the most meaningful presentation to the users of the financial statements for contracts meeting the four criteria specified in paragraph 11 of this SOP. In addition, that presentation allows financial statement users to more readily analyze investment returns of insurance enterprises by excluding amounts that are legally insulated from the general account and not available to shareholders.

A.8 Separate accounts often are used in conjunction with nontraditional products that have both fixed and variable features. For example, variable annuity and variable life contracts frequently offer fixed rate investment options (typically through the insurer's general account) and may provide contractually guaranteed benefits that are paid upon the death of the contract holder (minimum guaranteed death benefits) or at a specified date in the accumulation phase of the contract (guaranteed minimum accumulation benefits). Those products have made it difficult to determine whether the criterion in paragraph 53 of FASB Statement No. 60, that "the contract holder generally assumes the investment risk," has been met and thus whether assets and liabilities associated with such separate account arrangements should be classified as general account, separate account, or some combination of both. In addition, fixed contracts in which the insurance enterprise guarantees investment return or otherwise bears the investment risk may be offered through separate accounts, for example, as a means to provide additional credit protection to the contract holder.

A.9 AcSEC believes that the emergence of new products has created a need for criteria to be developed for evaluating separate account arrangements and applying the guidance in paragraphs 53 and 54 of FASB Statement No. 60. AcSEC concluded that a defining characteristic of separate accounts is their designation as such by appropriate regulatory bodies. AcSEC also believes that legal insulation of separate account assets, such that to the extent of contract holder liabilities, the assets would not be available to the general creditors and shareholders of the insurance enterprise in the event of insolvency, is a unique aspect of separate account assets. AcSEC also concluded that a defining characteristic of separate accounts is that the contract holder dictates the allocation of deposits among investment alternatives and receives the pass-through of investment performance (that is, the contract holder receives the investment reward). In the case of certain group contracts, this feature may take the form of the contract holder's establishment of specific investment guidelines and objectives. AcSEC also noted that an implicit ceiling could exist through the use of certain sliding-scale performance-based fees, thereby not meeting the criteria in paragraph 11(d).

A.10 AcSEC considered whether only the assets and liabilities associated with the pure pass-through contracts offered through separate account arrangements, such as traditional variable annuities and other variable contracts that have neither guaranteed minimum death benefits nor accumulation guarantees, should be presented as single line items in the statement of financial condition of an insurance enterprise. That treatment would require that the insurer not include in the separate account summary totals the assets and liabilities related to a contract if the insurance enterprise bore *any* investment risk related to that contract. That view was rejected because the contract holder, rather than the insurance enterprise, controls the investments and is entitled to all the rewards of owning the assets underlying variable contracts. AcSEC concluded that separate account presentation for the portion of the separate account arrangement meeting the four criteria specified in paragraph 11 of this SOP is appropriate. Guarantees on such contracts provided by the insurance enterprise are viewed as incremental contract benefits that may require recognition of any additional liability in the general account of the insurance enterprise.

A.11 Several respondents to the exposure draft expressed a view that the definition and proposed reporting of separate account arrangements in paragraph 11 of this SOP do not recognize the unique nature of certain non-U.S. products where legal insulation may not be achieved. AcSEC believes that the criteria for separate account treatment should be applied consistently to U.S. and non-U.S. products and that changes to the definition to permit classification of certain non-U.S. products as separate accounts would inappropriately expand the use of separate account presentation to certain U.S. products. AcSEC reaffirmed that legal insulation is a key criterion for summary total presentation and statement of operations separate account treatment.

Accounting for an Insurance Enterprise's Interest in a Separate Account

A.12 When a separate account is established, the insurance enterprise may transfer non-contract-holder-related funds, commonly referred to as seed money, from its general account to the separate account to support the initial or ongoing operations of the separate account. Such transfers give the insurance enterprise an ownership interest in the separate account. The insurance enterprise's interest may also include undistributed earnings on the seed money and contract charges that have not been transferred to the general account.

A13. AcSEC recognized that there was diversity in practice regarding the classification and measurement of an insurance enterprise's proportionate interest in a separate account. Some insurance enterprises classified such amounts in the separate account caption along with separate account assets attributable to contract holders. Other insurance enterprises reclassified such amounts to general account assets. In terms of measurement, some insurance enterprises marked separate account assets to market through income, including the insurance enterprise's proportionate interest, while others accounted for the insurance enterprise's proportionate interest as general account assets. Some insurance enterprises viewed the separate account as if it were a separate legal entity, and thus considered their portion of "separate account units" to be equity securities. Other insurance enterprises looked through the separate account arrangement and viewed their investment as a proportionate interest in the underlying mutual funds, debt and equity securities, mortgage loans, real estate, or other assets in which the separate account arrangement was invested.

A.14 AcSEC concluded that an insurance enterprise's proportionate interest in the assets of a separate account does not qualify for separate account treatment, as it does not represent contract holder funds. Consequently, the assets underlying the insurance enterprise's proportionate interest should be classified and measured as general account assets in accordance with paragraphs 45 through 51 of FASB Statement No. 60, as amended.

A.15 AcSEC noted that a separate account is not a distinct legal entity under general corporate statutes, but rather an accounting entity created by and under the control of the insurance enterprise that owns 100 percent of the assets. The insurance enterprise's proportionate interest in the separate account typically would be available to general creditors in the event of the insurance enterprise's insolvency. AcSEC concluded that an insurance enterprise's proportionate interest in a separate account should not be viewed as an investment in "equity securities" of the separate account. Instead, AcSEC concluded that the insurance enterprise should "look through" to the underlying investments held in the separate account for purposes of classification and measurement as general account assets. In reaching that conclusion, AcSEC believed that assets should not be accounted for differently depending on whether an insurance enterprise has an interest in those assets through the general account or through the separate account (for example, fair value versus historical cost for real estate).

A.16 Many respondents to the exposure draft commented on the complex and burdensome task of maintaining detailed records of daily percentage ownership of bonds or stocks or other investments as required under the SOP. While AcSEC continued to believe that the guidance noted in paragraph 11 is appropriate, AcSEC considered these comments and decided to permit an insurance enterprise to account for its investment in a separate account as an investment in equity securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, when the insurance enterprise's proportionate interest represents less than 20 percent of the separate account and the underlying separate account investments are securities under Statement No. 115 or paragraph 46 of FASB Statement No. 60, as amended by FASB Statement No. 115, or cash and cash equivalents. AcSEC acknowledged that there should not be a difference between the aggregate fair value of the individual securities and a proportionate share of the fair value of the aggregate investments in the separate account. Therefore, in these limited situations, the cost appeared to outweigh the commensurate benefit of applying the proposed guidance.

A.17 AcSEC also acknowledged that under this alternative an insurance enterprise should perform an impairment test on the value of the interest in the separate account (or individual subaccounts, as applicable). AcSEC believes it would not be appropriate to allow this alternative for circumstances where the underlying separate account investments are other than securities under FASB Statement No. 115 or paragraph 46 of FASB Statement No. 60, as amended by FASB Statement No. 115, or cash and cash equivalents, such as mortgage loans or real estate, as the alternate method would result in different bases of accounting. AcSEC concluded that to apply the alternate method the underlying separate account investment related to the insurance company's proportionate interest should be classified as trading with changes flowing through the income statement, as classification as available for sale would defer the recognition of investment income.

A.18 Contract holders may have the right to continue to make deposits and direct transfers of their account balances, and new contract holders are permitted to invest in the various separate account arrangements. In those cases, the insurance enterprise is effectively holding for sale its proportionate interest in the separate account assets if those separate account arrangements would meet the criteria in paragraph 11 of this SOP. Consequently, the insurance enterprise should recognize an impairment loss on its proportionate interest in the assets of a separate account arrangement meeting the criteria in paragraph 11 in a situation where the current fair value of the insurance enterprise's proportionate interest in the separate account assets is less than its carrying amount.

Transfers to Separate Accounts

A.19 AcSEC concluded that transfers of assets to separate accounts should be recognized at fair value to the extent of third-party contract holders' interests in the separate account if the separate account arrangement meets the criteria in paragraph 11 of this SOP, with any resulting gains or losses recognized immediately in earnings of the insurance enterprise. Gain or loss recognition is appropriate in such cases because the contract holders are unrelated third parties to whom subsequent risks and rewards of ownership of a portion of the asset have been transferred, and the assets will subsequently be carried at fair value with changes reported in earnings (offset by changes in contract holder liabilities). Furthermore, although the insurance enterprise holds legal title to assets in separate account arrangements, the contract holders will be entitled to receive the investment performance of the assets after the transfer. This treatment is consistent with the presentation of separate account assets as summary totals in the statement of financial position, because the risks and rewards of ownership of the assets reside with the contract holders rather than the insurance enterprise that has legal ownership of the assets. If the insurance enterprise guarantees the asset's value or minimum rate of return or commits to repurchase the asset, the risks of ownership have not been transferred, and no gain should be recognized. However, loss recognition is still appropriate as noted in paragraph A.18 of this

SOP. AcSEC concluded that in the limited circumstances where the alternate method, as described in paragraph 18 of this SOP, is applied, 100 percent of any gain on transfers of assets to separate accounts should be recognized as the underlying investments are designated as trading. AcSEC had already concluded that all losses were required to be recognized for transfers of assets to separate accounts.

A.20 For separate account arrangements for which the insurance enterprise is actively marketing units and hold real estate, AcSEC concluded that, in cases in which the held for sale criteria for real estate are not met, the impairment test should be performed solely using cash flows from ultimate disposition. Cash flows related to the use of the asset during the period preceding ultimate disposition should be zero because the enterprise does not have control over the dilution of its interest.

Valuation of Liabilities

A.21 *Account balance*. Paragraph 17(a) 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*, does not explicitly define "the balance that accrues to the benefit of policyholders at the date of the financial statements," which is commonly referred to as the "account balance." FASB Statement No. 97, paragraph 18, provides that the account balance is an amount that should not be reduced for "amounts that may be assessed against policyholders in future periods, including surrender charges...."

