Financial reporting developments

A comprehensive guide

Insurance contract modifications or exchanges

Accounting for deferred acquisition costs in connection with modifications or exchanges of insurance contracts (before the adoption of ASU 2018-12, Financial Services — Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI))

Revised July 2024

EY

Building a better working world

To our clients and other friends

The American Institute of Certified Public Accountants (AICPA) issued in 2005 the Statement of Position (SOP) 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*, to provide a conceptual framework for determining the proper accounting for modifications or exchanges of insurance contracts. The guidance was primarily codified in Accounting Standards Codification (ASC) 944-30, *Financial Services — Insurance: Acquisition Costs*. The AICPA also issued technical questions and answers related to the guidance (AICPA Q&A Section 6300). The questions and answers are nonauthoritative but provide an additional resource for industry practice.

The Financial Accounting Standards Board (FASB) issued guidance (ASU 2018-12) in August 2018 that changes how insurers account for and make disclosures about long-duration contracts to provide users of the financial statements with more meaningful information about the amount, timing and uncertainty of cash flows related to these contracts. The guidance changes how insurers recognize and measure insurance liabilities and deferred acquisition costs. It also requires them to make new disclosures. An SEC filer that is not a smaller reporting company (SRC) was required to adopt the guidance for fiscal years beginning after 15 December 2022 (i.e., 2023 for calendar-year insurers) and for interim periods therein. All other entities (i.e., SRCs and private insurers) are required to adopt the guidance for annual periods beginning after 15 December 2024 (i.e., 2025 for calendar-year insurers) and interim periods within fiscal years beginning a year later. See our Technical Line, ***A closer look at how insurers will have to change their accounting and disclosures for long-duration contracts*** (SCORE No. 05073-181US), for a detailed discussion.

This publication has been updated to include our observations on this guidance and other topics based on our experience in addressing our clients' insurance accounting, actuarial, tax and financial reporting issues. This publication is intended to help you understand and apply the accounting requirements relating to contract modifications and exchanges. We are available to assist you in understanding and complying with these requirements and are ready to address your concerns and answer questions.

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Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

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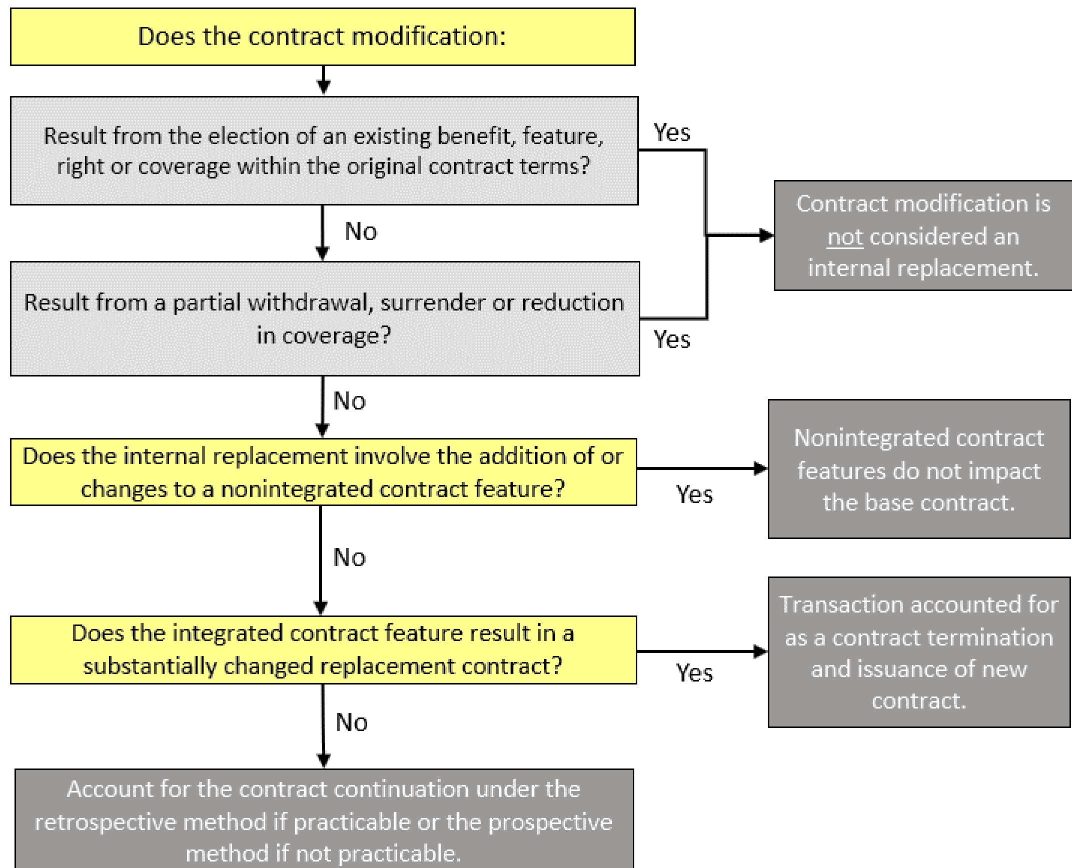
1 Deferred acquisition costs in connection with contract modifications or exchanges

Insurance entities often develop new product offerings or give contract holders the ability to make modifications to existing contracts to enhance contract holder satisfaction and retention. For example, when universal life contracts became popular, they were often purchased as replacements for traditional life insurance contracts issued by the same company, with the cash surrender value of the traditional life insurance contract used to make the initial premium deposit for the new contract.

