

Statutory Issue Paper No. 51

Life Contracts

STATUS

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Type of Issue

Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance on income recognition and policy reserves for life contracts as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50) is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts and Chapter 18, Premium Income, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). That guidance applies to premiums and considerations and related policy reserves for all contracts with life contingencies. Amounts left on deposit under optional settlement modes and amounts left to accumulate at interest are recognized as deposit-type funds or considerations for supplemental contracts, as appropriate. In addition, policy reserves must make a good and sufficient provision for all unmatured obligations guaranteed under the terms of the contracts and are generally computed based on the provisions of the NAIC Model Standard Valuation Law (SVL), the Actuarial Opinion and Memorandum Model Regulation, the Actuarial Standards of Practice promulgated by the Actuarial Standards Board and the actuarial guidelines adopted by the NAIC; however, variations by state do exist.

2. GAAP guidance for life contracts recognizes premium income when it is contractually due from the policyholder. However, for investment contracts and universal life-type contracts, GAAP requires the consideration received from the policyholder to be treated as a deposit. For limited-payment contracts, GAAP requires that income be recognized over the total benefit period rather than the premium collection period. GAAP guidance also requires policy reserves to be established using actuarial assumptions applicable at the time the insurance contracts are made or, for certain long-duration contracts, the balance that accrues to the benefit of the policyholder.

3. The purpose of this issue paper is to establish statutory accounting principles for income recognition and policy reserves for all contracts classified as life contracts as defined in Issue Paper No. 50, except for universal-life type contracts as discussed in *Issue Paper No. 56—Universal Life-Type Contracts, Policyholder Dividends, and Coupons* (Issue Paper No. 56) and credit insurance contracts as discussed in *Issue Paper No. 59—Credit Life and Accident and Health Insurance Contracts* that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper prescribes the income recognition and general policy reserve requirements for all contracts with life contingencies discussed in Issue Paper No. 50. Also as discussed in Issue Paper No. 50, subsequent issue papers, where needed, will establish specific statutory accounting principles that are applicable to unique characteristics of certain life contracts (e.g., universal life-type, credit life and variable contracts).

Types of Premiums

5. The gross premium is the amount charged to the policyholder and taken into operations as premium income.
6. The net premium is the amount calculated on the basis of the interest and mortality table used to calculate the reporting entity's statutory policy reserves.
7. The difference between the gross premium and the net premium is referred to as 'loading.' Loading generally includes allowances for acquisition costs and other expenses but also includes the differences in mortality and interest assumptions utilized for pricing and statutory reserving purposes.

Premium Income Recognition

8. Premiums shall be recognized as income on the gross basis (amount charged to the policyholder) when due from policyholders under the terms of the insurance contract. As a result, premium income shall include first year and renewal premiums, as well as any related premium adjustments (i.e., retrospective premium contracts which are discussed in *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts*) provided for by the insurance contract. In addition, single and flexible premium amounts shall also be recorded as premium income when received from the policyholder. Premiums on flexible premium products are discussed in Issue Paper No. 56. The contractual due date shall be established through the predetermined billing procedure agreed to by the parties. Further, the recognition of premium income and the change in loading shall be consistent with the assumptions made in calculating the related policy reserve.
9. Premium income shall include dividends, coupons, guaranteed annual pure endowments, and similar benefits provided by the insurance contract when such amounts are applied by the terms of the contract to provide additional paid-up insurance, annuities, or to shorten the endowment or premium-paying period. Premiums and considerations waived by the reporting entity under disability provisions contained in its policies and contracts, and reported in operations as a disability benefit, are included in premium income.
10. Premium income shall exclude premiums that have been received by the reporting entity prior to the reporting date but which are due on or after the next policy anniversary date (i.e., advance premiums as discussed below).
11. Premium income should be reduced for premiums returned and allowances to industrial policyholders for the direct payment of premiums.
12. Premium income shall be increased by reinsurance premiums assumed and reduced by reinsurance premiums ceded. Reinsurance premiums assumed and ceded shall be defined and addressed in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance*.
13. Death or other benefits used to fund new policies shall be accounted for as a benefit payment and as a new premium, another type of income, or a liability, as appropriate.

Premium Adjustments

14. In the Summary of Operations, the change in gross deferred and uncollected premiums is recorded as premium income. Deferred premiums are further discussed in paragraph 21. Since only the net premiums are included in the computation of reserves and reported as an asset, it is necessary to adjust the gross premium for an amount representing the change in loading on deferred and uncollected premiums. The change in loading is included as an expense in the Summary of Operations and is not shown as a reduction to premium income.

Uncollected Premium Balances

15. Gross premiums that are due and unpaid as of the reporting date, net of loading, shall be classified as uncollected premiums. Uncollected premium balances which are less than 90 days past due meet the definition of assets as set forth in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*, and are admitted assets to the extent they conform to the requirements of this paper.

Other Considerations Received

16. Considerations for supplementary contracts, dividends left to accumulate at interest, and amounts deposited and accumulated for guaranteed interest and group annuity contracts shall be recognized as deposit-type funds or considerations for supplemental contracts, as appropriate. These amounts are further discussed in *Issue Paper No. 52—Deposit-Type Contracts*.

Policy Reserves

17. Statutory policy reserves shall be established for all unmatured contractual obligations guaranteed under the terms of the policies. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required by Appendix A-820. These statutory policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Statutory policy reserves meet the definition of liabilities as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.

18. The reserving methodologies and assumptions used in computation of policy reserves shall meet the provisions of Appendices A-820 and A-822, and the actuarial guidelines found in Part 9 of the Financial Examiners Handbook. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

19. The preceding two paragraphs summarize the general reserve requirements for all types of life contracts. In addition to these general reserve requirements, Appendix A-820 provides additional guidance with respect to certain types of accumulation annuities classified as life contracts that have flexible features (e.g., guaranteed nonforfeiture benefits such as interest guarantees, annuitization options, bailout features, partial withdrawals) which can create varying benefit streams if elected by the policyholder. Specific policies with such flexible features covered by this additional guidance include individual and group annuity and pure endowment contracts, but excludes any disability and accidental death benefits in these contracts. For benefits under these contracts, reserves shall be established according to the commissioners' annuity reserve valuation method (CARVM). Generally, under CARVM, the difference between all possible future guaranteed benefits streams, including guaranteed nonforfeiture benefits, over the future considerations is computed as of the end of each contract year. Each of these differences is discounted to the reporting date at the applicable valuation interest rate. A reserve is then recorded based on the greatest present value difference of each of the contract year calculations.