A.22 AcSEC also noted that FASB Statement No. 97 defines contract holder balance indirectly through the following:

> Premium payments are credited to the policyholder balance, against which amounts are assessed for contract services and to which amounts are credited as income. The policyholder balance provides a base upon which interest accrues to the policyholder and, when compared with the death benefit amount, fixes the insurer's net amount at risk. [paragraph 45]

> ...the balance that accrues to the benefit of individual policyholders represents the minimum measure of an insurance enterprise's liability.... For many universal life-type contracts, this amount takes the form of an account balance that, absent future action by the policyholder, will continue to fund operation of the contract until exhausted or reduced to a contract minimum. The insurer has a present obligation, arising from past transactions, to continue to maintain the contract and provide mortality protection as long as an adequate account balance exists. Other universal life-type contracts do not have an explicit policyholder account but do have a policyholder balance to which interest is accrued at a variable rate. In either case, future events and transactions will change the amount of the enterprise's obligation as policyholders make additional premium deposits and realize contract benefits. The present obligation, however, is fixed by the amount that has accrued to the benefit of the policyholder. [paragraph 53]

Recent product innovation and the lack of explicit guidance has led to diversity in the application of the definition of account balance. AcSEC therefore believes that interpretive guidance is needed for determining the balance that accrues to the benefit of the policyholder at the date of the financial statements.

A.23 AcSEC concluded that all surrender charges or credits should be ignored in measuring the policyholder liability because, as noted in FASB Statement No. 97, paragraphs 18 and 53, the liability should be measured assuming no future action by the policyholder. FASB Statement No. 97 is a long-duration contract model that does not assume policyholders will surrender at the balance sheet date but rather amortizes deferred acquisition costs over the expected life of the contract. Additionally, the FASB Statement No. 60, as amended, and FASB Statement No. 97 accounting models do not require that the contract holder liability, net of unamortized acquisition costs, equal or exceed the cash surrender value of the contract. AcSEC considered whether the presence of an additional amount due on surrender but not due upon maturity, such as a market value annuity adjustment, should result in the recognition of an additional liability. AcSEC concluded that recording an additional liability for surrender adjustments prior to the contract holder's elected surrender would be inconsistent with the long-duration model.

A.24 AcSEC concluded that, in accordance with FASB Statement No. 97, it is appropriate to accrue to the amount that the contract holder could receive in cash or its equivalent, before reduction for future fees and charges, at the earlier of the date that the rate credited to the contract is reset or contractual maturity. That conclusion is consistent with the long-duration model, which does not permit the anticipation of surrenders and also with the accounting for debt instruments, under which interest is accrued to maturity using the interest method. Accrual of interest at an effective interest rate is consistent with existing accounting for debt instruments with fixed nonlevel interest payments. A delay in crediting to the contract holder account balance an amount that is to be credited in the future should not prevent the accrual of the amount ratably over the period the contract holder earns the amount.

A.25 AcSEC believes that a contract in which the amount due at maturity is based on a referenced pool of assets is similar to indexed debt, which prior to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, was accounted for in accordance with Emerging Issues Task Force (EITF) Issue No. 86-28, *Accounting Implications of Indexed Debt Instruments*. EITF Issue No. 86-28 provides the following accounting guidance:

> ... as the applicable index increases such that the issuer would be required to pay the investor a contingent payment at maturity, the issuer should recognize a liability for the amount that the contingent payment exceeds the amount, if any, originally attributed to the contingent payment feature. The liability for the contingent payment feature should be based on the applicable index value at the balance sheet date and should not anticipate any future changes in the index value. When no proceeds are originally allocated to the contingent payment, the additional liability resulting from the fluctuating index value should be accounted for as an adjustment of the carrying amount of the debt obligation.

Therefore, AcSEC concluded that, to the extent such contracts are not accounted for under the provisions of FASB Statement No. 133, the balance that accrues to the benefit of the contract holder should be based on the fair value of the referenced pool of assets because the change in the fair value of the referenced pool of assets represents the change in the account balance. To the extent the amount credited does not equal the change in fair value of the referenced pool of assets, an adjustment as described in paragraph 20(e) of this SOP would be required. Many respondents to the exposure draft commented that this guidance would result in misleading volatility and a mismatch in the financial statements when the referenced assets are not also recorded at fair value. AcSEC reaffirmed the liability model in this SOP and noted that changing the valuation of investments was not within the scope of this project.

Contracts With Death or Other Insurance Benefit Features

A.26 *Determination of applicable accounting standard.* AcSEC decided the FASB Statement No. 97 universal life model should apply to insurance benefit features only if (*a*) the fees assessed or the benefits provided are not fixed and guaranteed, and (*b*) the mortality and morbidity risks are other than nominal. Those contracts having insurance benefit features where the fees assessed and the benefits provided are fixed and guaranteed should be accounted for under FASB Statement No. 60, as amended. Those insurance benefit features that do not pass the test of significance result in the contracts being classified as investment-type contracts under FASB Statement No. 97, and no additional liability for insurance benefits should be provided, other than a claim liability resulting from the occurrence of the insurance event.

A.27 *Determining the significance of mortality and morbidity risk*. AcSEC considered how the test of significance of mortality and morbidity risk should be applied to contracts with insurance benefit features. The significance test contained in paragraph 8 of FASB Statement No. 97 is based on the present value of the expected life contingent payments relative to the present value of all expected payments. AcSEC considered whether that test should be modified for insurance benefit features offered with annuity contracts. The test was written for payout annuities for which the entire deposit may be subject to mortality risk. For accumulation-phase annuity contracts containing insurance benefit features, the contract has a deposit element, which under all circumstances the contract holder will receive, and a mortality and morbidity element for payments in excess of the deposit element. AcSEC decided that because the timing and nature of benefit payments are different between payout annuities and an accumulation-phase annuity with a minimum guaranteed death benefit (MGDB) or other insurance benefit feature, the measurement of the significance of the mortality related payments needed to be modified. AcSEC believes a better method to determine significance for these contracts is to compare the present value of expected insurance benefit excess payments with the fee revenue or spreads the insurance enterprise will collect for accepting that and other risks.

A.28 AcSEC considered whether the test of significance should be performed only at the inception of the contract or throughout the life of the contract. It was noted that performing the test throughout the life of the contract could result in situations where contracts would switch from one accounting model to another and potentially back again as the estimate of expected benefit costs changed. AcSEC decided to require the test of significance to be performed only at the inception of the contract or reinsurance contract, noting that it is consistent with current practice for applying the test for classifying payout annuities under FASB Statement No. 97. Similarly, the comparison of the timing of expected assessments and related benefits for determining whether the amounts assessed against the contract holder each period for the insurance benefit feature are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function would occur at inception only, as well. As discussed in the transition section of this SOP, an exception is made for contracts in force at the date of transition for which the test of significance would be performed as of transition.

A.29 For certain contracts with insurance benefit features, such as MGDBs offered with variable annuities, the expected benefit costs or the expected revenue vary with market elements such as interest rates or the performance of an underlying pool of equities. AcSEC considered whether to require expected benefit costs and expected revenue to be determined based on a single set of assumptions or a range of results. AcSEC decided that the test of significance should be based on models that use more than a single set of assumptions, because that approach would better reflect the effect of market elements on both expected benefit costs and expected revenue. This approach is consistent with FASB Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which concludes that expected values are more useful for present value calculations, and is further supported by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, which states that when evaluating the possibility of the reinsurer incurring a loss, reasonably possible scenarios should be considered. Because the test of significance requires consideration of a range of scenarios and the market is inherently volatile, AcSEC concluded that there is a rebuttable presumption that a contract with an insurance benefit that varies significantly in response to capital market volatility has significant mortality risk.

A.30 *Establishment of an additional liability.* AcSEC considered whether, under the universal life model of FASB Statement No. 97, a separate liability in addition to the account balance should be recognized. AcSEC noted that FASB Statement No. 97, paragraph 17, states:

> The liability for policy benefits for universal life-type contracts shall be equal to the sum of:
>
> a. The balance that accrues to the benefit of policyholders at the date of the financial statements

b. Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (paragraph 20)

c. Any amounts previously assessed against policyholders that are refundable on termination of the contract

d. Any probable loss (premium deficiency) as described in paragraphs 35-37 of Statement No. 60. [Footnote omitted]

A.31 AcSEC noted that the universal life model under FASB Statement No. 97 requires additional liabilities for revenue assessed for services to be performed in future periods and any probable future loss (premium deficiency). In studying the attributes of contracts with insurance benefit features, AcSEC observed that, in some contracts, periodic charges are not assessed in proportion to the risk associated with these benefit features. For example, charges may be assessed for a ratchet MGDB offered with variable annuities based on a percentage of the account balance. In such an MGDB design, as the account balance and assessments increase, the likelihood of a death benefit payment in excess of the account balance decreases. AcSEC noted that FASB Statement No. 97, paragraph 61, states, "An amount assessed might be considered unearned, for example, if it is assessed only in certain contract periods or in a manner that is expected to result in current profits and future losses from a specific contract function." AcSEC concluded that, for contracts where amounts are assessed in a manner that is expected to result in current profits and future losses from the insurance benefit function, a liability should be established in addition to the account balance. This conclusion is also appropriate when considering the reinsurer that assumes, under a long-duration contract, the MGDB risk for a level basis point charge but does not assume the account balance. Without this conclusion, the reinsurer would be recognizing revenue without the related expected benefit cost.

A.32 AcSEC also considered, but rejected, the view that an additional liability for expected losses on insurance benefit payments would only be established if all the margins of the product combined to create a premium deficiency. The premium deficiency concept would in most cases result in no additional liability being established and all amounts assessed during the period being recognized in income even for assessments that are clearly not proportionate to the risk borne by the insurance enterprise for the period. AcSEC rejected that view because such disproportionate assessments are made in part to compensate the insurance enterprise for the risk it assumes in future periods.

A.33 In calculating the liability for the insurance benefit feature, AcSEC decided it is appropriate to use assumptions, such as the interest rate, lapse rate, and mortality, consistent with those used in estimated gross profits and consequently the amortization of deferred acquisition costs. This approach is supported by paragraph 20 of FASB Statement No. 97.

