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AICPA Releases SOP 05-1

Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts

by John W. Morris

AICPA Releases SOP 05-1

In September 2005, the American Institute of Certified Public Accountants, (AICPA) released the long-awaited Statement of Position 05-1: **Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts** (SOP or SOP 05-1). More than five years in development, the SOP provides guidance on how insurance companies should account for deferred acquisition costs (DAC) relating to insurance and investment contracts that have had modifications in product benefits, features, rights or coverages. The modifications can occur in various forms, such as a contract exchange, by amendment, endorsement or rider to an existing contract, or by the election of a feature or coverage within an existing contract. The SOP (and this article) refers to all such modifications as "internal replacements," thus defining the term more broadly than what the insurance industry may have referred to in the past as internal replacements (typically explicit contract exchange programs).

The primary issue addressed by the SOP is the treatment of DAC associated with replaced policies. Is the replacement considered to be a termination of the initial contract, which would therefore result in a reduction in the DAC asset? Or, is the replacement effectively a continuation of the original contract and, therefore, is there continued amortization of the DAC asset relating to the original contract? In addition to the financial reporting impact, the SOP may have an effect on future policy designs.

This article provides a review of the requirements of the SOP, concentrating on the definition of an internal replacement and the criteria for determining whether such replacements are considered substantially changed. It also raises potential implementation issues, and raises the possibility that companies will consider modification to policy designs as a result of issues highlighted by the SOP. As companies develop, update and execute their in-force management strategies, the SOP generates further considerations for companies seeking to address profitability, customer service and compliance issues

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associated with customer-driven and company-driven replacements.

Requirements of the SOP

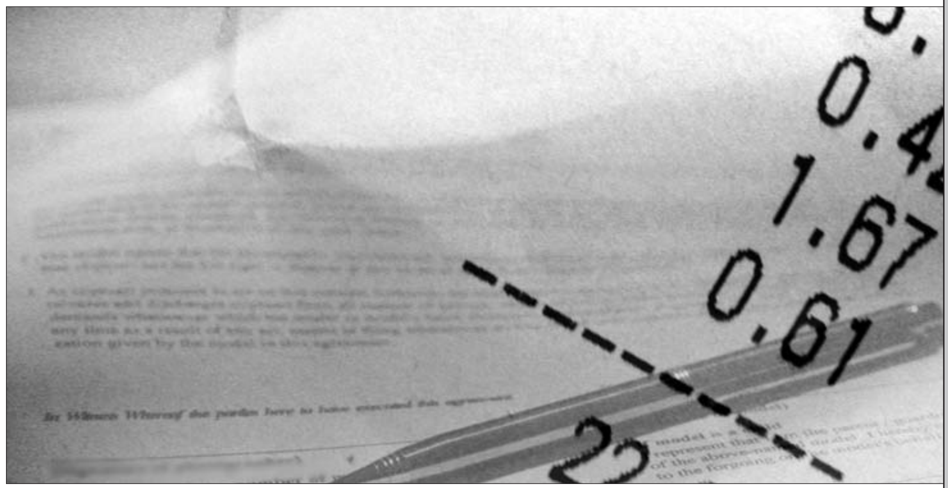
On the surface, internal replacements may not appear to be a difficult subject. It would seem that everyone knows what internal replacements are, or at least would be able to recognize one when they saw it. However, developing and applying a definition of an internal replacement that fits all situations is not simple once one gets into the details and variety of transactions that companies have with their policyholders. (For example, is there an accounting implication of adding a general account option to a variable annuity, or of adding a second driver on an auto policy?) Since the SOP contains extensive guidance, any reasonable summary of the SOP is sure to omit certain provisions that may be important to a company's specific situation. As always, readers (particularly preparers of financial statements) are strongly encouraged to read the SOP and not to rely on this or other summaries as their sole source of information.

Overview

The initial guidance in the SOP covers whether the provisions of the SOP apply to specific contract exchanges or modifications by:

- Determining whether the internal replacement relates to the election of a benefit or right that was present in the existing contract. If so, determine whether it meets the exclusion criteria in the SOP.
- Determining whether the feature being added is a "nonintegrated contract feature," as defined in the SOP. If so, the feature is not considered to change the original contract, and is treated in a manner similar to a separately issued contract, thus not impacting the accounting for the original contract.