Valuation (Reserve) Method and Deferred Premiums

20. Reserves shall be established for all benefits guaranteed under the terms of the policy as of the reporting date using appropriate valuation methods, interest, mortality, and morbidity, as appropriate. However, as a practical expedient, reserves have been generally calculated as of the policy anniversary date (i.e., terminal reserves), not the reporting date. As a result, it is necessary to adjust the terminal reserve back to the reporting date. The components used to compute a terminal reserve shall consist of an interest rate, a mortality and/or morbidity table, and a valuation method (e.g., net level, full preliminary term, Commissioners Reserve Valuation Method (CRVM), or Commissioners Annuity Reserve Valuation Method (CARVM)). A terminal reserve is based on the assumption that all net premiums have been received, all interest earned, and all benefits paid to the end of the policy year.

21. Since terminal reserves are computed as of the end of a policy year and not the reporting date, the terminal reserve must be converted to reflect that portion of the net premium that is unearned at the reporting date. This is generally accomplished using either the mean reserve method or the mid-terminal method as described below:

- a. Under the mean reserve method, the policy reserve equals the average of the terminal reserve at the end of the policy year and the initial reserve (the initial reserve is equal to the previous year's terminal reserve plus the net annual valuation premium for the current policy year). When reserves are calculated on the mean reserve basis, it is assumed that the net premium for a policy is collected annually at the beginning of the policy year and that policies are issued ratably over the calendar year.

However, as premiums are often received in installments more frequently than annually and since the calculation of mean reserves assumes payment of the current policy year's entire net annual premium, the policy reserve is overstated by the amount of net modal premiums not yet received for the current policy year as of the valuation date. As a result, it is necessary to compute and report a special asset to offset the overstatement of the policy reserve.

This special asset is termed "deferred premiums." Deferred premiums are computed by taking the gross premium (or premiums) extending from (and including) the modal (monthly, quarterly, semiannual) premium due date or dates following the valuation date to the next policy anniversary date and subtracting any such deferred premiums that have actually been collected. Deferred premium assets shall also be reduced by loading. Since the calculation of mean reserves assumes payment of the current policy year's entire net annual premium, deferred premium assets are considered admitted assets to compensate for the overstatement of the policy reserve.

- b. Under the mid-terminal method, the policy reserves are calculated as the average of the terminal reserves on the previous and the next policy anniversaries. These reserves shall be accompanied by an unearned premium reserve consisting of the portion of valuation premiums paid or due covering the period from the valuation date to the next policy anniversary date.

Advance Premiums

22. Advance premiums are those premiums that have been received by the reporting entity prior to the valuation date but which are due on or after the next policy anniversary date. The policyholder may remit one or more premiums in advance of specific due dates. Where premiums are remitted sufficiently far in advance, the premiums charged to the policyholder may be reduced or discounted to reflect the time value of money. The difference between the gross and discounted premium is ratably charged as interest in the Summary of Operations from the date of payment to the premium due date. At the premium due date, the amount received from the policyholder plus the accumulated interest equals the gross premium necessary to fund the policy. The total amount of such advance premiums, less any discount as of the valuation date, is reported as a liability in the statutory financial statement and is not considered premium income until due. The gross premium, not the net valuation premium, is recorded as the advance premium in recognition of the reporting entity's liability to refund such premiums in the event the policy is terminated.

Reserve Recognition

23. The difference between the policy reserves for life contracts at the beginning and end of the reporting period shall be reflected as the change in reserves in the Summary of Operations, except for any difference due to a change in valuation basis.

Change In Valuation Basis

24. A change in valuation basis shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3). Consistent with Issue Paper No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the Summary of Operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a new method and a specific transition that allows for grading.

Supplemental Benefits

25. In addition to the basic policy benefit, the insurance contract may provide supplemental benefits. Supplemental benefits include, but are not limited to, accidental death benefits and waiver of premium benefits. Appropriate reserves shall be established for these supplemental benefits based on the terms of the contract.

Unearned Income

26. Amounts assessed that represent compensation to the reporting entity for services to be provided in future periods and which are required to be refunded upon policy termination are not earned in the period assessed. Such amounts, if not already considered in the policy reserve, shall be reported as unearned income, a liability, and recognized as income as the related services are provided.

Accelerated Benefits

27. Accelerated benefits are benefits payable under a life insurance contract to a policyholder or certificateholder during the lifetime of the insured, in anticipation of death or upon the occurrence of specified life-threatening or catastrophic conditions as defined by the policy or rider. These benefits reduce the death benefit otherwise payable under the life insurance contract and are payable upon the occurrence of a single qualifying event which results in the payment of a benefit amount fixed at the time of acceleration. When benefits are provided through the acceleration of benefits under group or individual life policies or riders to such policies, policy reserves shall be determined in accordance with Appendices A-820 and A-822. Reserves for such benefits in the aggregate shall be sufficient to cover policies upon which no claim has yet arisen as well as policies upon which an accelerated claim has arisen. Accounting guidance for accelerated benefit payments made in the form of a loan are addressed in *Issue Paper No. 49—Policy Loans*. In addition, accelerated benefit payments, for those accelerated benefits that reduce the policy, shall not be deferred but shall be charged to the Summary of Operations as a benefit expense when paid to the policyholder.

Additional Reserves Not Included Elsewhere

28. Additional actuarial liabilities are commonly held for such items as:
- a. Valuation net premiums in excess of gross premiums (i.e., deficiency reserves)
 - b. Provision for either nondeduction of deferred fractional premiums or return of premiums at death of the insured
 - c. Surrender values in excess of reserves otherwise required or carried
 - d. Substandard extra premiums, extra mortality on group conversions, and guaranteed insurability options

- e. Additional reserves required based on cash flow testing and/or asset/liability matching requirements
- f. Additional reserves for policies which contain conversion privileges or future contingent benefits

Disclosures

29. For life and annuity reserves the financial statements shall disclose the following:
- a. A description of reserve practices concerning the following:
 - i. Waiver of deduction of deferred fractional premiums upon death of insured;
 - ii. Return of portion of final premium for periods beyond the date of death; and
 - iii. Amount of any surrender value promised in excess of the reserve as legally computed;
 - b. The methods employed in the valuation of substandard policies;
 - c. The amount of insurance, if any, for which the gross premiums are less than the net premiums according to the valuation standards;
 - d. The method used to determine tabular interest, tabular less actual reserves released, and tabular cost (by formula or from the basic data for such items); and
 - e. The nature of significant other reserve changes.
30. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:
- a. Subject to discretionary withdrawal:
 - i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;
 - (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer;
 - (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period;
 - ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in (v.(d)) below;
 - iii. At market value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;
 - iv. Total with adjustment or at market value;

- v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:
 - (a) In a lump sum without adjustment;
 - (b) In installments over less than five years, with or without a reduction in interest rate during the installment period;
 - (c) In a lump sum subject to a fixed surrender charge of less than 5%;
 - (d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues;
 - (e) All others;
- b. Not subject to discretionary withdrawal;
- c. Total gross;
- d. Reinsurance ceded;
- e. Total net.

31. If the reporting entity has reported life insurance premiums and annuity considerations deferred and uncollected on policies in force as of the financial statement date, disclose separately the amounts and the loading excluded for each of the following lines of business:

- a. Industrial business;
- b. Ordinary new business;
- c. Ordinary renewal;
- d. Credit life;
- e. Group life;
- f. Group annuity.

32. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

- a. Name and address of managing general agent or third party administrator;
- b. Federal Employer Identification Number;
- c. Whether such person holds an exclusive contract;
- d. Types of business written;

- e. Type of authority granted (i.e., underwriting, claims payment, etc.);
- f. Total premium written.

33. Reporting entities shall disclose the relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional income allocated to participating policyholders in the financial statements.

DISCUSSION

SAP Considerations

34. The statutory accounting principles outlined in the conclusion above regarding income recognition and policy reserves for life contracts are consistent with the Statement of Concepts which states:

Conservatism

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

Consistency

The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

Recognition

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

35. Except as discussed in paragraphs 36-41, the statutory accounting principles outlined in the conclusion above regarding income recognition and policy reserves for life contracts are consistent with current statutory accounting.

Unearned Income

36. Unearned income and other similar amounts described in paragraph 26 are not currently addressed in statutory accounting. Unearned income and other similar amounts meet the definition of liabilities as defined in Issue Paper No. 5. Recording unearned income and other similar amounts as deferred income and recognizing the amounts as income only as the earnings process is completed is consistent with the objectives of the Statement of Concepts.

Cost of Collection Liability

37. Current statutory accounting requires a liability to be established for the costs of collecting deferred and uncollected premiums in excess of loading when loading is not adequate to cover these costs. As previously discussed, deferred premiums are only recorded when using the mean reserve method and are computed by taking the gross premium extending from the modal premium due date following the valuation date to the next policy anniversary date and subtracting any such deferred premiums that have actually been collected. As a result, current statutory accounting requires this liability to be established when using the mean reserve method but not the mid terminal reserve method. Due to the generally conservative nature of the mortality and interest rates prescribed in computing policy reserves, the requirement to establish a liability for the costs of collecting deferred and uncollected premiums in excess of loading has been eliminated. In addition, by eliminating the requirement to establish this liability, the inconsistent practice of requiring this liability to be established when using the mean reserve method as it relates to deferred premiums, but not the mid terminal reserve method has also been eliminated.

Premium Deficiency

38. Due to the manner in which the liability for the costs of collecting deferred and uncollected premiums in excess of loading has historically been computed, any deficiencies in gross deferred premiums relative to corresponding net deferred valuation premiums from the valuation date to the next policy anniversary date were accrued in this liability.

39. As further discussed in Appendix A-820, basic policy reserves are required to be increased in certain circumstances. If in any contract year the gross premium is less than the valuation net premium, the minimum reserve required shall be the greater of

- a. the reserve currently held for the contract or
- b. the reserve calculated by the method currently used but using minimum valuation standards of mortality and interest. The gross premium on the policy is substituted in this reserve calculation at each contract year in which it is less than the valuation net premium.

Although Appendix A-820 makes no explicit reference to deficiency reserves, the excess of reserves described in b) over those described in a) is often referred to as a deficiency reserve.

40. Historically, this calculation has been performed from the next policy anniversary forward. However, since the liability for the cost of collection in excess of loading has been eliminated, which considered deficiencies in gross deferred premiums relative to corresponding net deferred valuation premiums from the valuation date to the next policy anniversary date, this calculation should be performed from the valuation date through the end of the premium paying period.

Accelerated Benefits

41. Current statutory accounting does not address the accounting for accelerated benefits. Consistent with current statutory accounting which requires benefits paid to policyholders to be recorded as an expense in the Summary of Operations and the Statement of Concepts which generally prohibits accounting practices which defer the recognition of expense, this issue paper requires accelerated benefits to be charged to the Summary of Operations as a benefit expense when paid to the policyholder.

Deferred Premiums

42. Reserves for life contracts are generally calculated on the mean reserve basis. Mean reserves are calculated on the assumption that the net premium for a policy is collected annually at the beginning of the policy year. To the extent such premiums have not been collected, reserves calculated on the mean reserve basis overstate the required policy reserve for life contracts. As a result, an adjustment is needed to offset the overstatement of the policy reserve. Historically, this adjustment has been recorded as an asset called “deferred premiums.” For practical reasons related to maintenance, accounting, and financial reporting of reserves for life contracts, these amounts have been reported as assets. As this practice does not affect net income or surplus and considering the importance of consistent financial reporting as well as the anticipated costs and benefits associated with changing this current and pervasive practice, this codification does not change the practice of presenting deferred premiums as admitted assets.

GAAP Considerations

43. Although this issue paper generally reflects the basic accounting for income recognition on life contracts prescribed by GAAP which requires that premiums from life contracts be recognized as income when due from policyholders and that policy reserves be established for the excess of the present value of future benefits and expenses over future net premiums, it rejects the GAAP literature referenced in paragraphs 44 and 45 for the reasons set forth therein.

44. The statutory accounting principles in this issue paper differ from GAAP which specifies different income recognition principles for different types of life contracts. *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* (FAS 97) excludes certain considerations received from premium income on universal life-type contracts and certain limited-payment contracts. For investment and universal life-type contracts, FAS 97 (paragraphs 15 and 19, respectively) recognizes the considerations received as funds on deposit and income is recognized from amounts assessed against policyholders for mortality, contract administration, and surrender charges, as applicable. For limited-payment contracts, FAS 97 (paragraph 16) specifies any gross premium received in excess of the net premium for limited-payment contracts shall be deferred and recognized in income in a constant relationship with insurance in force (when accounting for life insurance contracts) or with the amount of expected future benefit payments (when accounting for annuity contracts). These differences are inconsistent with the recognition concept in the Statement of Concepts which states that SAP income should reflect the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners.

45. *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), FAS 97, *FASB Statement 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts* (FAS 120), *AICPA Practice Bulletin No. 8, the AICPA Audits of Stock Life Insurance Companies* (AICPA Life Audit and Accounting Guide), and *AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises* (SOP 95-1) prescribe the following with respect to policy reserves:

- a. Specifies that policy reserves represent the present value of future benefits to be paid to or on behalf of policyholders and related expenses less the present value of future net premiums (portion of gross premium required to provide for all benefits and expenses).