A.34 Due to multiple contractual designs, some of which may include no explicit fee for the insurance benefit feature, AcSEC concluded that the liability in addition to the account balance should be based on total assessments, including investment spread, to eliminate different design features receiving different accounting treatment. This approach implicitly assumes that the assessment each period for the insurance benefit feature is a level amount of the total basis point charge. AcSEC noted that this approach is relatively easy to apply for all contracts even if there is not a separate explicit charge in the contract for the insurance benefit feature. If there is a separate explicit charge for the insurance benefit feature, AcSEC believes it is appropriate to determine the liability using total assessments because it will result in more consistent application of the methodology. In situations where expenses included in estimated gross profits are proportionate to assessments, AcSEC understands that the use of estimated gross profits instead of assessments for purposes of determining the benefit ratio may produce consistent results.

A.35 The additional liability is in substance an FASB Statement No. 60 policyholder benefit liability, but with the unlocking of assumptions each period as required under FASB Statement No. 97 to recognize the variability of the insurance benefit payments and contract assessments. That is, the FASB Statement No. 60 policy benefits liability is calculated as the present value of future expected benefits and related expenses minus the present value of future net premiums. In substance, the FASB Statement No. 60 approach is a type of unearned revenue model, although the policyholder benefit liability does not include a profit margin, in that it provides for the addition to the policyholder benefit reserve each period of a constant percentage of gross premium. AcSEC considered whether the additional liability should be reflected as unearned premium. The concept of unearned revenue includes an element of profit margin, other than in an FASB Statement No. 60 policyholder benefit liability. Allocation of profit to specific contract features such as an MGDB would require allocation of costs across all product features. Such analysis would require further actuarial modeling of costs for other product features considering a range of assumptions, which would add substantial effort to the determination of the MGDB liability. Such analysis to ascertain a profit margin for each benefit feature reconciling to the total profit margin for the contract introduces further subjectivity into the liability determination. The additional liability required in this SOP is based on the relationship of total expected benefits and related expenses to total expected revenue and thus is consistent with the FASB Statement No. 60 policyholder benefit liability with the unlocking of assumptions each period to be consistent with FASB Statement No. 97. Therefore AcSEC concluded that, because profit margin was not being considered in the calculation, the best presentation of the liability would be as a policyholder benefit liability.

A.36 *Statement of operations presentation*. AcSEC considered whether changes in the liability for insurance benefit features offered with annuity contracts should be reflected in the statement of operations as an increase or decrease in revenue or expense. AcSEC concluded for the reasons mentioned in paragraph A35 of this SOP that the change in the liability should be reported as a benefit expense consistent with changes in policyholder benefit liabilities under FASB Statement No. 60.

A.37 *Accounting for contracts that provide only death or other insurance benefit features*. FASB Statement No. 113, paragraph 12, requires that, for long-duration contracts, the reinsurance contract subjects the reinsurer to the "reasonable possibility that the reinsurer may realize significant loss from assuming insurance risk as that concept is contemplated in FASB Statement Nos. 60 and 97." Therefore, AcSEC concluded that the reinsurer should follow the same guidance as a direct writer when testing for significance of mortality and morbidity risk and when accounting for the insurance benefit feature.

Accounting for Contracts That Provide Annuitization Benefits

A.38 Certain variable annuities provide a guaranteed minimum amount available to annuitize after a specified period in addition to a guaranteed minimum annuity interest rate. Other contracts may provide a lower-tier crediting rate during the accumulation phase and a higher rate that is available only upon annuitization. There was diversity in practice with regard to the accounting for these and other annuitization options.

A.39 The conclusion in the exposure draft of the proposed SOP was that no liability should be recognized during the accumulation phase of a contract for the potential effect of annuitization options. This view was based on AcSEC's initial interpretation of FASB Statement No. 97, paragraph 7, which states in part that "a contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms." AcSEC had initially concluded that those words precluded accounting recognition of an annuitization option before the option is exercised. However after further discussion, AcSEC concluded that the language in paragraph 7 could be interpreted to apply only to testing for the presence of mortality risk, and not to preclude recognition of a liability. Supporters of this latter view note that FASB Statement No. 97 states in paragraph 40 that "the risk that the guaranteed price of an annuity may prove to be unfavorable to the guaranteeing enterprise when the annuity is purchased is a price risk not unlike a guaranteed price of any commodity and does not create a *mortality risk* [*emphasis added*]." Supporters of accruing an additional liability believe that, although that guidance prohibits accounting for the contract as if the payout phase were elected and mortality risk existed, it acknowledges the existence of price risk inherent in the annuitization option, thereby allowing for the recognition of the effect of significant annuitization options in the accumulation phase.

A.40 A majority of respondents to the exposure draft of the proposed SOP noted that the exposure draft's initial conclusion to not accrue the costs related to annuitization options would, in many instances, result in an accounting treatment that does not appropriately reflect the economics of the product. Some noted that the financial statement result could be recognition of earnings during the accumulation phase followed by losses during the annuitization phase of the contract. Respondents noted that establishing a liability for these features would be consistent with fundamental generally accepted accounting principles concepts, including the definition of a liability, unearned income, and loss recognition. AcSEC redeliberated the issue and ultimately concluded that the guidance in paragraph 7 of FASB Statement No. 97 should, therefore, be interpreted to require the recognition of a liability related to any such options that are other than nominal, reversing the conclusion reached in the exposure draft of the proposed SOP. AcSEC members believe that recording a liability during the accumulation phase of a contract for expected annuitization benefits would better reflect the economics of the contract. Some amount of revenue or fees was explicitly, or in some cases implicitly, being charged for this additional contract feature; therefore, the cost of providing the potential future benefits should also be recognized in the accumulation phase. Such additional benefits can be clearly and materially favorable to the contract holder and thus represent a loss contingency that is both probable and reasonably estimable. The obligation to provide a service/benefit under an annuitization guarantee also meets the definition of a liability under FASB Concepts Statement No. 6, *Elements of Financial Statements*.

A.41 AcSEC noted that annuitization benefits are similar in many respects to MGDBs in that they provide an additional benefit beyond the account balance. For example, both the MGDB and guaranteed minimum income benefit (GMIB) features represent a minimum guaranteed amount on a variable account balance, with the principal difference being that one is promised upon death, the other upon annuitization. Based on this similarity to MGDB, AcSEC concluded that the MGDB model should be used to accrue an additional liability for GMIB if, at the expected annuitization date, the present value of expected annuitization payments exceeds the expected accrued account balance. In addition, AcSEC noted that if an insurance enterprise has reinsured the GMIB risk, in many instances the reinsurance contract results in a derivative recognized as an asset on the statement of financial condition. If the GMIB liability was not recognized, stockholders' equity would be increased, when in fact that asset is substantially offset by an unrecorded liability. However, AcSEC observed that the GMIB liability recognized under the guidance in this SOP will not be measured at fair value and therefore would not necessarily offset the reinsurance asset.

A.42 In reaching a conclusion relative to accounting for annuitization option benefits, AcSEC considered several alternative models, including the loan commitment and written option models. AcSEC's consideration of those models is discussed in the following paragraphs of this SOP.

A.43 *Consideration of the loan commitment model.* AcSEC considered an analogy between annuitization options provided to contract holders and loan commitments offered to borrowers, the accounting for which is prescribed by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which effectively defers revenue recognition until the economic sacrifice has occurred. FASB Statement No. 91 states in paragraph 8 that "fees received for a commitment to originate or purchase a loan or group of loans shall be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield...." Under this analogy, all fees related to an annuitization option should be deferred until the contract holder selects an annuity option; the fees would then be recognized over the payout phase of the annuity or, if annuitization was not elected, recognized in income at the date the contract is surrendered.

A.44 AcSEC believes that problems would arise in applying the loan commitment model to annuity contracts. First, it would be difficult to reasonably determine which fees should be deferred within a fee-based product as the fees related to the annuitization guarantee often are not stated explicitly, or even if stated explicitly, may have been priced on an integrated basis with other revenue components within the contract rather than on a stand-alone basis. Also, it is unclear how to apply this model to products where the insurance enterprise derives its income from investment spreads and thus the contracts have no explicit fee of any kind to defer.

A.45 In addition, AcSEC noted that there are differences between annuitization options and loan commitments. Annuitization options are of a long-term nature (for example, the contract holder may have until age 65, 80, or 90 to annuitize), whereas a loan commitment is generally for a much shorter period. Also, in deciding whether or not to annuitize, there are additional economic factors that contract holders must consider, such as alternative investment options, cash flow considerations, their tax situations, and needs of beneficiaries. Those factors are not relevant to the process of taking a loan, as the commitment is entered into with the intent to borrow and the principal decision is whether the loan terms are competitive. In view of the significant practical implications and many differences between annuitization options and loan commitments, AcSEC decided to reject the FASB Statement No. 91 approach in accounting for annuitization and similar elective benefits.

A.46 *Consideration of the written option model.* AcSEC also considered whether elective benefit options should be accounted for as written options by recording the fair value of the options both at inception and throughout the accumulation phase of the contract, with changes in fair value recognized in income. Supporters of this view believe that similar to the conclusion reached by AcSEC as noted in paragraph A37 of this SOP, the guidance in paragraph 7 of FASB Statement No. 97 should be interpreted to require the recognition of a liability related to any such options.

A.47 AcSEC also noted that under FASB Statement No. 133, reinsurance of a GMIB option typically would be accounted for as a derivative contract by both the direct writer of the deferred annuity contract with the GMIB feature (ceding company) and the reinsurer, as such reinsurance contracts are typically net settled. Also, although the FASB concluded that certain annuitization options such as GMIBs offered in direct annuity contracts typically are not net settled and therefore fall outside the scope of FASB Statement No. 133, some argue that there are other written options that fall outside the scope of FASB Statement No. 133 that nevertheless are required to be fair valued. For example, EITF Issue No. 99-2, *Accounting for Weather Derivatives*, requires fair value for certain written options even though they fall outside the scope of FASB Statement No. 133. However, those are examples of contracts falling outside of the scope of Statement No. 133 that represent written options in their entirety and not a component embedded in a contract.

