Statutory Issue Paper No. 56

Universal Life-Type Contracts, Policyholder Dividends, and Coupons

STATUS
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Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance for universal life-type contracts, policyholder dividends, and coupons is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 15, Liabilities Related to Policyholder Dividends, Chapter 18, Premium Income, and Chapter 20, Policy and Contract Benefits, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). General reserve requirements and accounting for life contracts has been established in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50) and *Issue Paper No. 51—Life Contracts* (Issue Paper No. 51). Current SAP requires liabilities for dividends on participating policies to be established for dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following calendar year, and dividends left on deposit to accumulate at interest. Unmatured policyholder coupons are recorded at the present value of the unmatured coupons, discounted at interest and mortality.

2. GAAP guidance for universal life-type contracts and coupons requires policy reserves or liabilities to be established using the balance that accrues to the benefit of the policyholder and requires all dividends to be accrued based on the results to date, regardless of when due or payable.

3. The purpose of this issue paper is to provide additional guidance on certain unique features and characteristics relating to universal life-type contracts, policyholder dividends, and coupons consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to all universal life-type contracts described in Issue Paper No. 50, all participating contracts, and to all life insurance contracts with coupons. It applies the basic reserving principles relating to life contracts as established in Issue Paper No. 51, prescribes additional accounting requirements regarding unique features of universal life-type contracts, as well as accounting requirements for dividends on participating policies and coupons on life policies.

5. Universal life-type contracts include, among others, flexible premium universal life and fixed premium universal life contracts. Participating contracts include any contract where policyholders are entitled to policy dividends.

6. Premium recognition for fixed premium universal life-type contracts shall be consistent with the accounting requirements of Issue Paper No. 51. Premium on flexible premium universal life-type contracts shall be recorded when received from the policyholder.

Flexible Premium Universal Life-Type Contracts

7. Policy reserves are generally established 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. Unlike traditional life insurance contracts, flexible premium universal life-type contracts do not have guaranteed premiums and some assumption as to future premiums is required. Appendix A-585 establishes a minimum reserving method for universal life-type contracts by providing guidance on how to estimate future premiums on flexible premium universal life-type contracts so that traditional valuation methodologies could be used. Alternative minimum reserves shall be required, if applicable, for flexible premium universal life-type contracts if the guaranteed maturity premium is less than the valuation net premium. Appendix A-585 shall be used in establishing reserves for flexible premium universal life-type contracts.

Fixed Premium Universal Life-Type Contracts

8. Policy reserves are generally established 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. Fixed premium universal life-type contracts shall also follow the guidance in Appendix A-585. Certain fixed premium products offer the policyholder a secondary guarantee. A secondary guarantee provides the policyholder a guaranteed set of cash values, death benefits, and maturity benefits that will be provided regardless of the performance of the policy value. Appendix A-585 requires secondary guarantees to be considered when establishing policy reserves and shall be followed in establishing reserves for fixed premium universal life-type contracts.

Policyholder Dividend Liability

9. A reporting entity shall accrue, as applicable, the following items relating to participating policies. They are dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following twelve months, and dividends left on deposit to accumulate at interest.

10. Dividends due and unpaid represent dividends payable to the policyholder in the current year but which have not been disbursed or otherwise applied at the reporting date.

11. Dividends payable in the following calendar year represent the estimated amount of all dividends declared by a reporting entity’s board of directors prior to the end of the statement year which are not yet paid or due at the end of the year (dividends apportioned for payment) as well as all dividends payable in the following calendar year that have not been declared (dividends not yet apportioned for payment). For individual insurance the amount of this liability shall be equal to the aggregate amount of the dividends estimated to be payable in the following calendar year whether or not declared or apportioned. For group insurance and pensions, the amount of liability is generally equal to the portion of the dividend payable in the following calendar year which has been earned in the current calendar year.

12. Dividends left on deposit with the reporting entity shall be recorded in the amount of the deposit and accrued interest thereon. At the balance sheet date, the interest accrued but not yet credited to the policyholders’ accounts, shall be established as part of this liability.