- b. Specifies that the liability is estimated using methods that include assumptions, such as estimates of expected investment yields, mortality, terminations, and expenses, applicable at the time the insurance contracts are made. The assumptions shall include provision for the risk of adverse deviation. Original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (often referred to as the “lock-in concept”) unless a premium deficiency exists.
 - c. Specifies that a premium deficiency exists if the existing contract liabilities, together with the present value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits to be paid to or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts and (b) to recover unamortized acquisition costs.
 - d. Requires the retrospective deposit method of accounting for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder.
 - e. Specifies that the liability for future policy benefits relating to certain participating contracts be equal to the sum of 1) the net level premium reserve for death and endowment policy benefits, 2) the liability for terminal dividends, and 3) any premium deficiency.
46. This issue paper rejects the GAAP literature related to policy reserves referred to in the preceding paragraph, including the excerpts shown in paragraphs 50-52 below. These GAAP pronouncements permit the use of generally less conservative assumptions of expected investment yields, mortality, terminations, and expenses applicable at the time the insurance contracts are made and usually produce smaller reserves than current SAP. Current SAP assumptions and estimates are generally more conservative in nature and therefore are more consistent with the objectives in the Statement of Concepts. Further, since the requirements for establishing policy reserves for life contracts are directly related to and are inseparable from the income recognition requirements on both a SAP and GAAP basis, the income recognition requirements of the GAAP literature referenced in this paragraph are similarly rejected in this issue paper.
47. GAAP does not specifically address valuation methods, deferred and uncollected premiums, advance premiums, liability for cost of collection, supplemental benefits, and miscellaneous reserves discussed above. Current practice is to account for these items in a manner similar to SAP but consistent with the GAAP reserve methods used to calculate the basic policy reserve.

Drafting Notes/Comments

- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- Issue Paper No. 53 addresses Property Casualty Contracts – Premiums.
- Issue Paper No. 54 addresses Individual and Group Accident and Health Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.
- Issue Paper No. 56 addresses Universal Life-Type Contracts, Policyholder Dividends, and Coupons.
- Issue Paper No. 59 addresses Credit Life and Accident and Health Insurance Contracts.
- Issue Paper No. 66 addresses Accounting for Retrospectively Rated Contracts.
- Issue Paper No. 74 addresses Life, Deposit-Type and Accident and Health Reinsurance.
- Issue Paper No. 89 addresses Separate Accounts.

- No guidance was added from FAS 120, AICPA Practice Bulletin No. 8 or the AICPA Life Audit and Accounting Guide since the guidance was not applicable or was already reflected in FAS 60, FAS 97, and SOP 95-1.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (ONLY PERTINENT EXCERPTS ARE INCLUDED BELOW)

Statutory Accounting

48. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance on life policy reserves:

CHAPTER 10 AGGREGATE RESERVES FOR LIFE AND ANNUITY CONTRACTS

Life insurance pays the beneficiary on the death of the insured. An endowment pays the policyholder if he lives to the end of the period, or a beneficiary if the policyholder dies. An annuity or pure endowment pays the policyholder if he is living. Policies written today may include numerous provisions, which are either written directly into the policy or attached as a rider.

This chapter discusses the reserves that a company must establish. Aggregate reserves are reported as liabilities in the statutory financial statement.

Statutory Reserves

This type of life insurance policy dictates the amount of the reserve that must be established and how long it must be maintained. Within the ordinary life and industrial line of business, there are three basic types of policies: whole life, endowment, and term. (Annuities and pure endowments are discussed later in this chapter.)

Whole life insurance provides coverage for the life of the insured as long as the premiums are paid in conformity with the policy. Under a whole life plan of insurance, the company is obligated to maintain a reserve until the death of the insured.

Term life insurance provides coverage only for the period that is specified in the policy. Under a term insurance plan, the company maintains a required reserve which reduces to zero upon expiration of the term period.

Similar to term insurance, endowment life insurance provides coverage for a period specified in the policy. Unlike term insurance, the proceeds of endowment insurance are payable if the insured lives to the end of the period.

In the aggregate, policy reserves for all life insurance policies that are reported in the statutory financial statements must equal or exceed reserves calculated by using certain assumptions and methods that produce the minimum required by law. Further, each state requires a Statement of Actuarial Opinion which provides the opinion of an actuary that aggregate reserves make good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies and meet the minimum requirements of the laws of the state of domicile.

Minimum Reserves Required

The components necessary to compute reserves are an interest rate, a mortality table, and a method of valuation. The standards for determining the minimum statutory reserves that are required in life insurance policies are prescribed in statutes or regulations. Generally, the states follow the provisions of the NAIC Model Valuation Law and its interpretations; however, variations by state do exist.

These standards vary by line of business and by issue date of the policy. Further limitations are placed on policies having nonforfeiture benefits.

Types of Reserves

The reserves calculated for a block of life insurance policies as of the valuation date may be based upon different assumptions concerning the anniversary (issue) date and the average date when premiums are due. The different types of reserves that may be used are terminal, initial, mid-terminal, and mean.

The terminal reserve is the policy reserve at the end of the policy year. It is based on the assumption that all net premiums have been received, all interest earned, and all benefits paid to the end of the policy year.

The initial reserve is the previous year's terminal reserve plus the net valuation premium for the current policy year. This reserve basis is not frequently utilized in financial reporting.

In computing reserves on ordinary insurance, most companies use mean reserves. These are defined as the average of the initial and terminal reserves for the current year, on the assumption that policies are issued uniformly throughout the calendar year on an annual premium basis. Any fractional premium (e.g., monthly, quarterly, semiannual) for the current policy year which is not yet due must be reported as a deferred premium.

Mid-terminal reserves are generally used to value industrial insurance, on which premiums are usually paid monthly or weekly. Mid-terminal reserves are the average of the terminal reserves on the last and the next policy anniversaries. These reserves must be accompanied by an unearned premium reserve consisting of the portion of valuation premiums paid or due covering the period from the valuation date to the due date of the next modal premium. Any premiums due beyond the valuation date but paid prior to that date are included in the advance premium liability. Certificates of fraternal benefit societies generally are reserved on a mid-terminal basis.

Reserves for permanent group life insurance plans usually are calculated in the same way as individual insurance and can be either mean (with deferred premium) or mid-terminal plus the unearned premium.

Supplemental Benefits

In addition to the basic death benefit, life insurance policies may provide other benefits. These supplemental benefits are sold for additional premiums or for a basic premium that has been calculated to include their costs. In either case, the company must establish appropriate reserves for these benefits. Examples of reserves for these benefits include:

1. Accidental death benefits. The most common additional death benefit is double indemnity which provides for an additional payment equal to the face amount of the policy in the event of accidental death. Triple indemnity also is offered, but it usually is limited to accidental death in connection with commercial travel.
2. Total and permanent disability benefits - active lives. It is common for a life insurance policy to be sold with an additional benefit for waiver of premiums upon the disability of the policyowner. This is called waiver of premiums benefit. The company, of course, must establish a reserve for waiver of premium benefits.

A benefit rider for disability payments to the policyowner/insured also may be attached to a life insurance policy.

3. Total and permanent disability benefits - disabled lives. In the event of a waiver of premiums or payment of benefits due to total and permanent disability, a reserve must be established to cover the present value of the future gross premium to be waived or the

payments to be paid. Policies on which benefits are currently being paid are called disabled lives. For ordinary contracts this reserve usually is reported as a part of the aggregate life reserves. This is in addition to the basic policy reserve for active lives.