A.48 It was also noted that following the approach of valuing all elective options at fair value would be a change in practice and would require insurance enterprises to determine the fair value of every available annuitization option. Traditional annuity purchase options may have little value, but it would be necessary to continuously determine their value. AcSEC also discussed the issues of the lack of a ready market to determine the fair value of the annuity options because each contract's features are unique by product as well as by insurance enterprise, and of the difficulty involved in splitting apart an integrated fee-based contract to determine applicable fees representing the implicit option premium received, adding to the practical problems of applying this approach.

Sales Inducements to Contract Holders

A.49 Sales inducements to contract holders typically can be characterized as one of the following types: immediate, persistency, and enhanced crediting rate. The actual structure of the inducement can take many forms. Economically, recovery of the costs associated with sales inducements is predicated on a future income stream of items such as fees charged against the assets, investment margins, surrender charges, cost of insurance charges, or reduction of other cost components. In some cases, insurance enterprises may accept lower margins on the product. Sales inducements may be part of an arrangement whereby the sales agent is willing to accept lower commissions, which may offset some or all of the associated cost. In some cases, inducement programs may be initiated to prevent recognition of more dramatic losses if the insurance enterprise is unable to retain contract holders (for example, the insurance enterprise may be required to sell investments at a loss to fund contract surrenders).

A.50 *Consideration of the debt model.* Asset accumulation products accounted for under FASB Statement No. 97 as investment products or universal life-type contracts are viewed as 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.

A.51 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." In connection with an immediate inducement, cash is given to the insurance company in exchange for a promise to pay back an amount in excess of the cash received. Persistency and enhanced inducements are also analogous to nonlevel interest on fixed income securities. FASB Statement No. 91 requires that fees or costs be recognized as yield adjustments over the life of the contract by the interest method of recognition for nonlevel interest. AcSEC concluded that sales inducements meeting the criteria in paragraph 37 of this SOP should result in an effective yield being recognized over the expected life of the contract, rather than expensing the persistency and enhanced interest rate inducements as amounts are credited to the contract holder. This treatment will result in recognition of the sales inducement as it is accrued or when it is credited to the account balance, whichever is earlier.

A.52 *Consideration of sales inducements as deferred acquisition costs*. AcSEC considered the arguments in favor of accounting for sales inducements as a deferred acquisition cost. Insurance companies price the products based on total cash inflows and outflows. Some argued that the form of the transaction that splits these outflows between agent and the customer should be of no consequence, and the substance of the transaction is that certain outflows are paid to induce the customer to acquire the product. AcSEC concluded that sales inducements do not meet the definition of a deferrable acquisition cost because they are benefits paid to contract holders, not payments to third parties.

A.53 *Criteria for capitalization*. AcSEC considered the criteria for determining when a sales inducement is in excess of normal crediting rates that would warrant capitalization. AcSEC believed it was necessary for an insurance enterprise to explicitly demonstrate that such amounts are (*a*) incremental to amounts the enterprise credits on similar contracts without sales inducements, and (*b*) higher than the contract's expected ongoing crediting rates for periods after the inducement; that is, the crediting rate excluding the inducement should be consistent with assumptions used in estimated gross profits, contract illustrations, and interest crediting strategies. These criteria are necessary to prevent capitalization of interest crediting amounts that are current period benefit expenses.

A.54 AcSEC believes that in determining whether an enhanced crediting rate is incremental to amounts the enterprise credits on similar contracts, an insurance enterprise should compare the enhanced crediting rate with the current rate offered on a similar product sold without a sales inducement, if available. In cases where a similar product is not actively marketed and sold without the enhanced crediting rate, AcSEC believes the enterprise should demonstrate that the enhanced crediting rate is incremental to the effective crediting rate on the enterprise's other product(s) that have common characteristics and substance. For example, variable annuities may offer a fixed return over a six-month period until the funds are transferred into equity funds (dollar cost averaging options). The fixed return is often in excess of the interest rate credited on other variable annuity general account fixed income investment alternatives of similar duration that are actively marketed and sold by the enterprise. The excess interest rate would meet the criterion in paragraph 37 of this SOP of "incremental to amounts the enterprise credits on similar contracts without sales inducements."

A.55 Normally day-one and persistency bonuses would meet the criteria in paragraph 37 of this SOP, because crediting occurs on a specific date and thus the bonus would be incremental to other similar contracts with a different anniversary.

A.56 *Consideration of expensing sales inducements in the period credited.* AcSEC also considered and rejected the view that benefits payable to contract holders should be charged to benefit expense in the period credited to the contract holder consistent with other benefit payments. Under this method, AcSEC noted that sales inducements would be recorded as a liability to the customer at the time they meet the definition of a liability, with an immediate charge to expense as a benefit cost.

A.57 AcSEC recognized the long-duration nature of the contracts as defined in FASB Statements No. 60 and No. 97 and was concerned that expensing sales inducements in the period credited could lead to different accounting for contracts that are economically similar. AcSEC noted that contract wording could easily be changed to obtain different accounting treatments. For example, contracts with identical economic benefits to the contract holder could be designed, one with an immediate bonus with a surrender charge expiring after five years and one with a persistency bonus credited at the end of five years. Expensing sales inducements in the period credited would result in very different accounting results even though the contracts were identical economically and would result in loss at inception on the contract that offered an immediate sales inducement. Another contract with a persistency bonus would give the contract holder the same cash in the future and not have a loss at inception. Based on those concerns, AcSEC rejected the concept of expensing sales inducements in the period credited and concluded to expense sales inducements over the period that the long-duration contract is in force.

A.58 *Amortization of deferred sales inducements.* For contracts accounted for under FASB Statement No. 97, the asset arising from sales inducements should be amortized using methodology and assumptions consistent with those used for deferred acquisition costs under FASB Statement No. 97, which is effectively the expected life of the accumulation phase of the contract. Because FASB Statement No. 97 requires that the annuitization phase be viewed as a separate contract, the annuitization phase should not be combined with the accumulation phase. AICPA Practice Bulletin 8, *Application of FASB Statement No. 97,* Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, *to Insurance Enterprises*, states:

> 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 revenue from sources other than the investment of contract holders' funds. This method matches amortization of deferred policy acquisition costs (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).

This guidance is provided for the amortization of deferred acquisition costs, which in this context is similar to debt issuance costs.

A.59 AcSEC considered, but rejected, the view that a qualifying sales inducement should be amortized over the shorter of the expected life of the contract or the period during which the sales inducement is effectively operating to incent persistency. As the recovery of sales inducements is through future income streams [such as fees charged against the assets, investment margins, cost of insurance charges, reduction of other cost components (such as commissions), or surrender charges] during the expected contract life, AcSEC concluded that qualifying sales inducements should be amortized over the expected life of the contract. In addition, amortization of deferred sales inducements will include an expected lapse assumption that is updated each period.

Disclosures

A.60 AcSEC concluded that it is important to provide details of the investments of variable separate accounts with guarantees because this provides information on a significant asset for many insurance enterprises. In addition, the nature of the guarantee is affected by the nature of the investments in the separate account. Some respondents to the exposure draft recommended that gains and losses on assets transferred to a separate account also should be disclosed. AcSEC agreed that this would be useful information to readers of financial statements, and, therefore, required differentiation of gains and losses that were generated from the insurance enterprise's general account investments.

A.61 Several respondents to the exposure draft of the proposed SOP suggested that the required disclosures should also include the significant assumptions used to estimate liabilities for additional insurance benefits and minimum guarantees. AcSEC agreed that this information would help improve transparency and comparability of financial statements, and concluded that the significant assumptions should be required disclosures. AcSEC concluded that the detail and amount of the separate account liability balances subject to various types of guarantees would be useful information to readers of financial statements and promote comparability. AcSEC also concluded that it is important to disclose the net amount at risk by type of guarantee because this provides readers of financial statements with the maximum amounts the insurance enterprise is at risk for guaranteeing.

A.62 AcSEC discussed including sensitivity analysis related to significant assumptions used for liability balances related to minimum guarantees, and concluded that this information would be more appropriate in the management discussion and analysis section of an enterprise's public reporting.

Effective Date and Transition

A.63 AcSEC concluded that this SOP should be initially applied at the beginning of the fiscal year that begins after December 15, 2003, which should permit companies sufficient time to implement this SOP. AcSEC also concluded that it should allow companies the option of early adoption.

A.64 AcSEC concluded that the effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*) and that restatement of prior annual financial statements should be prohibited. AcSEC recognizes the benefits of comparable financial statements but believes that due to significant judgment and the possible use of hindsight in applying this SOP, and the significance of the efforts and costs likely to be incurred, retroactive restatement or pro forma disclosures in the year of adoption should not be required.

A.65 AcSEC considered allowing entities the choice, for certain provisions of this SOP, to reclassify previously reported financial statements provided there was no valuation basis adjustment affecting earnings, while prohibiting reclassification when the valuation provisions of this SOP would affect earnings. AcSEC concluded that the provisions of this SOP are not fundamentally different from the FASB Statement No. 97 model and that allowing entities the option of applying certain provisions and not others would result in inconsistent recognition of liabilities, revenue, and acquisition costs. AcSEC concluded that allowing restatement in certain circumstances and not allowing restatement in other circumstances is not appropriate. Therefore, AcSEC decided not to permit restatement.

A.66 AcSEC concluded that securities subject to FASB Statement No. 115 previously carried at fair value that are reclassified to the general account may be designated as held-to-maturity for debt securities, available-for-sale for debt and equity securities, or trading for debt and equity securities. AcSEC believed that prior to implementation of this SOP the assets were being accounted for under separate account valuation basis and, after reclassification to the general account per the guidance of this SOP, they are to be valued under general account guidance. Accordingly, AcSEC concluded this designation is similar to an enterprise initially adopting FASB Statement No. 115 for those securities. The guidance provided by AcSEC is consistent with that provided in FASB Statement No. 115 for its initial adoption.