Coupons

13. Some entities issue policies that guarantee an annual return, usually evidenced by a coupon that is part of the policy and matures on the policy’s anniversary. This return represents an annual pure endowment, and is essentially a return of premium previously paid by the policyholder. For matured coupons that have been left to accumulate, the liability is determined in the same way as the liability for dividend accumulations. Interest accrued is calculated for each coupon from the date each matures. The liability for unmatured policyholder coupons shall be the face value of the coupon, discounted at interest and mortality.

Disclosures

14. 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.

15. 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.

16. 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.

17. 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.

18. 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

Statutory Guidance

19. The statutory accounting principles outlined in the conclusion above are consistent with current statutory accounting and Issue Paper No. 51.

Flexible Premium Universal Life-Type Contracts

20. As discussed in Issue Paper No. 51, policy reserves are generally established 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. Traditional life insurance contracts generally provide a guaranteed set of future cash values and death benefits for a stated premium. Flexible and fixed premium universal life contracts typically develop cash surrender values that are based on a retrospective accumulation of premiums less mortality and expense charges, at a rate of interest declared by the reporting entity or based upon an index. Features such as flexible premiums and variable interest contracts are not compatible with the valuation procedures used for traditional contracts.

21. Flexible premium contracts produce a special valuation problem in that some assumption as to future premiums is required. The method of estimating the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums must be modified to apply to a flexible premium universal life-type contract since neither future premiums nor future benefits are known for a particular policy. The Model UL Regulation established a minimum reserving method for universal life-type contracts by providing guidance on how to estimate future premiums and related benefits on flexible universal life-type contracts so that traditional valuation methodologies could be used.

22. The Model UL Regulation provides a method for calculating reserves for flexible premium universal life contracts as the present value of future guaranteed benefits less the present value of valuation net premiums where the present value of valuation net premiums takes into account an expense allowance, multiplied by a ratio. This ratio is determined at each valuation date as the policyholder account balance divided by the Guaranteed Maturity Fund (GMF), the ratio not to exceed 1. The GMF's are an accumulation of Guaranteed Maturity Premiums (GMP) which are level gross premiums that provide for endowment at the latest permissible maturity date under the contract. Alternative minimum reserves shall be required, if applicable, for flexible premium universal life-type contracts if the guaranteed maturity premium is less than the valuation net premium, both as defined in the Model UL Regulation.

Fixed Premium Universal Life-Type Contracts

23. Many reporting entities offer products whose cash values are calculated using universal life-type contract accumulation procedures, but which lack complete flexibility in premium payments. These products follow a similar set of valuation rules set forth in Appendix A-585. However, some of these products also offer the policyholder a secondary guarantee. A secondary guarantee provides the policyholder a guaranteed set of cash values, death benefits, and maturity benefits that will be provided regardless of the performance of the policy value.

24. Reserves for these products under Appendix A-585 are determined by computing the excess of the projected present value of future guaranteed benefits, taking into account secondary guarantees, over the present value of the future valuation net premium guaranteed at issue.

Policyholder Dividend Liability

25. Ordinary life and industrial life policies may be issued either on a participating or a nonparticipating plan. Under participating plans, policyholders are entitled to policy dividends that have been declared by the reporting entity's board of directors. These dividends reflect all or a part of the difference between the premium charged for a given class of policies and the actual cost of these policies as experienced by the reporting entity based on the terms of the contract.

26. On ordinary policies, the policyholder generally may choose one of five ways of receiving or using the dividend. If no choice is made, the policy usually states which option is to be automatically used. Dividends may be either (1) paid in cash, (2) applied as a reduction of the next premium, (3) applied to buy paid-up additional insurance, (4) left on deposit with the reporting entity to accumulate at a guaranteed rate of interest, or (5) applied to purchase one-year term insurance up to the maximum specified in the agreement (generally the policy cash surrender value) with any balance of the dividend being applied under one of the four other options. Other options may also be available.

27. On industrial policies, dividends are usually paid as premium credits (applied to pay renewal premiums) or as paid-up additional insurance, as specified in the policy.

28. Group life may also be issued on a participating or a nonparticipating basis. If the contract is nonparticipating, it may provide for refunds or premium adjustments through a variety of experience rating arrangements. The group contract may state the experience rating formula to be used in the calculation of refund of premium adjustment. See *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts regarding* experience rating refunds.