Miscellaneous Reserves

Since the actuarial liabilities must include provision for any contingent benefit or right which may arise, statutory statements provide for estimates of a number of miscellaneous reserve items. For example, state laws or regulations may require minimum reserves when valuation net premiums exceed gross premiums. The additional reserve needed to meet the minimum may appear separately as a miscellaneous reserve or may be included with the life reserve in accordance with the applicable state regulations. Similarly, provision for either nondeduction of deferred fractional premiums or return of premiums at death of the insured may be made as a separate reserve or as part of the life reserve. Approximate reserving methods are accepted and frequently used to estimate such items. Another minimum reserve which must be provided for is a reserve for surrender values in excess of reserves otherwise required or carried. There are other miscellaneous items commonly encountered, such as reserve for substandard extra premiums, a reserve for extra mortality on group conversions, and reserve for guaranteed insurability options.

Changes in Valuation Bases

Where the interest rate, mortality basis, reserving method (e.g., net level, preliminary term, etc.), or other basis affecting reserve computation of in force business is changed during the year, any increase or decrease in actuarial reserves resulting from this change in valuation basis must be charged directly to surplus rather than as a part of the reserve increase item in the summary of operations. For various reasons, any change in valuation bases which produces an increase in reserves (reserve strengthening) or decrease in reserves (reserve destrengthening) may require the approval of the applicable regulatory authority. Procedures and timing for such approval vary from state to state.

49. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to premium income recognition:

CHAPTER 18 PREMIUM INCOME

Premiums are generally recorded in the company's general ledger when received. This necessitates adjustments as of the balance sheet dates for premiums received in advance of their due date, for premiums which are due but have not yet been received, and for "deferred" premiums. Premium income reported in the Summary of Operations includes reinsurance assumed and is reduced by reinsurance ceded.

Deductions should be made for premiums and annuity considerations returned and allowances to industrial policyholders for direct payment of premiums. Commissions and allowances on reinsurance premiums assumed and ceded may not be deducted.

Single premiums and considerations include dividends, coupons, guaranteed annual pure endowments, and similar benefits applied to provide paid-up additional insurance or annuities. Renewal premiums collected are to include dividends and coupons applied to pay renewal premiums and to shorten the endowment or premium-paying period.

Premiums and considerations waived by the company under disability provisions contained in its policies and contracts, and reported in operations as a disability benefit, are included in premium income.

Gross and Net Premiums and Loading

A “gross” premium is the amount charged to the policyholder and taken into operations as premium income. A “net” premium is the amount calculated on the basis of the interest and mortality table used to calculate the insurance company’s policy reserves.

The difference between the gross and net premium is called “loading.” Loading is an amount of the gross premium that provides the company with the funds to pay commissions, to meet operating expenses, to provide for contingencies, and to return a profit.

Deferred and Uncollected Premiums

The increase in reserves for life insurance policies which is charged against operations for the year is based on reserves frequently calculated on what is called the mean reserve basis. Mean reserves are calculated on the assumption that the entire annual premium for a policy is collected annually at the beginning of the policy year.

However, since premiums are often received in installments more frequently than annually and since the mean reserves assume payment of the current year’s net annual premium, it becomes necessary to compute and report a special asset item to offset the additional liability. This asset item is termed “deferred premiums.” It represents the premium (or premiums) extending from (and including) the modal (monthly, quarterly, semiannual) premium due date or dates following the valuation date to the next policy anniversary date. The company, therefore, reports deferred premiums not yet due as premium income “gross” and as an asset net of loading. Policies with premiums payable annually on the policy anniversary will not have deferred premiums.

Since the policy reserve liability calculated on the mean reserve basis assumes the collection of premiums to the following policy anniversary, deferred premiums (semiannual, quarterly, or monthly premiums due in the following year prior to the anniversary date) which have been collected in the current year reduce the deferred premium asset. The liability for advance premiums would consequently exclude such premiums.

Life insurance premium income also includes, on a gross basis, those premiums that have been billed and are due and unpaid on the valuation date. An asset item is allowable for any such uncollected premiums net of loading. Theoretically, only policies in their grace period would have uncollected premiums at the balance sheet date because policies beyond the grace period would have been lapsed. However, in actual practice most companies, to avoid processing a large number of transactions in the first month or so after the grace period, may not process policies with uncollected premium until 30 to 60 days after expiration of the grace period. These policies, therefore, may still be shown and valued as being premium-paying.

The amount of deferred and uncollected premiums that should be reported as an asset is the aggregate of the related net premiums because the sole purpose of the asset is to offset the net premium included in the policy reserves. If the company reported gross premiums deferred and uncollected as an asset, it would be required to provide an offset for the amount of loading for expenses and profits that have not yet been incurred or realized.

Net premiums deferred and uncollected may be determined in one of two ways. Either a seriatim listing of gross and net premiums may be prepared or the company may calculate ratios of net to gross premiums deferred and uncollected. In this second case, the company must be able to support its factors with studies that consider the mix of business, the amounts applicable first year and renewal premiums, and so forth. In any case, the company should be able to demonstrate that the net premiums are the same as those used in the calculation of the reserves.

In the Summary of Operations the change in gross deferred and uncollected premiums is taken in as premium income. Since only the net premiums are included in reserves and reported as an asset, it is necessary to make an adjustment for the change in the loading on deferred and uncollected premiums.

Cost of Collection in Excess of Loading

A liability should be provided for the cost of collection on premiums and annuity consideration deferred and uncollected in excess of total loading thereon if the company deems the loading to be inadequate. The increase in this item and the increase in loading on deferred and uncollected premiums are both recorded in the same line in the Summary of Operations. Provisions for cost of collection should include commissions, collection fees, and taxes contingent upon the collection of the deferred and uncollected premiums.

Premiums Received in Advance

Premium income reported in operations must exclude premiums that have been received by the company prior to the valuation date but which are due on or after the next policy anniversary date. The accounting treatment is the same for both life and accident and health premiums.

A policyholder may remit one or more premiums in advance of specific due dates. Where premiums are remitted sufficiently far in advance, the premiums may be discounted for interest from their due dates to the date of payment. The total amount of such gross premiums, less any discount as of the valuation date, is reported as a liability in the statutory financial statement. The gross premium less any discount is recorded as the advance premium, not the net valuation premium, in recognition of the company's liability to refund such premiums in the event the policy is terminated.

Advance premiums must be recorded for industrial as well as ordinary and group policies. Advance premiums received on group policies may be reported in the liability for premiums received in advance or as a 100% unearned premium reserve.

Premium and Other Deposit Funds

A company may also receive premiums over one year prior to their due date and include them in a premium deposit fund. These amounts are not reported as income. The premium deposit fund may or may not represent payment of specific future premiums. Interest at contracted rates is credited annually to each individual account. Interest on such funds must be accrued to the balance sheet date. The terms of the fund (interest rate, disposition, and so forth) are specified in the provisions of the policy or in a separate endorsement. An explanation of other deposit funds can be found in Chapter 12.