A.67 AcSEC also concluded that debt or equity securities subject to FASB Statement No. 115, previously classified as part of a separate account but valued in accordance with paragraphs 45 through 51 of FASB Statement No. 60, as amended, should maintain the original designation as held-to-maturity, available-for-sale, or trading. That designation previously was made in accordance with FASB Statement No. 115 when the security was purchased and classified as a separate account asset. Although under this SOP the securities are now classified as part of the general account, the insurance enterprise has already assessed its intent under FASB Statement No. 115, which is not changed.

A.68 Any revaluation adjustment for the securities described in paragraph A.66 of this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle through net income or accumulated other comprehensive income, as appropriate. In its deliberations, AcSEC considered both the transfer and transition guidance provided in FASB Statement No. 115, paragraphs 15 and 25, related to reclassifications among categories. AcSEC believes that the transition requirements of FASB Statement No. 115 are consistent with AcSEC's decision not to permit restatement resulting from adoption of this SOP.

A.69 AcSEC concluded that, for debt or equity securities subject to FASB Statement No. 115 and classified as available-for-sale that are part of a contractually referenced pool of assets where a total return will be accrued to the account balance liability, and a transition adjustment for the liability valuation is reported in accordance with paragraph 41(e), the related debt or equity securities may be reclassified to trading upon initial adoption of the SOP. In this case, AcSEC believes the combined effect of the asset and liability transition adjustments should be reported in a manner similar to the cumulative effect of a change in accounting principle. An enterprise may not have designated a security as available-for-sale when it purchased the security if it had known a contract holder liability designed to mimic the return would be recorded based on the referenced asset in the statement of operations. In addition AcSEC noted that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, provides for similar transition treatment because the guidance for hedge accounting significantly changed. AcSEC also made the analogy to the transition guidance in EITF Issue No. 97-14, *Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested*.

A.70 The insurance enterprise's accounting policies with regard to assets other than those subject to FASB Statement No. 115 should be consistently applied upon reclassification of assets from separate accounts to the general account at the date of initial adoption of the SOP. AcSEC concluded that any revaluation adjustments related to assets other than those subject to FASB Statement No. 115 should be reported in a manner similar to the cumulative effect of a change in accounting principle.

A.71 AcSEC concluded that, because this SOP may change the way an insurance enterprise applies the mortality and morbidity significance test and that the results of that test may change the required liability valuation model, insurance enterprises should perform a new determination of significance of mortality and morbidity risk resulting from the insurance benefit features of the contract for purposes of contract classification at the date of initial adoption of this SOP. AcSEC considered requiring this determination to be made as of original contract issuance, but rejected that approach because it would not be practicable to obtain and document a range of reasonably possible cash flow outcomes as of those inception dates without the inappropriate use of hindsight. In addition to the burden of performing the test without original information, it would be difficult to verify the appropriateness of the outcomes. AcSEC also considered requiring the determination only for new contracts, but was concerned that would cause inconsistencies in the accounting for similar contracts of an enterprise for many years due to the long-duration nature of such contracts.

A.72 AcSEC considered whether to require restatement of contract holder liabilities as a result of adoption of this SOP, but concluded that restatement is not necessary and may not be possible to reconstruct. AcSEC concluded that any adjustment to contract holder liabilities from adoption of this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20, through net income or, for amounts previously reported under EITF Topic No. D-41, accumulated other comprehensive income.

A.73 AcSEC, in discussing sales inducements, recognized that some insurance enterprises charged those costs to expense as incurred. AcSEC believes that the costs of developing the information that would be necessary to determine the costs that would be capitalized if this SOP were applied retroactively would exceed the benefits retroactive application might offer and that such retroactive determination should not be made. AcSEC believes this treatment is consistent with transition rules of other accounting guidance, such as SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*.

A.74 AcSEC further concluded that the unamortized capitalized sales inducement balance at transition should not be adjusted, but the balance should be subject to the amortization provisions of this SOP on a prospective basis. Prospective treatment and prohibition on restating sales inducements capitalized is consistent with AcSEC's conclusions on restatement of previously expensed inducements. Identification and amortization of previously capitalized costs in accordance with the provisions of this SOP should result in an acceptable level of comparability and understandability.

APPENDIX B

Illustration for Presentation of an Insurance Enterprise's Interest in a Separate Account

B.1 The following example illustrates the presentation in the financial statements of an insurance enterprise's proportionate interest in separate accounts:

> An insurance enterprise has a separate account that consists of two subaccounts, Subaccount ABC and Subaccount XYZ. The insurance enterprise has a 10 percent interest in Subaccount XYZ, determined based on the fair value of Subaccount XYZ's investments. Subaccount XYZ has debt securities, mutual fund investments, mortgage loans, and real estate. Subaccount XYZ carries its investments at fair value; if the general account held these investments, they would be accounted for at amortized cost or fair value, depending on the applicable literature. Accounting for equity investments, including mutual funds, would depend on percentage ownership. If Subaccount XYZ owns more than 50 percent of the outstanding shares of a mutual fund, the accounting and classification of the items included in the column titled "Separate Account at General Account Value" would reflect consolidating the mutual fund into Subaccount XYZ. That is, if the mutual fund held debt and equity securities, those amounts would be included in the debt and equity securities lines of the table below.

The assets of Subaccount XYZ are composed of the following:

Investment	Separate Account at Fair Value	Separate Account at General Account Value[1]	Insurer's Interest	Proportionate Interest
Debt securities	400	400	10%	40
Equity securities	300	300	10%	30
Mortgage loans	250	200	10%	20
Real estate	130	100	10%	10
Total assets	$1,080	$1,000	10%	$100

Balances presented in the insurer's statement of financial condition would reflect:

Assets:	Debt securities[2]	40
	Equity securities[2,3]	30
	Mortgage loans	20
	Real estate	10
	Total investments	100
	Separate account—Assets	$972[4]
Liabilities:	Separate account—Liabilities	$972

The applicable disclosures for the insurer's proportionate interest in these specific assets would be included within the applicable disclosures for the general account invested assets.

1. Underlying investments valued in a manner similar to any other general account asset as prescribed in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended, paragraphs 45 through 51.
2. Debt and equity securities need to be designated as either trading or available-for-sale.
3. If Subaccount XYZ separate account held an investment in a mutual fund, a typical situation would be that the insurance enterprise's investment would represent less than a 20 percent ownership and the interest would be reported as an FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, equity security.
4. Separate account assets at fair value of $1,080 x 90% (contract holders' proportionate interest).

The XYZ separate account's balances for net investment income and gains and losses:

	XYZ Separate Account Total	Insurer's Interest	Apportioned Values	General Account Classification
Net investment income (NII)	65	10%	6.5	Revenue
Realized gains and losses	20	10%	2.0	Revenue
Unrealized gains and losses:				
Debt securities	8	10%	0.8	Revenue or OCI[5]
Equity securities	25	10%	2.5	Revenue or OCI[5]
Mortgage loans	5	10%	0.5	Not recognized[6]
Real estate	2	10%	0.2	Not recognized[6]
Total NII and gains and losses	$125		12.5	

Assume in the second year:

- Insurer interest is lowered to 5 percent on the last day of the first quarter.
- At the time of dilution:
  - Separate account at fair value was $ 1,090.
  - Separate account at general account value was $ 1,007.
- Fair value of each investment increases 1 percent.

5. Unrealized gains should be included in revenue or other comprehensive income (OCI) depending on security classification as trading or available-for-sale. Unrealized losses result in other than temporary impairments, as noted in paragraph 14(a) of this SOP, and should be recognized immediately.
6. Unrealized gains are not recognized. Cumulative unrealized losses may result in recognition of an other-than-temporary impairment.

End of first quarter:

Investment	Separate Account at Fair Value	Separate Account at General Account Value	Insurer's Interest	Proportionate Interest After Dilution
Debt securities	404	404	5%	20
Equity securities	303	303	5%	15
Mortgage loans	252	200	5%	10
Real estate	131	100	5%	5
Total assets	$1,090	$1,007		50

Balances presented in the insurer's statement of financial condition would reflect:

Assets:	Debt securities	20
	Equity securities	15
	Mortgage loans	10
	Real estate	5
	Total investments	50
	Separate account—Assets	$1,036[7]

The XYZ separate account's balances for net investment income and gains and losses for the quarter:

	XYZ Separate Account Total	Insurer's Interest	Apportioned Values
Net investment income	16.3	10%	1.6
Unrealized gains and losses:			
Debt securities	4.0	10%	0.4
Equity securities	3.0	10%	0.3
Mortgage loans	2.5	10%	0.3
Real estate	1.2	10%	0.1
Total NII and gains and losses	$27		2.7

7. $1,090 x 95%

The seed money change for the quarter would be accounted for as follows:

Amount due to proportionate interest in revenue	2.3
Gain recognition on dilution of interest	4.2[8]

8. Fair value of separate account less general account value of separate account multiplied by dilution, ($1,090–$1,007) x 5%. This is the gain on mortgage loans and real estate, assuming debt and equity securities have been classified as trading. If debt and equity securities had been classified as available for sale, the gain or loss on dilution would also be calculated using amortized cost of debt and equity securities.

APPENDIX C

Sample Disclosures

C.1 This appendix provides an illustration of the financial statement disclosure requirements relating to paragraph 38 of this Statement of Position (SOP). Entities are not required to display the disclosure information contained herein in the specific manner illustrated. Alternative ways of disclosing the information are permissible provided that the disclosure requirements of this SOP, as described in paragraph 38, are met, such as showing account balances of contracts with guarantees by type of benefit.

> The company issues variable contracts through its separate accounts for which investment income and investment gains and losses accrue directly to, and investment risk is borne by, the contract holder (traditional variable annuities). The company also issues variable annuity and life contracts through separate accounts where the company contractually guarantees to the contract holder (variable contracts with guarantees) either (*a*) return of no less than total deposits made to the contract less any partial withdrawals, (*b*) total deposits made to the contract less any partial withdrawals plus a minimum return, or (*c*) the highest contract value on a specified anniversary date minus any withdrawals following the contract anniversary. These guarantees include benefits that are payable in the event of death, annuitization, or at specified dates during the accumulation period. During 20X1 and 20X2 there were no gains or losses on transfers of assets from the general account to the separate account.
>
> The assets supporting the variable portion of both traditional variable annuities and variable contracts with guarantees are carried at fair value and reported as summary total separate account assets with an equivalent summary total reported for liabilities. Amounts assessed against the contract holders for mortality, administrative, and other services are included in revenue and changes in liabilities for minimum guarantees are included in policyholder benefits in the Statement of Operations. Separate account net in-

vestment income, net investment gains and losses, and the related liability changes are offset within the same line item in the Statement of Operations.