If the internal replacement does not meet either of the exclusions noted above, it is considered an integrated contract feature, and must meet all of the six conditions specified in the SOP to be considered a "substantially unchanged" contract. In general, that guidance in the SOP is:



- For internal replacements, which result in contracts that are "substantially unchanged," the replacement contract should be treated as a continuation of the original contract for the purpose of DAC amortization.
- Otherwise, when an internal replacement results in contracts that are "substantially changed," the original contract should be accounted for as a termination, and the modified contract accounted for as a new issue. In these situations, because the original contract is effectively considered extinguished, the DAC asset relating to the terminated contract can no longer be deferred. New acquisition costs associated with the replacement contract are to be capitalized and amortized as DAC if they meet the criteria for deferral, and amortization would be based on the characteristics of the replacement contract only.
- Accounting for sales inducement assets, unearned revenue liabilities and any additional liabilities (e.g., guaranteed minimum death benefits of variable annuities) associated with the original contract would be accounted for in a similar manner as described above for the DAC asset. That is, if the contracts are substantially unchanged, those balances would continue to be recognized as part of the replacement contract accounting. If the contract were considered substantially changed, those asset and liability balances would be accounted for as

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part of the extinguishment of the replaced contract and the issuance of a new contract.

Although the guidance in the SOP is applicable to life as well as property & casualty insurance companies, life companies will experience the main impact of the pronouncement.

Definition of Internal Replacement

An internal replacement under the SOP could result from one of three main types of modifications to the benefit features in the contract:

1. A contract exchange (legal extinguishment of one contract and the issuance of a new contract),
2. Amendment or attachment of an endorsement or a rider to an existing contract, or
3. The election of a benefit feature, right or coverage within an existing contract.

The purpose of having such a broad definition of an internal replacement is to enable application of the guidance in the SOP consistently to similar transactions regardless of the form of the transaction. For example, the same accounting guidance applies to a variable annuity in the following two situations:

a Additional variable account investment options are added to the contract through a contract amendment, or

b. The contract is replaced with another variable annuity, with the only changes being the addition of additional variable account investment options.

Similarly, the same accounting guidance applies when a guaranteed minimum withdrawal benefit (GMWB) is added to a variable annuity in either of two situations:

a. A GMWB rider is added to a contract previously issued without such a guarantee, or

b. The contract is replaced with a new contract where the only material change is the addition of the GMWB.

Likewise, there are instances when the election of a benefit feature within an existing contract will result in a contract modification, for example, when a guarantee feature can voluntarily be elected subsequent to contract issuance and the fee charged for this additional benefit is not specified until elected.

Substantially Unchanged

Perhaps at the heart of the SOP are the six criteria that must all be satisfied in order for a contract modification to be considered "substantially unchanged." While all six are important, the first two criteria involving the insured event and investment return rights are the most critical for the usual contract modifications currently occurring in the marketplace.

1. The first criterion requires that there be no significant change in the kind and degree of insurance risk within the contracts. For example, replacing a mortality contract with a morbidity contract changes the kind of insured event. In addition, although a life insurance contract and a life contingent payout annuity both contain mortality risk, they are clearly different types of mortality risk.

   When the kind of risk is determined to be the same, the degree of risk needs to be assessed. That determination will be subjective as there is no specific guidance in the SOP on how to measure "degree of risk." Re-underwriting all or a portion of the original base contract will generally result in a substantial change to the insurance risk. Companies will need to develop and consistently follow an accounting policy on what constitutes a significant change in the degree of risk.

2. The second criterion requires that there be no change in the nature of the investment return (i.e., the manner is which the policyholder's investment return rights are determined). The SOP provides examples of various ways that interest may be credited in the policy—either by formula (such as that found in equity indexed products), pass-through of actual performance (such as that typically found in separate account products), or credited at the discretion of the insurance company (the typical general account product design). Changes between these three different types of interest crediting would fail the "substantially unchanged" test and require the original contract to be considered terminated and the modified contract to be considered a new issue.

One of the most challenging aspects of application is likely to be in the interpretation of what constitutes a change in the degree of mortality risk and in the nature of investment return for modifications relating to complex contracts such as variable contracts with minimum guarantees. For example, variable contracts with existing mortality guarantees may be modified to offer enhanced mortality guarantees. In some cases, the enhancement may be deemed to be so significant as to result in a substantial change, while in other cases, it may not. The addition of a significant investment floor, such as a GMWB added to a variable product, is considered to be a significant change. Interestingly, it is not clear in the SOP if the deletion of such a floor should also be considered a substantial change. If the original contract contains a clear right of the policyholder to delete the coverage, this type of transaction could be interpreted as not being an internal replacement subject to the guidance in the SOP. In analyzing the effect of the SOP on a change in the investment floor, the company will need to consider the degree of change associated with the modification when applying the SOP to this type of transaction.

The remaining four criteria include provisions that the internal replacement not require any additional deposit/premium/charge, a reduction in the contract holder's account value, a change in the participation or dividend features or a change in the amortization method or revenue classification of the contract. If any of the criteria are not met, then the internal replacement is deemed to be a "substantial change."