29. A liability shall be established for the estimated dividends that will be paid on participating policies in the next twelve months, whether declared or not (dividends not yet apportioned for payment), since dividends are generally paid in the next policy year. Ordinary life contract dividends should also include those contingent on the payment of renewal premiums (generally first year dividends).

GAAP Guidance

30. In Issue Paper Nos. 50 and 51, the GAAP guidance (principally, *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), *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), and *AICPA Statement of Position 95-1*, *Accounting for Certain Activities of Mutual Life Insurance Enterprises* (SOP 95-1)) related to insurance contracts, including universal life-type and participating contracts, was rejected for the reasons set forth therein.

Drafting Notes/Comments

- SAP literature was not excerpted from Chapters 10 and 18 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies since all such literature is included in Issue Paper 51 which is consistent with this issue paper.
- Issue Paper No. 50 addresses Classifications and Definitions of Insurance Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- 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. 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.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (only pertinent excerpts are included below)

Statutory Accounting

31. The Life/A&H Accounting Practices and Procedures Manual, Chapter 15, Liabilities Related to Policyholder Dividends, provides the following guidance with respect to policyholder dividends:

> A company may have three liabilities for policyholder dividends. They are dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following calendar year, and dividends left on deposit to accumulate at interest. (Some companies may have an additional dividend liability to provide for amounts provisionally held for payment under deferred dividend policies beyond the following calendar year. Deferred dividend policies, generally prohibited or no longer issued, provide for dividends payable at less frequent intervals than annually.)
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> Dividends Due and Unpaid
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> These are dividends payable to the policyholder in the statement year but which have not been disbursed or otherwise applied at the balance sheet date. This may happen when the cash dividend has not yet been disbursed or, to a greater extent, when the premium to which the dividend is to be applied has not been collected and the full premium has been recorded as due and uncollected.
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> Dividends applied to reduce the premium usually are recorded when the premium is collected. Thus, if a premium is due at the balance sheet date, the premium is recorded as uncollected and a liability for the dividend is established. This may not be the case if the company does all of its bookkeeping for due premiums as if the premium had been collected on the due date. If it does, it would have effectively applied all dividends except those payable in cash.
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> Some companies pay a first policy year dividend conditional on the payment of the second year premium. Treatment would be similar to that of a dividend used to reduce premium payments.
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> Dividends Payable in the Following Calendar Year
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> The estimated amount of all dividends declared by a company's board of directors prior to the end of the statement year which are not yet paid or due at the end of the year, must be included under the liability "Dividends apportioned for payment" in the annual statement. Since companies may declare dividends to policyholders based on other than calendar year anniversary dates (i.e., July 1 to July 1), it is occasionally necessary to estimate the amount of dividends which may be ultimately paid. Thus, at December 31 of the current year, dividends payable from January 1 to June 30 of the following year would be reported under "Dividends apportioned for payment" and an estimate of dividends payable from July 1 of the following year to December 31 of the following year would be reported under "Dividends not yet apportioned". In other words, a company must establish a liability for all dividends payable in the following calendar year whether declared or not. In some instances, the board does not declare dividends until after the end of the year at which time the surplus earnings for the statement year will have been determined. The estimated amount of such dividends to be authorized for payment in the calendar year following the statement date must also be included under "Dividends not yet apportioned."
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> For individual insurance the amount of this liability should be equal to the aggregate amount of the dividends estimated to be payable in the following calendar year whether or not declared or apportioned. Such dividends should include those contingent on the payment of renewal premiums (generally first year dividends).
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> For group insurance and pensions, the amount of liability is generally equal to the portion of the dividend payable in the following calendar year which has been earned in the current calendar year. For group pensions the dividend year is generally a calendar year.

Dividend Accumulations

If the policyholder elects to leave the dividend on deposit with the company, the company must record an appropriate liability. This liability is for the amount of the deposit and accrued interest thereon. Interest usually is credited annually on the policy anniversary at the rate stated in the policy or at a rate declared by the company if greater than the stated contract or guaranteed rate. At the balance sheet date, the interest accrued but not yet credited to the policyholders' accounts, must be established as part of this liability.