Amounts deposited and accumulated for guaranteed interest contracts may be included in this classification. Finally, other deposit items of a generally similar nature may also be included herein.

Withdrawals from deposit accounts to pay premiums are credited to the appropriate income account. Provision is made in the statutory financial statement for reporting the balance of such deposits as of the balance sheet date.

Industrial Policies

Mid-terminal reserves are generally held for industrial insurance policies. Because of the collection of premiums due after the statement date and up to the next policy anniversary is not assumed in the calculation of mid-terminal policy reserves, no deferred premium asset is recorded and no deferred premiums are taken into operations as premium income.

Uncollected premiums due on industrial policies are defined in the same way as uncollected ordinary premiums and are bound by the same limitations. For industrial policies on which an asset is recorded for uncollected premiums, reserves should be established on the same basis as for those where the premiums have been collected and such uncollected premiums are taken into operations as premium income.

Group Life Policies

Group term policies generally carry unearned premium or one-year term insurance reserves and where premiums are accounted for on a true monthly premium basis no deferred premium asset would generally be appropriate. However, where premiums are accounted for on an annual premium basis and payable in installments more frequently than annually, it would be appropriate to take deferred premiums into premium income and to set up a net deferred premium asset, based on the valuation standards used, together with an appropriate addition to reserves.

Uncollected premiums are allowed as an asset and should be recorded net of loading. The corresponding reserve liabilities must reflect the uncollected premiums that are taken as an asset.

Group permanent policies may have deferred and uncollected premiums if reserves are calculated on a mean basis. They may have only uncollected premiums if reserves are calculated on a mid-terminal basis.

Annuity Contracts

Certain annuity contracts, usually group pension contracts, frequently provide for the payment to the company of amounts other than premiums or considerations to be accumulated at interest for the purpose of providing pensions for employees at retirement and similar benefits. Amounts withdrawn from the fund to purchase annuity benefits reduce "Annuity and other fund deposits" and increase premium and annuity considerations.

Uncollected and deferred annuity considerations are calculated on deferred annuity contracts other than single payment contracts. The asset item is recorded net of loading.

Considerations for Supplementary Contracts

The Summary of Operations includes as income all policy proceeds which have been left with the company during the year under optional modes of settlement to provide beneficiaries or the policyowner with periodic income under a supplementary contract. Supplementary contracts may provide for an income payable for the lifetime of the payee(s), in which case the considerations would be reported as "Considerations for supplementary contracts with life contingencies." A supplementary contract may also provide for the payment of a periodic income for a specified number of years or for payments of a specified amount until the funds with interest earnings are exhausted. The considerations for such supplementary contracts are reported separately as "Considerations for supplementary contracts without life contingencies."

These considerations arise from proceeds retained at death, disability, surrender, or maturity of policies and annuity contracts. The amount of these retained proceeds is included in the amount reported in the Summary of Operations for policy and contract benefits.

Considerations for Dividend Accumulations

Another income item in the Summary of Operations is "Consideration for dividend accumulations." The accounting treatment for dividend accumulation deposits, dividend accumulation payments, and the change in the liability is similar to accounting for life insurance. Consideration for dividend accumulations represents the amount of policy dividends left on deposit with the company during the year to accumulate at interest. This amount would normally agree with the amount reported in the Dividends and Coupons to Policyholders exhibit of the annual statement as being left on deposit with the company.

Generally Accepted Accounting Principles

50. FAS 60, as amended by FAS 97 and FAS 120, provides the following guidance related to income recognition and related policy reserves for life and accident and health contracts:

Insurance contracts, for purposes of this Statement, need to be classified as short-duration or long-duration contracts. Long-duration contracts include contracts, such as whole-life, guaranteed renewable term life, endowment, annuity, and title insurance contracts, that are expected to remain in force for an extended period. All other insurance contracts are considered short-duration contracts and include most property and liability insurance contracts.

Premiums from long-duration contracts are recognized as revenue when due from policyholders. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future new premiums to be collected from policyholders are accrued when premium revenue is recognized. Those estimates are based on assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. Claim costs are recognized when insured events occur.

INTRODUCTION

1. The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death, disability, property damage, injury to others, and business interruption. Insurance transactions may be characterized generally by the following:

- a. The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.
- b. When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.

2. Two methods of premium revenue and contract liability recognition for insurance contracts have developed, which are referred to as short-duration and long-duration contract accounting in this Statement. Generally, the two methods reflect the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract.

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim¹ costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

¹ Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this Statement.

4. Premiums from long-duration insurance contracts, including many life insurance contracts, generally are level even though the expected policy benefits and services do not occur evenly over the periods of the contracts. Functions and services provided by the insurer include insurance protection, sales, premium collection, claim payment, investment, and other services. Because no single function or service is predominant over the periods of most types of long-duration contracts, premiums are recognized as revenue over the premium-paying periods of the contracts when due from policyholders. Premium revenue from long-duration contracts generally exceeds expected policy benefits in the early years of the contracts and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts. Accordingly, a liability for expected costs relating to most types of long-duration contracts is accrued over the current and expected renewal periods of the contracts.

APPLICABILITY AND SCOPE

6. This Statement establishes accounting and reporting standards for the general-purpose financial statements of stock life insurance enterprises, property and liability insurance enterprises², title insurance enterprises, mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies. Except for the sections on premium revenue and claim cost recognition and acquisition costs (paragraphs 9-11, 13-18, and 20-31), this Statement applies to mortgage guaranty insurance enterprises. *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, addresses the accounting for certain long-duration participating life insurance contracts.*

* The accounting for certain long duration insurance contracts referred to as investment contracts, limited-payment contracts, and universal life-type contracts is established by FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.

² Property and liability insurance enterprises, for purposes of this Statement include stock enterprises, mutual enterprises, and reciprocal interinsurance exchanges.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General Principles

10. Premiums from long-duration contracts shall be recognized as revenue when due from policyholders. A liability for expected costs relating to most types of long-duration contracts shall be accrued over the current and expected renewal periods of the contracts. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders (liability for future policy benefits) shall be accrued when premium revenue is recognized. Those estimates shall be based on assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. In addition, liabilities for unpaid claims and claim adjustment expenses shall be accrued when insured events occur.

Liability for Future Policy Benefits

21. A liability for future policy benefits relating to long-duration contracts other than title insurance contracts (paragraph 17) shall be accrued when premium revenue is recognized. The liability, which represents the present value of future benefits to be paid to or on behalf of policyholders and related expenses less the present value of future net premiums (portion of gross premium required to provide for all benefits and expenses), shall be estimated using methods that include assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. The liability also shall consider other assumptions relating to guaranteed contract benefits, such as coupons, annual endowments, and conversion privileges. The assumptions shall include provision for the risk of adverse deviation. Original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (often referred to as the "lock-in concept") unless a premium deficiency exists (paragraphs 35-37). Changes in the liability for future policy benefits that result from its periodic estimation for financial reporting purposes shall be recognized in income in the period in which the changes occur.