At December 31, 20X1 and 20X2, the company had the following variable contracts with guarantees. (Note that the company's variable contracts with guarantees may offer more than one type of guarantee in each contract; therefore, the amounts listed are not mutually exclusive.) For guarantees of amounts in the event of death, the net amount at risk is defined as the current guaranteed minimum death benefit in excess of the current account balance at the balance sheet date. For guarantees of amounts at annuitization, the net amount at risk is defined as the present value of the minimum guaranteed annuity payments available to the contract holder determined in accordance with the terms of the contract in excess of the current account balance. For guarantees of accumulation balances, the net amount at risk is defined as the guaranteed minimum accumulation balance minus the current account balance.

	December 31	
	20X1	20X2
Return of net deposits		
In the event of death		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Average attained age of contract holders	xx	xx
At annuitization		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Weighted average period remaining until expected annuitization	xx	xx
Accumulation at specified date		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Return of net deposits plus a minimum return		
In the event of death		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Average attained age of contract holders	xx	xx
Range of guaranteed minimum return rates	x–x%	x–x%
At annuitization		
Account value	$xxx	$xxx

Net amount at risk	$xxx	$xxx
Weighted average period remaining until expected annuitization	xx	xx
Range of guaranteed minimum return rates	x–x%	x–x%
Accumulation at specified date		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Range of guaranteed minimum return rates	x–x%	x–x%
Highest specified anniversary account value minus withdrawals post anniversary		
In the event of death		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Average attained age of contract holders	xx	xx
At annuitization		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Weighted average period remaining until expected annuitization	xx	xx
Accumulation at specified date		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx

Account balances of contracts with guarantees were invested in variable separate accounts as follows:

Asset Type	December 31, 20X1	December 31, 20X2
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$	$
Obligations of states of the United States and political subdivisions of the states		
Corporate debt securities:		
—Investment grade		
—Noninvestment grade		
Foreign debt securities		
Mortgage-backed securities		

Equity securities (including mutual funds)[1]		
Real estate		
Mortgage loans		
Derivative financial instruments		
Cash and cash equivalents		
Total	$X,XXX,XXX	$X,XXX,XXX

The following summarizes the liabilities for guarantees on variable contracts reflected in the general account:

	Minimum Guaranteed Death Benefit (MGDB)	**Guaranteed Minimum Accumulation Benefit (GMAB)**	**Guaranteed Minimum Income Benefit (GMIB)**	**Totals**
Balance at January 1	$X,XXX,XXX	$X,XXX,XXX	$X,XXX,XXX	$X,XXX,XXX
Incurred guarantee benefits[2]	X,XXX,XXX	X,XXX,XXX	X,XXX,XXX	$X,XXX,XXX
Paid guarantee benefits	X,XXX,XXX	X,XXX,XXX	X,XXX,XXX	$X,XXX,XXX
Balance at December 31, 20X2	$X,XXX,XXX	$X,XXX,XXX	$X,XXX,XXX	$X,XXX,XXX

The MGDB liability is determined each period end by estimating the expected value of death benefits in excess of the projected account balance and recognizing the excess ratably over the accumulation period based on total expected assessments. The Company regularly evaluates estimates used and adjusts the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. [*Include discussion of change in estimate if material.*]

1. The insurance enterprise may want to consider disclosing mutual funds by investment objective or other meaningful groupings that are useful in understanding the nature of the guarantee risk.
2. For guaranteed minimum accumulation benefits, incurred guarantee benefits incorporates all changes in fair value other than amounts resulting from paid guarantee benefits.

The following assumptions and methodology were used to determine the MGDB liability at December 31, 20X2:

- Data used was 1,000 stochastically generated investment performance scenarios.
- Mean investment performance assumption was XX.
- Volatility assumption was XX.
- Mortality was assumed to be 90 percent of the Annuity 2000 table.
- Lapse rates vary by contract type and duration and range from 1 percent to 20 percent, with an average of 3 percent.
- Discount rate was XX%.

Guaranteed minimum accumulation benefits are considered to be derivatives under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and are recognized at fair value through earnings.

The guaranteed minimum income benefit (GMIB) liability is determined each period end by estimating the expected value of the annuitization benefits in excess of the projected account balance at the date of annuitization and recognizing the excess ratably over the accumulation period based on total expected assessments. The Company regularly evaluates estimates used and adjusts the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. [*Include discussion of change in estimate if material.*] The assumptions used for calculating the GMIB liability at December 31, 20X2, are consistent with those used for calculating the MGDB liability. In addition, the calculation of the GMIB liability assumes X percent of the potential annuitizations that would be beneficial to the contract holder will be elected.

APPENDIX D

Application of Statement of Position—Product and Product Feature Examples

Market Value Annuity

D.1 A market value annuity (MVA) provides for a return of principal plus a fixed rate of return if held to maturity (referred to herein as book value), or, alternatively, a "market adjusted value" if surrendered prior to maturity. The product is also sometimes referred to as a "market value adjusted annuity" or "modified guaranteed annuity." The product typically provides for a single premium that may be invested for a specified term, with typical terms of 1 to 10 years. A fixed interest rate is specified in the contract based upon the term selected. The contract contains surrender values that are based upon a market value adjustment formula if held for shorter periods. The formula typically is based on current crediting rates being offered for new MVA purchases with terms equal to the remaining term to maturity. The market value adjustment may be positive or negative, depending on crediting rates at surrender.

D.2 Because the insurance enterprise provides a fixed return for a specified period, market value adjusted annuities written through a separate account do not meet the criteria in paragraph 11(d) of this Statement of Position (SOP). Under paragraph 11(d) of this SOP, all investment performance, net of contract fees, must be required to be passed through to the contract holder to qualify for separate account treatment. Therefore, the assets and liabilities related to market value adjusted annuities should be accounted for and reported as general account assets and liabilities.

D.3 Under the model, described in paragraphs 20 through 23 of this SOP, the liability to be held for market value adjusted annuities is the accrued account balance using the contractually specified rate. The market value adjusted amount generally is available at surrender only and is not available at contract maturity; therefore, the market value adjustment is considered a surrender charge or credit.

Two-Tier Annuity

D.4 A two-tier annuity has two crediting rates applied to funds deposited into the contract. One rate is used to calculate the account balance if the contract holder elects to surrender the contract for cash, and is referred to as the "lower tier." A second rate, typically higher, is used to calculate the account balance, but only if the contract holder elects to annuitize the contract, and is referred to as the "upper tier."

D.5 This SOP requires that the accrued account balance during the accumulation phase be calculated using the lower-tier rate because the account balance accumulated at the lower tier is the amount that would be available in cash at maturity if the contract holder elects not to annuitize the contract. An additional liability determined in accordance with paragraphs 31 through 33 of this SOP should be recognized during the accumulation phase for the annuitization benefit in excess of the accrued account balance. When there is an additional liability for the annuitization benefit and a contract holder elects to annuitize, the present value of annuitization payments, including related incremental claims adjustment expenses, discounted at expected investment yields would represent the single premium used to "purchase" the annuitization benefit.

Variable Annuity With Guaranteed Minimum Accumulation Benefit

D.6 Some deferred annuities provide a minimum accumulation benefit or a guaranteed account value floor that is available to the contract holder in cash. These benefits are often referred to as guaranteed minimum accumulation benefits, or GMABs.

D.7 *Example:* Contract holder deposits $100,000 in a deferred variable annuity that provides for a GMAB that guarantees that at a specified anniversary date (for example, five years), the contract holder's account balance will be the greater of (*a*) the account value, as determined by the separate account assets, or (*b*) deposits less partial withdrawals accumulated at 3 percent interest compounded annually. At the specified anniversary date the contract holder's account balance has declined to $80,000 due to stock market declines. The guaranteed minimum value of the $100,000 deposit compounded annually at 3 percent interest is $115,930. The contract holder's account balance will be increased to the greater amount, resulting in an account balance of $115,930. Financial Accounting Standards Board (FASB) Derivative Implementation Issue B8, *Identification of the Host Contract in a Nontraditional Variable Annuity Contract*, specifies that a GMAB is an embedded derivative subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The remaining part of the hybrid contract should be accounted for separately.

Variable Annuity With Guaranteed Minimum Income Benefit

D.8 Some deferred variable annuities guarantee that, regardless of separate account investment performance, the contract holder will be able to annuitize after a specified date and receive a defined minimum periodic benefit. These benefits are available only if the contract holder elects to annuitize and are often referred to as guaranteed minimum income benefits, or GMIBs.

D.9 *Example:* A contract holder deposits $100,000 in a deferred variable annuity that provides a GMIB. The GMIB contract specifies that if the contract holder elects to annuitize, the amount available to annuitize will be the higher of the then account balance or the sum of deposits less withdrawals. The contract holder directs the deposit to equity-based funds within the separate account. At the date that the contract holder chooses to annuitize, the account balance has declined to $80,000 due to stock market declines. The contract holder elects a 20-year period-certain fixed payout annuity, payable monthly in arrears. Using the $100,000 guaranteed minimum account value at the date of annuitization and a guaranteed 3 percent crediting rate, the fixed monthly periodic annuity payment is $554.

D.10 During the accumulation phase, if the GMIB feature is not accounted for under the provisions of FASB Statement No. 133, an additional liability should be established if the present value of expected annuitization payments at the annuitization date exceeds the expected account balance at the expected annuitization date. That additional liability should be determined in accordance with paragraphs 31 through 33 of this SOP. When there is an additional liability for the annuitization benefit and a contract holder elects to annuitize, the present value of annuitization payments, including related claims adjustment expenses, discounted at expected investment yields would represent the single premium used to "purchase" the annuitization benefit.