Coupons

Some companies issue policies that guarantee an annual return, usually evidenced by a coupon that is part of the policy and matures on the policy's anniversary. This return represents an annual pure endowment, and is essentially a return of premium previously paid by the policyholder. Some states prohibit or strictly regulate policies with such provisions. To collect the return, in most cases, the policyholder must submit the coupon to the company. If the coupon is not submitted for payment, it should be treated as a deposit (accumulation) and accrue interest at the stated rate.

Coupons may be presented for cash, be used to reduce the premium, or left at interest. If the company permits, a coupon also may be used to purchase paid-up additional insurance.

The liability for unmatured coupons is generally carried as part of the policy reserve or as a separate policy liability. No matter how the liability is presented, it generally is the same as that for a one-year pure endowment policy in the amount of the face value of the coupon.

For matured coupons that have been left to accumulate, the liability is determined in the same way as the liability for dividend accumulations. Interest accrued is calculated for each coupon from the date each matures.

32. The Life/A&H Accounting Practices and Procedures Manual, Chapter 20, Policy and Contract Benefits, provides the following guidance with respect to policy and contract benefits including policyholder dividends:

Other Benefits

Other contract benefits reported in the Summary of Operations are:

1. Coupons, guaranteed annual pure endowments, and similar benefits.

2. Surrender benefits. These are amounts payable on termination of a policy other than by death or maturity. Such surrender benefits, where available, are guaranteed in the policy. The surrender value of additional insurance purchased by application of dividends is included in this item as well as amounts applied to repay any existing policy loan.

3. Interest on policy or contract funds. Included here are incurred interest payments made on deferred benefit payments and interest credited on premium and other deposit funds after deducting the discount allowed on policy proceeds paid in advance. Excluded from this item are interest on supplementary contracts, dividend accumulations and accumulations of coupons, and guaranteed annual pure endowments which do not exceed the annual premium and similar benefits.

4. Payments on supplementary contracts with life contingencies. In addition to the periodic payments incurred this would include the commuted value of any remaining guaranteed payments upon termination of the contract by death or surrender.

5. Payments on supplementary contracts without life contingencies and of dividend accumulations. The commuted value of any remaining payments upon termination of supplementary contracts without life contingencies by death or surrender would also be included.

6. Accumulated coupon payments.

Dividends to Policyholders

Individual life and health insurance policies may be issued either on a participating or a nonparticipating plan. Under the participating plan, policyholders are entitled to policy dividends that have been declared by the company's board of directors. These dividends reflect the difference between the premium charged for a given class of policies and the actual cost of these policies as experienced by the company. Under the nonparticipating plan, policies are written for a premium that is usually lower than the gross premium on participating insurance.

Group life and health insurance pensions also may be issued on a participating or a nonparticipating basis. If the contract is nonparticipating, it may provide for refunds or premium adjustments through a variety of experience rating arrangements. The group contract may state the experience rating formula to be used in the calculation of refund of premium adjustment. If the formula is stated, it will usually provide that the difference of premiums and interest over claims, reduced by applicable contingency reserves and a retention percentage, will be paid to the group contract holder. The retention percentage is based on the amount the company estimated to be necessary for administration costs, contingency reserves, insurance costs (for pooled experience in all similar groups, i.e., to pay some of the claims in other similar groups when these claims exceed the premiums collected for those similar groups), and a margin for profit. If the contract is participating, dividends will be paid in cash to the employer or, on his written request, be used toward the payment of the next premium.

Should dividend adjustments exceed the amounts contributed by an employer in a contributory plan, the excess must be used for the benefit of the employees—refunded to them, used to enable them to skip contributions for a period, or applied to buy additional insurance or benefits.

Dividends distributed to participating policyholders are not profits in a commercial sense; instead; they represent a return of a portion of the gross premium. The portion of the company's earnings before dividends that is not deemed necessary to strengthen surplus or contingency reserves may be distributed among individual policyholders.

The method of calculating dividends is rarely, if ever, stated in the policy. Instead, the policy makes some declaration that, perhaps, may state: "While this policy is in force...the share of the divisible surplus accruing on this policy shall be annually determined by the company and apportioned as a dividend payable on the following policy anniversary. It is not anticipated that a dividend will be payable for at least two years from date of issue." The statutes of various states describe the conditions under which policyholder dividends are to be declared and paid.