Investment Yields

22. Interest assumptions used in estimating the liability for future policy benefits shall be based on estimates of investment yields (net of related investment expenses) expected at the time insurance contracts are made. The interest assumption for each block of new insurance contracts

(a group of insurance contracts that may be limited to contracts issued under the same plan in a particular year) shall be consistent with circumstances, such as actual yields, trends in yields, portfolio mix and maturities, and the enterprise's general investment experience.

Mortality

23. Mortality assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected mortality.

Morbidity

24. Morbidity assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected incidences of disability and claim costs. Expected incidence of disability and claim costs for various types of insurance (for example, noncancelable and guaranteed renewable accident and health insurance contracts) and other factors, such as occupational class, waiting period, sex, age, and benefit period, shall be considered in making morbidity assumptions. The risk of antiselection (the tendency for lower terminations of poor risks) also shall be considered in making morbidity assumptions.

Terminations

25. Termination assumptions used in estimating the liability for future policy benefits shall be based on anticipated terminations and nonforfeiture benefits, using anticipated termination rates and contractual nonforfeiture benefits. Termination rates may vary by plan of insurance, age at issue, year of issue, frequency of premium payment, and other factors. If composite rates are used, the rates shall be representative of the enterprise's actual mix of business. Termination assumptions shall be made for long-duration insurance contracts without termination benefits because of the effects of terminations on anticipated premiums and claim costs.

Expenses

26. Expense assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected nonlevel costs, such as termination or settlement costs, and costs after the premium-paying period. Renewal expense assumptions shall consider the possible effect of inflation on those expenses.

Premium Deficiency

32. A probable loss on insurance contracts exists if there is a premium deficiency relating to short-duration or long-duration contracts. Insurance contracts shall be grouped consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists.

Long-Duration Contracts

35. Original policy benefit assumptions for long-duration contracts ordinarily continue to be used during the periods in which the liability for future policy benefits is accrued (paragraph 21). However, actual experience with respect to investment yields, mortality, morbidity, terminations, or expenses may indicate that existing contract liabilities, together with the present value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits to be paid to or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts and (b) to recover unamortized acquisition costs. In those circumstances a premium deficiency shall be determined as follows:

Present value of future payments for benefits and related settlement and maintenance costs, determined using revised assumptions based on actual and anticipated experience	\$XX
Less the present value of future gross premiums, determined using revised assumptions based on actual and anticipated experience	XX -----
Liability for future policy benefits using revised assumptions	XX
Less the liability for future policy benefits at the valuation date, reduced by unamortized acquisition costs	XX -----
Premium deficiency	\$XX =====

36. A premium deficiency shall be recognized by a charge to income and (a) a reduction of unamortized acquisition costs or (b) an increase in the liability for future policy benefits. If a premium deficiency does occur, future changes in the liability shall be based on the revised assumptions. No loss shall be reported currently if it results in creating future income. The liability for future policy benefits using revised assumptions based on actual and anticipated experience shall be estimated periodically for comparison with the liability for future policy benefits (reduced by unamortized acquisition costs) at the valuation date.

37. A premium deficiency, at a minimum, shall be recognized if the aggregate liability on an entire line of business is deficient. In some instances, the liability on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits would be recognized in early years and losses in later years. In those situations, the liability shall be increased by an amount necessary to offset the losses that would be recognized in later years.

51. FAS 97, as amended by FAS 120, provides the following guidance on premium income recognition:

Summary

This Statement establishes standards of accounting for certain long-duration contracts issued by insurance enterprises, referred to in this Statement as universal life-type contracts, that were not addressed by *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*. The Statement also establishes standards of accounting for limited-payment long-duration insurance contracts and investment contracts and amends Statement 60 to change the reporting of realized gains and losses on investments.

New life insurance contracts have evolved since the development of specialized insurance industry accounting principles and practices in the early 1970's. Many of those new life insurance contracts have different provisions than do the life insurance contracts to which Statement 60 applies. Those new life insurance contracts are characterized by flexibility and discretion granted to one or both parties to the contract. Statement 60 identifies but does not address those contracts, noting that the accounting was under study by the insurance industry and the accounting and actuarial professions.

This Statement requires that the retrospective deposit method be used to account for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount

determined by the account or contract balance that accrues to the benefit of the policyholder. Premium receipts are not reported as revenues when the retrospective deposit method is used. The Statement also requires that capitalized acquisition costs associated with universal life-type contracts be amortized based on a constant percentage of the present value of estimated gross profit amounts from the operation of a “book” of those contracts. Any gain or loss resulting from a policyholder’s replacement of other life insurance contracts with universal life-type contracts is recognized in income of the period in which the replacement occurs.

This Statement requires that long-duration contracts issued by insurance enterprises that do not subject the enterprise to risks arising from policyholder mortality or morbidity (investment contracts) be accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments. Payments received on those contracts are not reported as revenue.

This Statement also addresses limited-payment contracts that subject the insurance enterprise to mortality or morbidity risk over a period that extends beyond the period or periods in which premiums are collected and that have terms that are fixed and guaranteed. This Statement requires that revenue and income from limited-payment contracts be recognized over the period that benefits are provided rather than on collection of premiums.

INTRODUCTION

1. *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*, issued in June 1982, contains specialized accounting principles and practices based on AICPA insurance Industry Audit Guides and Statements of Position. Statement 60 identifies but does not address a number of areas that were being studied by the insurance industry and the accounting and actuarial professions when that Statement was issued. One of those areas is the accounting for universal life insurance and similar products that were developed after the issuance of the AICPA Guides and Statements of Position.

2. Statement 60 describes two methods of premium revenue and contract liability recognition, referred to as long-duration and short-duration contract accounting. Each method is designed to reflect the insurance enterprise’s obligations and policyholder rights under the provisions of the contract. The insurance contracts addressed in this Statement are generally considered long-duration insurance contracts.

3. Recognition of premiums as revenue when due from policyholders and measurement of a liability for policyholder benefits based on a uniform percentage of anticipated premiums are distinguishing features of the accounting for long-duration insurance contracts specified in Statement 60. Because no single function or service is predominant over the periods of most long-duration insurance contracts, recognition of premiums as revenue over the premium-paying periods was considered a reasonable measure of service performed.

4. The differences between universal life insurance and the long-duration contracts described in Statement 60 led many to question the propriety of applying the accounting method described in Statement 60 to universal life insurance. Universal life insurance contracts lack the fixed and guaranteed terms that are typical for the contracts for which the accounting specified in Statement 60 was designed. Policyholders are frequently granted significant discretion over the amount and timing of premium payments. Insurers are frequently granted significant discretion over amounts that accrue to and that are assessed against policyholders.

5. Some long-duration insurance contracts that are addressed by Statement 60 have terms that are fixed and guaranteed but lack either the level premiums or the insurance protection characteristics contemplated in Statement 60. The increasing number of those contracts led the Board to reconsider the accounting for them at the same time it considered the accounting for universal life insurance.