D.11 FASB Derivative Implementation Issue B25, *Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period*, specifies that a GMIB does not meet the definition of an embedded derivative if it cannot be net settled. If the GMIB can be net settled, the guarantee is an embedded derivative in the accumulation period and should be accounted for under FASB Statement No. 133.

Variable Annuity and Life Insurance

D.12 Variable annuity and variable life insurance contracts provide the contract holder with a number of investment alternatives. Many of those investment alternatives will be separate account funds, such as equity, aggressive equity, high-grade corporate bond, mortgage loan, real estate and similar funds, that satisfy the criteria contained in paragraph 11 of this SOP. Other investment alternatives could include guaranteed investment and market value adjusted separate accounts as well as a general account fixed interest rate option.

D.13 *Example*: The contract holder deposits $100,000 in a deferred variable annuity that has no front-end load. The contract holder directs the allocation of the deposit to the following: aggressive growth equity fund, $25,000; high-yield corporate bond fund, $25,000; five-year guaranteed interest separate account, $25,000; and general account, $25,000.

D.14 Assets representing the contract holder's funds in the aggressive growth equity fund and high-yield corporate bond fund separate accounts satisfy all the criteria of paragraph 11 of this Statement of Position (SOP). The allocation to the guaranteed interest separate account does not satisfy the criterion in paragraph 11(d) of this SOP. Therefore, assets representing the contract holder's funds in the guaranteed interest separate account will be presented in the insurance enterprise's financial statements integrated with general account assets and liabilities. This reporting is appropriate even in those instances where the separate account arrangements with those contracts have been approved by regulatory authorities as separate account contracts. These contracts are often referred to as spread products, where the insurer bears the investment risk and its profits are derived primarily from the excess of investment performance over net amounts credited to the contract holder. Amounts related to this contract that are directed to the general account option will, of course, be shown within general account balances.

Group Participating Pension Contracts

D.15 Some 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*, contracts between insurance enterprises and pension plans have account balance crediting provisions that give the contract holder the total return based on a referenced pool of assets over the life of the contract either through crediting rates or termination adjustments. The ongoing crediting to the account balance may be based on statutory, cash basis, or book value returns. The contracts may not have a maturity date but specify that upon surrender any remaining return on the referenced pool of assets on the termination date not yet credited will be a termination adjustment. The referenced pool of assets may include mortgage loans, real estate, and equity and debt securities.

D.16 This SOP requires that, for contracts not accounted for under the provisions of FASB Statement No. 133, the liability for the contract holder account balance be based on the fair value of the referenced pool of assets without regard to the accounting under generally accepted accounting principles for the assets in the referenced pool of assets, with any change in the liability recognized through earnings.

Sales Inducements to Contract Holders

D.17 Sales inducements to contract holders typically can be characterized as one of the following types: immediate bonuses, persistency bonuses, and enhanced crediting rate bonuses.

D.18 In the case of the immediate bonus, the insurance company is obligated to credit to the contract holder's account the sales inducement as a result of signing the contract. The contract holder account balance is increased for the full amount of the immediate bonus on the date that the bonus is contractually granted. If the criteria in paragraph 37 of this SOP are met, an asset should be established for the same amount. Even if a company were to impose a prepayment penalty designed to recover the sales inducement, paragraph 18 of FASB Statement No. 97 specifies that amounts assessed against policyholders in future periods cannot be considered in determining the liability for policy benefits. The prepayment penalty for the sales inducement would be treated no differently than any other surrender charge.

D.19 A persistency bonus is credited to the contract holder account balance at the end of a specified period if the contract remains in force at that date. The amount that will be credited in accordance with the terms of the contract should be accrued as a component of the contract holder account balance ratably over the vesting period. If the criteria in paragraph 37 of this SOP are met, an asset should be established. While it may not become payable by the insurance company until some future vesting or crediting date, the insurance enterprise is prohibited by FASB Statement No. 97 from anticipating surrenders and must assume the contract holder will persist to earn the bonus.

D.20 In an enhanced crediting rate sales inducement, the insurance enterprise offers customers a crediting rate for a stated period in excess of that currently being offered by the company for other similar contracts. Pursuant to the contract, the enhanced crediting rate is applicable for a limited period of time, after which, the rate is "reset" under the contractual provisions, typically at the discretion of the insurance enterprise. The liability for an enhanced crediting rate sales inducement should be accrued ratably over the bonus crediting period. If the criteria in paragraph 37 of this SOP are met, an asset should be established for the same amount.

Variable Annuity With Long-Term Care Benefit

D.21 Some deferred annuities provide that if during the accumulation phase, the contract holder has an insurable event (for example, disability, loss of "activities of daily living") that meets the criteria specified in the contract, additional benefits in excess of the account balance will be available. This feature should be evaluated and accounted for in accordance with paragraphs 24 through 30 of this SOP.

Annuities With Earnings Protection Benefit

D.22 Some annuities provide that in the event of death, the beneficiary will receive a benefit in addition to the account balance equal to a percentage (for example, 40 percent) of the difference between the account balance and the deposits less withdrawals. This feature is a death benefit and should be evaluated and accounted for in accordance with paragraphs 24 through 30 of this SOP.

APPENDIX E

Illustrations of the Calculation of Minimum Guaranteed Death Benefit Liability

E.1 The accompanying schedules illustrate how to calculate an additional liability for a portfolio of variable annuity contracts with a minimum guaranteed death benefit (MGDB) feature as noted in paragraphs 24 through 29 of this Statement of Position (SOP). For this illustration it is assumed that the guidance in paragraphs 24 and 25 of this SOP has been followed, with the conclusion that the mortality and morbidity risk associated with insurance benefit features is other than nominal.

E.2 The following is assumed for contracts in this illustration:

a. Variable annuity contracts have no front-end loads.

b. Mortality assessments include any explicit assessments for enhanced death benefit feature.

c. Surrender charges are calculated based on a percentage of premiums.

d. Expense assessments are a fixed annual charge.

e. Discount rate of 8 percent is the same rate as used for deferred acquisition cost amortization.

E.3 Schedules 6 through 10 contain the same basic assumptions as Schedule 1, but with the impact on the adjusted gross profits of a 10 percent increase in account balances (not shown in schedules) in year 2.

E.4 The illustrations display the computations involved in:

a. Gross profits

b. Benefit ratio

c. Additional MGDB liability

d. Adjusted gross profits that should be used for the amortization of deferred acquisition costs[1]

Note: Columns in schedules do not cross foot due to rounding.

1. The estimated gross profits used for the amortization of deferred acquisition costs should be adjusted to reflect the incidence of assessments and loss expense as a result of the recognition of the liability; refer to paragraph 29 of this Statement of Position.

Schedule 1—Illustration of Unadjusted Gross Profits Calculation

Year	Expense Assessments	+	Mortality Assessments	+	Surrender Charges	=	Total Revenue[1]	–	Recurring Expenses Incurred	–	Excess Death Benefits Paid	=	Unadjusted Gross Profits
1	30.00		820.50		17.50		868.00		25.00		0.00		843.00
2	29.75		871.65		44.62		946.02		170.27		12.20		763.55
3	29.48		919.29		61.42		1,010.20		177.78		20.61		811.80
4	29.20		969.80		68.12		1,067.12		185.96		25.94		855.22
5	28.89		1,034.77		64.99		1,128.65		196.53		31.58		900.54
6	28.55		1,086.61		95.16		1,210.32		204.89		44.05		961.38
7	28.18		1,143.53		58.71		1,230.42		214.07		49.53		966.82
8	27.78		1,086.61		0.00		1,114.39		224.32		52.00		838.07
9	27.34		1,268.91		0.00		1,296.25		234.27		65.93		996.05
10	26.87		1,333.10		0.00		1,359.97		244.57		76.78		1,038.61
11	26.35		1,382.93		0.00		1,409.28		252.45		93.75		1,063.08
12	25.79		1,433.09		0.00		1,458.87		243.67		104.76		1,110.44
13	25.18		1,487.10		0.00		1,512.27		268.83		120.67		1,122.78
14	24.52		1,539.66		0.00		1,564.18		278.10		142.22		1,143.86
15	23.81		1,597.88		0.00		1,621.69		286.16		151.25		1,184.28
16	23.06		1,662.23		0.00		1,685.28		296.25		153.64		1,235.39
17	22.25		1,691.70		0.00		1,713.95		300.49		210.92		1,202.54
18	21.39		1,723.70		0.00		1,745.09		305.11		236.72		1,203.27
19	20.48		1,751.22		0.00		1,771.70		308.93		270.72		1,192.05
20	19.52		1,788.11		0.00		1,807.63		314.28		270.82		1,222.52
Present value							12,304.07				724.88		9,520.96

1. If the product had investment margins, they would be included in the schedule as an additional column.

Schedule 2—Computation of Benefit Ratio

Present value of excess death benefits paid		724.88
Divided by present value of total revenue		12,304.07
Equals benefit ratio		5.8914%

Schedule 3—Computation of Year 1 Additional MGDB Liability

Cumulative revenue recognized		868.00
Multiplied by benefit ratio		5.8914%
Equals year 1 additional liability	($)	51.14

Schedule 4—Additional MGDB Liability Amortized Over Total Revenue

Year	Beginning Additional MGDB Liability	+	Interest	+	Total Revenue X Benefit Factor	–	Excess Death Benefits Paid	=	Ending Additional MGDB Liability	Change in Additional Liability
1	0.00		0.00		51.14		0.00		51.14	51.14
2	51.14		4.09		55.73		12.20		98.76	47.63
3	98.76		7.90		59.51		20.61		145.57	46.81
4	145.57		11.65		62.87		25.94		194.15	48.57
5	194.15		15.53		66.49		31.58		244.59	50.45
6	244.59		19.57		71.30		44.05		291.41	46.82
7	291.41		23.31		72.49		49.53		337.69	46.28
8	337.69		27.02		65.65		52.00		378.35	40.66
9	378.35		30.27		76.37		65.93		419.06	40.70
10	419.06		33.52		80.12		76.78		455.92	36.86
11	455.92		36.47		83.03		93.75		481.67	25.75
12	481.67		38.53		85.95		104.76		501.39	19.72
13	501.39		40.11		89.09		120.67		509.93	8.54
14	509.93		40.79		92.15		142.22		500.65	-9.27
15	500.65		40.05		95.54		151.25		484.99	-15.66
16	484.99		38.80		99.29		153.64		469.44	-15.55
17	469.44		37.56		100.98		210.92		397.05	-72.39
18	397.05		31.76		102.81		236.72		294.91	-102.14
19	294.91		23.59		104.38		270.72		152.16	-142.75
20	152.16		12.17		106.49		270.82		0.00	-152.16