Each year the company must determine how much of the total earned surplus (previously existing, plus additions for the year) should be retained as a contingency fund (or as another special surplus appropriation) and how much should be distributed to the policyholders. It is important to note that no fixed relationship may exist between the surplus gain in a particular calendar year and the dividends distributed to the policyholders on the next policy anniversaries. The directors of the company make the decision as a matter of business judgment. The amount earmarked for distribution is designated as divisible surplus and, once set aside by action of the directors, loses its identity as surplus and becomes a liability of the company.

A company having both participating and nonparticipating policies in force usually must make a separate accounting of each class of insurance and include with its annual statement a separate statement of the operations of each class unless an overwhelming proportion of the business in force (90% of more in certain states) is either participating or nonparticipating. Some states limit the amount of surplus attributable to participating policies that may be transferred to the benefit of the stockholders.

Individual life insurance policies that will participate in the operating gains of the company are almost always sold as such. Occasionally, a company may pay a dividend on a nonparticipating policy or convert it to a participating plan. These situations, however, are very unusual.

Dividends are generally payable on the policy anniversary provided all premiums (annual premiums or installments) have been paid up to that date. The first dividend under a policy is usually paid at the end of the second or third policy year. Occasionally, a dividend is paid at the end of the first policy year on the condition that the annual premium for the second year has been collected.

On ordinary policies, the policyholder generally may choose one of five ways of receiving or using the dividend. If no choice is made, the policy usually states which option is to be automatically used. Dividends may be either (1) paid in cash, (2) applied as a reduction of the next premium, (3) applied to buy paid-up additional insurance, (4) left on deposit with the company to accumulate at a guaranteed rate of interest, or (5) applied to purchase one-year term insurance up to the maximum specified in the agreement (generally the policy cash surrender value) with any balance of the dividend being applied under one of the four other options. Other options may also be available.

On industrial policies, dividends are usually paid as premium credits (applied to pay renewal premiums) or as paid-up additional insurance, as specified in the policy.

Dividends to the policyholders incurred during the period represent the dividends paid or credited, adjusted to include the liabilities at the statement date for dividends due and unpaid, less the corresponding liabilities outstanding at the end of the previous period.

Generally Accepted Accounting Principles

33. FAS 60 provides the following guidance related to policyholder dividends (other relevant sections of FAS 60 have been excerpted in Issue Paper No. 51):

Policyholder Dividends

41. Policyholder dividends shall be accrued using an estimate of the amount to be paid.

42. If limitations exist on the amount of net income from participating insurance contracts of life insurance enterprises that may be distributed to stockholders, the policyholders' share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders' equity by a charge to operations and a credit to a liability relating to participating policyholders' funds in a manner similar to the accounting for net income applicable to minority interests. Dividends declared or paid to participating policyholders shall reduce that liability; dividends declared or paid in excess of the liability shall be charged to operations. Income-based dividend provisions shall be based on net income that includes adjustments between general-purpose and statutory financial statements that will reverse and enter into future calculations of the dividend provision.

43. For life insurance enterprises for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends (based on dividends anticipated or intended in determining gross premiums or as shown in published dividend illustrations at date insurance contracts are made) shall be accrued over the premium-paying periods of the contracts.

34. SOP 95-1 provides the following guidance on policy reserves for participating contracts issued by mutual life insurance enterprises, fraternal benefit societies and stock life insurance subsidiaries of mutuals or fraternals:

> Liability for Future Policy Benefits
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> 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.
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> c. Any probable loss (premium deficiency) as described in paragraphs 35 to 37 of FASB Statement No. 60.
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> 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.
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> 17. Terminal dividends should be accrued in the liability for future policy benefits if the following conditions are both met:[4]
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> a. Payment of the dividend is probable.
> b. The amount can be reasonably estimated.
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> [4] These conditions should be used in the same sense that they are used in FASB Statement No. 5, *Accounting for Contingencies*.
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> 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.)
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> 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, Chapters 15 and 20
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 51—Life Contracts*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts*

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*

State Regulations

- No additional guidance obtained from state statutes or regulations.