APPLICABILITY AND SCOPE

6. This Statement applies to all insurance enterprises to which Statement 60 applies. The Statement establishes standards of financial accounting and reporting for three classes of long-duration contracts issued by those insurance enterprises and for reporting realized investment gains and losses. Those contracts are referred to in this Statement as investment contracts, limited-payment contracts, and universal life-type contracts. The accounting for long-duration contracts not otherwise addressed by this Statement is prescribed in Statement 60 and *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*.

7. Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as investment contracts. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. 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.

8. Annuity contracts may require the insurance enterprise to make a number of payments that are not contingent upon the survival of the beneficiary, followed by payments that are made if the beneficiary is alive when the payments are due (often referred to as life-contingent payments). Such contracts are considered insurance contracts under this Statement and Statement 60 unless (a) the probability that life-contingent payments will be made is remote¹ or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant².

¹ The term remote is defined in paragraph 3 of FASB Statement No. 5, *Accounting for Contingencies*, as "the chance of the future event or events occurring is slight."

² Webster's New World Dictionary, Second College Edition, defines the term insignificant as "having little or no importance; trivial."

9. Long-duration insurance contracts with terms that are fixed and guaranteed, and for which premiums are paid over a period shorter than the period over which benefits are provided, are referred to in this Statement as limited-payment contracts. The period over which benefits are provided, as used in this Statement, includes the periods during which the insurance enterprise is subject to risk from policyholder mortality and morbidity and during which the insurance enterprise is responsible for administration of the contract. The benefit period does not include the subsequent period over which the policyholder or beneficiary may elect to have settlement proceeds disbursed.

10. Except as provided in paragraph 11 [not excerpted], long-duration insurance contracts with terms that are not fixed and guaranteed are referred to in this Statement as universal life-type contracts. Universal life-type contracts include contracts that provide either death or annuity benefits and are characterized by any one of the following features:

- a. One or more of the amounts assessed by the insurer against the policyholder -- including amounts assessed for mortality coverage, contract administration, initiation, or surrender -- are not fixed and guaranteed by the terms of the contract.
- b. Amounts that accrue to the benefit of the policyholder -- including interest accrued to policyholder balances -- are not fixed and guaranteed by the terms of the contract.

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

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Investment Contracts

15. Investment contracts issued by an insurance enterprise, as defined in this Statement, do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

Limited-Payment Contracts

16. Limited-payment contracts subject the insurer to risks arising from policyholder mortality and morbidity over a period that extends beyond the period or periods in which premiums are collected. For those contracts, the liability for policy benefits shall be established in accordance with the provisions of Statement 60. The collection of premium does not, however, represent the completion of an earnings process. Any gross premium received in excess of the net premium³ shall be deferred and recognized in income in a constant relationship with insurance in force (when accounting for life insurance contracts) or with the amount of expected future benefit payments (when accounting for annuity contracts).

³ Statement 60 defines gross premium as "the premium charged to a policyholder for an insurance contract." That Statement defines net premium as "the portion of the gross premium required to provide for all benefits and expenses."

Universal Life-Type Contracts

17. 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 statements⁴

⁴ Accounting methods that measure the liability for policy benefits based on policyholder balances are known as retrospective deposit methods.

 - 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 60

18. Amounts that may be assessed against policyholders in future periods, including surrender charges, shall not be anticipated in determining the liability for policy benefits. In the absence of a stated account balance or similar explicit or implicit contract value, the cash value, measured at the date of the financial statements, that could be realized by a policyholder upon surrender shall represent the element of liability described in paragraph 17.a. Provisions for adverse deviation shall not be made.

19. Premiums collected on universal life-type contracts shall not be reported as revenue in the statement of earnings of the insurance enterprise. Revenue from those contracts shall represent

amounts assessed against policyholders and shall be reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period.

20. Amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts shall be reported as unearned revenue and recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized acquisition costs. Amounts that are assessed against the policyholder balance as consideration for origination of the contract, often referred to as initiation or front-end fees, are unearned revenues.

Other Amendments to Statement 60

29. This Statement adds the following footnote to paragraph 6 of Statement 60:

*The accounting for certain long-duration insurance contracts referred to as investment contracts, limited-payment contracts, and universal life-type contracts is established by *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.

30. Paragraph 15 of Statement 60 is superseded by the following:

Premiums from long-duration contracts, such as whole-life contracts, guaranteed renewable term life contracts, and title insurance contracts, shall be recognized as revenue when due from policyholders.

52. *AICPA Statement of Position No. 95-1, Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, provides the following guidance on premium revenue recognition and policy reserves:

12. Premiums from participating insurance contracts should be reported as revenue in the statement of earnings when due from policyholders.

Liability for Future Policy Benefits

15. A liability for future policy benefits relating to participating life insurance contracts should be equal to the sum of --

- a. The net level premium reserve for death and endowment policy benefits.
- b. The liability for terminal dividends.
- c. Any probable loss (premium deficiency) as described in paragraphs 35-37 of FASB Statement No. 60.

16. The net level premium reserve should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contract. If the dividend fund interest rate is not determinable, the guaranteed interest rate used in calculating cash surrender values described in the contract should be used. If the dividend fund interest rate is not determinable and there is no guaranteed interest rate, the interest rate used in determining guaranteed nonforfeiture values should be used. Finally, if none of the above rates exists, then the interest rate used to determine minimum cash surrender values -- as set by the National Association of Insurance Commissioners' (NAIC) model standard nonforfeiture law--for the year of issue of the contract should be used. Regardless of the rate used, net premiums should be calculated as a constant percentage of the gross premiums.

17. Terminal dividends should be accrued in the liability for future policy benefits if the following conditions are both met:⁴

- a. Payment of the dividend is probable.
- b. The amount can be reasonably estimated.

⁴ These conditions should be used in the same sense that they are used in *FASB Statement No. 5, Accounting for Contingencies*.

If the two conditions are met (and they ordinarily will be), the terminal dividends should be recognized as an expense over the life of a book of participating life insurance contracts, at a constant rate based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield (net of related investment expenses). If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing the expense amount to be recognized. (The base substituted in this calculation should be the same one substituted in the amortization of deferred acquisition costs discussed in paragraph 20.)

18. Increases in the liability for future policy benefits should be reported as an expense in the statement of earnings.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 13, Aggregate Reserves for Accident and Health Policies, and Chapter 18, Premium Income
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- *AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises*
- *FASB Interpretation No. 40, Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises, an interpretation of FASB Statements No. 12, 60, 97, and 113*
- *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*
- *AICPA Audit and Accounting Guide: Stock Life Insurance Companies*

State Regulations

- No additional guidance obtained from state statutes or regulations. State regulations may be excerpted and discussed, as necessary, in subsequent issue papers dealing with unique aspects of specific life contracts.