Schedule 5—Estimated Gross Profits to Use for Amortization of Deferred Acquisition Costs

Year	Unadjusted Gross Profits	–	Change in Additional Liability	=	Estimated Gross Profits
1	843.00		51.14		791.86
2	763.55		47.63		715.92
3	811.80		46.81		765.00
4	855.22		48.57		806.64
5	900.54		50.45		850.09
6	961.38		46.82		914.56
7	966.82		46.28		920.55
8	838.07		40.66		797.40
9	996.05		40.70		955.35
10	1,038.61		36.86		1,001.75
11	1,063.08		25.75		1,037.34
12	1,110.44		19.72		1,090.72
13	1,122.78		8.54		1,114.24
14	1,143.86		-9.27		1,153.13
15	1,184.28		-15.66		1,199.94
16	1,235.39		-15.55		1,250.95
17	1,202.54		-72.39		1,274.93
18	1,203.27		-102.14		1,305.41
19	1,192.05		-142.75		1,334.80
20	1,222.52		-152.16		1,374.68

Schedule 6—Illustration of Unadjusted Gross Profits Calculation With 10 Percent Increase in Account Balances in Year 2

Year	Expense Assessments	+	Mortality Assessments	+	Surrender Charges	=	Total Revenue	–	Recurring Expenses Incurred	–	Excess Death Benefits Paid	=	Unadjusted Gross Profits
1	30.00		820.50		17.50		868.00		25.00		0.00		843.00
2	29.75		952.20		44.62		1,026.58		183.70		0.00		842.88
3	29.48		1,004.82		61.42		1,095.72		192.04		14.70		888.98
4	29.20		1,060.59		68.12		1,157.91		201.10		23.32		933.50
5	28.89		1,131.90		64.99		1,225.78		212.72		30.43		982.63
6	28.55		1,189.01		95.16		1,312.72		221.96		44.65		1,046.10
7	28.18		1,251.32		58.71		1,338.21		232.04		51.02		1,055.15
8	27.78		1,189.01		0.00		1,216.79		243.33		54.23		919.23
9	27.34		1,389.04		0.00		1,416.38		254.29		68.42		1,093.67
10	26.87		1,456.89		0.00		1,483.76		265.21		82.24		1,136.32
11	26.35		1,511.61		0.00		1,537.96		273.89		101.42		1,162.64
12	25.79		1,568.05		0.00		1,593.83		264.30		112.70		1,216.83
13	25.18		1,626.63		0.00		1,651.81		292.09		131.08		1,228.64
14	24.52		1,683.48		0.00		1,708.00		302.07		154.93		1,251.00
15	23.81		1,747.40		0.00		1,771.22		311.08		163.02		1,297.12
16	23.06		1,814.73		0.00		1,837.79		321.67		167.79		1,348.33
17	22.25		1,845.71		0.00		1,867.96		326.16		232.38		1,309.42
18	21.39		1,878.58		0.00		1,899.97		330.92		261.62		1,307.43
19	20.48		1,909.07		0.00		1,929.54		335.24		296.86		1,297.44
20	19.52		1,950.07		0.00		1,969.58		341.27		296.31		1,332.00
Present value							13,326.45				759.24		10,338.27

Schedule 7—Computation of Benefit Ratio at Year 2

Present value of excess death benefits paid		759.24
Divided by present value of total revenue	=	13,326.45
Equals benefit ratio		5.6972%

Schedule 8—Computation of Year 2 Additional MGDB Liability

Cumulative revenue recognized		
	Year 1	868.00
	Year 2	1026.58
	Total	1,894.58
Multiplied by benefit ratio		5.6972%
Equals year 2 additional liability[1]	($)	107.94

1. Excludes interest and any deduction for actual claim expenses.

Schedule 9—Additional MGDB Liability Amortized Over Total Revenue

Year	Beginning Additional MGDB Liability	+	Interest	+	Total Revenue X Benefit Factor	–	Excess Death Benefits Paid	=	Ending Additional MGDB Liability	Change in Additional Liability
1	0.00		0.00		49.45[1]		0.00		49.45[2]	51.14
2	49.45		3.96		58.49[1]		0.00		111.89[3]	60.75
3	111.89		8.95		62.43		14.70		168.57	56.68
4	168.57		13.49		65.97		23.32		224.71	56.14
5	224.71		17.98		69.84		30.43		282.09	57.38
6	282.09		22.57		74.79		44.65		334.79	52.70
7	334.79		26.78		76.24		51.02		386.80	52.01
8	386.80		30.94		69.32		54.23		432.84	46.04
9	432.84		34.63		80.69		68.42		479.74	46.90
10	479.74		38.38		84.53		82.24		520.41	40.67
11	520.41		41.63		87.62		101.42		548.24	27.83
12	548.24		43.86		90.80		112.70		570.21	21.97
13	570.21		45.62		94.11		131.08		578.86	8.65
14	578.86		46.31		97.31		154.93		567.55	-11.31
15	567.55		45.40		100.91		163.02		550.84	-16.71
16	550.84		44.07		104.70		167.79		531.82	-19.02
17	531.82		42.55		106.42		232.38		448.41	-83.41
18	448.41		35.87		108.25		261.62		330.91	-117.50
19	330.91		26.47		109.93		296.86		170.46	-160.45
20	170.46		13.64		112.21		296.31		0.00	-170.46

1. Year 1, 49.45 + year 2, 58.49 = 107.94, as noted in Schedule 8, plus interest of 3.96 = 111.89.
2. This represents the recomputed end-of-year liability using the new expense in year 2.
3. The difference between the actual year 1 liability (51.14 as seen in Schedule 4) and the recomputed amount of (49.45) of 1.69 will be the true-up adjustment included in the year 2 statement of operations (111.89 – 49.45 –1.69 = 60.75).

Schedule 10—Estimated Gross Profits to Use for Amortization of Deferred Acquisition Costs

Year	Unadjusted Gross Profits	–	Change in Additional Liability	=	Estimated Gross Profits
1	843.00		51.14		791.86
2	842.88		60.75		782.13
3	888.98		56.68		832.30
4	933.50		56.14		877.36
5	982.63		57.38		925.25
6	1,046.10		52.70		993.40
7	1,055.15		52.01		1,003.14
8	919.23		46.04		873.19
9	1,093.67		46.90		1,046.77
10	1,136.32		40.67		1,095.65
11	1,162.64		27.83		1,134.81
12	1,216.83		21.97		1,194.86
13	1,228.64		8.65		1,219.99
14	1,251.00		-11.31		1,262.31
15	1,297.12		-16.71		1,313.83
16	1,348.33		-19.02		1,367.35
17	1,309.42		-83.41		1,392.83
18	1,307.43		-117.50		1,424.93
19	1,297.44		-160.45		1,457.89
20	1,332.00		-170.46		1,502.46

GLOSSARY

accumulation phase. The period during an annuity contract prior to annuitization. An insurance enterprise may refer to this type of annuity as a deferred annuity.

annuitization phase. The period during which the contract holder is receiving periodic payments from an annuity, also referred to as the payout phase.

general account. All operations of an insurance enterprise that are not reported in the separate account(s).

guaranteed investment option. Component of a variable contract that guarantees a specific rate of performance.

guaranteed minimum income benefit (GMIB). Benefit normally offered with deferred variable annuities to provide a guaranteed minimum amount available for annuitization after a specified period in addition to a guaranteed minimum annuity rate. That is, the fixed periodic annuity payments would be determined using the higher of the current accumulated account value that exists at the date of annuitization or the guaranteed amount.

long-term care (LTC) benefit. Benefit offered in an annuity product with a rider providing amounts in excess of the account balance to provide for LTC benefits if contract holder meets the criteria for restrictions on activities of daily living.

minimum guaranteed death benefit (MGDB). A feature in an annuity, life insurance, or similar contract that provides that in the event of an insured's death, the beneficiary (or insurer in the case of a reinsurance contract) will receive the higher of the current account balance of the contract or another amount defined in the contract.

morbidity. The relative incidence of disability due to disease or physical impairment.

mortality. The relative incidence of death in a given time or place.

net amount at risk. The guaranteed benefit in excess of the current account balance. For guarantees in the event of death, the net amount at risk is the minimum guaranteed amount available to the contract holder upon death in excess of the contract holder's account balance at the balance sheet date. For guarantees of amounts at annuitization, the net amount at risk is defined as the present value of the minimum guaranteed annuity payments available to the contract holder determined in accordance with the terms of the contract in excess of the current account balance.

sales inducements. Sales inducements are product features that enhance the investment yield to the contract holder on the contract. 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.

seed money. An investment of non-contract holder funds by an insurer in a separate account when it is established, to support the initial or ongoing operations of the separate account.

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. Often for administrative purposes, separate account subaccounts with differing investment objectives are created within a single separate account.

separate account arrangement. An arrangement under which all or a portion of a contract holder's funds is allocated to a specific separate account maintained by the insurance enterprise. Examples include a variable life insurance contract offered through an insurance enterprise's high return separate account and a contract holder's allocation of a portion of his or her deposit in a deferred variable annuity to a growth equity fund.

traditional variable annuity. An insurance product in which all 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 alternatives and bears the investment risk. The units may be surrendered for their current value in cash (usually less a surrender change) or applied to purchase annuity income. The insurance enterprise periodically deducts mortality and expense charges from the account.

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