

# Statutory Issue Paper No. 51

## Life Contracts

### STATUS

Finalized March 16, 1998

Original SSAP: SSAP No. 51; Current Authoritative Guidance: SSAP No. 51R

### 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).



**Uncollected Premium Balances**

15. Gross premiums that are due and unpaid as of



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- 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:

- 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;

- 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 3 Tc 0 Tw -22.721 -1.1o



35. Except as discussed in paragraphs 36-41, the statutory accounting principles outlined in the conclusion above regarding income

**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

- 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 require

- 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 unmaturing 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

placed on icy year.

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### 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.







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

## 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 enterprises<sup>2</sup>, 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.

<sup>2</sup> 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

( 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



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



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*

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

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<sup>4</sup> 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.)

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.