Integrated vs. Non-Integrated Benefit Features

The SOP recognizes that there may be certain riders, benefit features, endorsements or coverages that function as separate contracts from the original contract. The underwriting and pricing for a non-integrated benefit are typically executed separately from other components of the contract. An accidental death benefit rider added to a whole life insurance policy is an example of a non-integrated benefit. In contrast, an integrated benefit feature for a long-duration contract, such as a universal life policy, is one in which the benefits provided by the feature can be determined only in conjunction with the balances related to the base contract. A GMWB is an example of an integrated benefit feature.

Under the SOP, the addition of a non-integrated benefit feature should be accounted for as if the feature is a separate contract, and, therefore, most of the other provisions of the SOP are not applicable. In contrast, additions or changes determined to be integrated features require further analysis to determine whether the addition of the integrated feature

produce a contract that is substantially changed or substantially unchanged.

Now if you think this is all getting a little complicated, you are not alone. The Accounting Standards Executive Committee of the AICPA thought so as well. Included as Appendix C of the SOP is an application flowchart designed to help clarify the complicated steps.

Prospective Revision Method for FAS 60 Products

An interesting provision in the SOP is the requirement to use a "prospective revision" method for applying the SOP for FAS 60 products that are substantially unchanged. Under the prospective revision method, DAC balances at the time of the transaction are unchanged, and any changes in the contract are reflected in future amortization only. Interestingly, the SOP states that this method is considered an appropriate application of the FAS 60 guidance on premium changes for indeterminate premium life insurance and guaranteed renewable health products. Although many have already considered this to be the appropriate GAAP accounting treatment for premium rate changes under FAS 60, the guidance in the SOP appears to be the first time this issue has been addressed in authoritative GAAP literature.

Implementation

Although the SOP has a required effective date of January 1, 2007, companies that have not begun to implement the SOP are probably already behind schedule. The long lead time was set knowing that the SOP will be difficult for many companies to implement.

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In addition, companies are likely to want to take proactive steps in managing their inforce or adjusting their new business product portfolios in advance of implementing the SOP.

The following steps are suggested as an approach to implement the SOP:

1. Prepare an inventory of current and expected potential internal replacement transactions (types and volume).
2. Determine whether any of the transactions meet one of the two exclusions provided by the SOP (i.e., either election by the contract holder of a benefit, feature, right or coverage that was within the original contract or qualifies as a non-integrated feature).
3. Determine whether each transaction that does not qualify for exclusion is an internal replacement resulting in (a) a substantially unchanged contract or (b) a substantially changed contract.
4. Follow the appropriate SOP accounting for the related deferred acquisition cost asset, sales inducement asset, unearned revenue liability and any additional liability categorized in Step (3) above.
5. Identify when the accounting treatments identified in Step 4 differ from a company's current accounting policies.
6. Create or modify administrative and accounting information systems as appropriate to capture the required information for implementing the SOP. DAC amortization models will likely need to be modified to properly account for internal replacements under the SOP.

For companies that are part of a large group of affiliated companies with multiple insurance company legal entities, the implementation of the SOP may be particularly challenging for several reasons. First, for a consolidated financial statement presentation, an internal replacement under the SOP could result from the replacement of a policy from one company by one from a different but affiliated company, causing the need to be able to track such replacements within the entire organization. In addition, the accounting for internal replacements may become even more taxing if stand-alone financial statements are also necessary for individual companies within the entire group.

Longer Term Effects

It is reasonable to predict that companies will not want to increase DAC amortization every time a floor is added to a separate account product. It is also reasonable to expect that product design professionals will consider, among other factors, how changes in contract designs effect the results in their GAAP financial statements, and may choose a design meeting other company objectives that lessens the effects of the SOP. Will, for example, the provisions in the SOP now make it more attractive for companies to fix the price at issue of the original contract of certain elect-able benefits? Will companies find a way to design product features so that they are considered to be non-integrated under the SOP? For example, would a GMWB tied to an outside index be as attractive to a company or a policyholder as one tied to the policyholder's specific account value? These are just a couple of examples of how the SOP may affect future policy design.

Conclusions

SOP 05-1 seeks to address current diversity in industry practice on accounting for internal replacements, providing authoritative and relatively detailed guidance for insurance entities. The required effective date of 2007 recognizes the administrative challenges, including likely systems development work, for implementation. In addition, companies are likely to want to take proactive steps in managing their inforce or adjusting their new business product portfolios in advance of implementing the SOP. As a result, the author strongly encourages companies to quickly begin a process to review in detail the guidance of the SOP, establish cross-functional teams to identify the variety of situations addressed by the SOP, and develop the administrative and financial system applications to track and implement the accounting requirements. $