Today's accounting guidance for deferred acquisition costs in connection with modifications or exchanges of insurance contracts (referred to as an internal replacement) primarily originated from SOP 05-01 that was issued by the AICPA and subsequently codified by the FASB in ASC 944-30. This guidance addresses the determination of whether modifications (including exchanges) meet the criteria of internal replacements and, if so, whether the internal replacements are characterized as integrated or nonintegrated contract features.

Conclusions reached under this guidance will determine whether an entity accounts for the activity as a continuation of the existing contract or an extinguishment of the existing contract followed by the establishment of a replacement contract. The following graphic summarizes these considerations.



Excerpt from Accounting Standards Codification

Master Glossary

Internal Replacements

A modification in product benefits, features, rights, or coverages that occurs by a contract exchange; by amendment, endorsement, or rider to a contract; or by the election of a benefit, feature, right, or coverage within a contract.

Contract Exchange

The legal extinguishment of one contract and the issuance of another.

The guidance provides a broad definition of transactions that should be categorized as internal replacements; however, there are two primary exceptions. First, modifications that result from the election by the contract holder of a benefit, feature, right or coverage that was within the original contract are not internal replacement transactions, provided certain conditions are met as outlined in section 2.2. Second, partial withdrawals, surrenders or reductions in coverage that are based on terms fixed and specified at the contract inception are generally not considered internal replacements as outlined in section 2.3. Reductions in coverage required by state law or regulation may also meet the terms of this exception.

Excerpt from Accounting Standards Codification

Master Glossary

Integrated Contract Feature

A contract feature in which the benefits provided by the feature can be determined only in conjunction with the base contract.

Nonintegrated Contract Feature

A contract feature in which the benefits provided are not related or dependent on the provisions of the base contract.

After identifying internal replacements, the insurance entity determines whether the internal replacements contain integrated or nonintegrated features, which would affect their accounting treatment. The concepts of integrated and nonintegrated contract features are separately distinguished in the guidance for long- and short-duration contracts and further addressed in section 3.

Nonintegrated contract features should be accounted for in the same manner as if they were separately issued contracts, as outlined in section 4. For contract modifications involving integrated features, insurance entities are further required to determine whether the contract has changed substantively as a result of the modification, as further addressed in section 5.

If the contract is determined to be substantially unchanged, any unamortized deferred acquisition costs, deferred sales inducement assets and unearned revenue liabilities associated with the replaced contract continue to be deferred and amortized or earned in connection with the replacement contract. For nontraditional long-duration and certain participating life insurance contracts (formerly Statement 97 and 120 contracts), the estimated gross profits or margins of the replacement contract are treated as revisions to the estimated gross profits or margins of the replaced contract in determining the amortization. Other balances associated with the replaced contract, such as any liability for guaranteed minimum death benefits (GMDBs), should be determined using the entire revised life of the contract.

For contracts that utilize the interest method amortization methodology discussed in ASC 310-20 (formerly Statement 91 contracts), the cash flows of the replacement contract are treated as revisions to the cash flows of the replaced contract. For short-duration contracts, amortization should be adjusted prospectively.

If the contract is determined to be substantially changed, it is accounted for as an extinguishment of the replaced contract. Unamortized deferred acquisition costs, unearned revenue liabilities, deferred sales inducement assets and other balances associated with the replaced contract are written off. Balances recorded in connection with the replacement contract reflect the issuance of a new contract and the consideration exchanged.

2 Internal replacements

Many individuals have traditionally viewed an internal replacement transaction as simply the legal extinguishment of an existing contract and the issuance of another by the same entity. However, as noted previously, the guidance provides a broad definition of internal replacements. Other forms of contract modification, whether by amendment, endorsement or rider, or by the election of a benefit, feature, right or coverage within the original contract, may achieve the same outcome, and result in a substantial change to the replaced contract.

For example, a policyholder may elect to exchange a universal life-type contract for a universal life-type contract that contains a no-lapse guarantee. Alternately, the same result could be achieved through the addition of a no-lapse guarantee rider. Both modifications result in a substantial change to the original contract (i.e., they change the period of coverage and introduce a combination of mortality and investment risk), and the legal structure or form used to effect the modification may simply be the result of company preference, convenience or regulatory constraint. For this reason, the FASB concluded that the substance of any transaction in which the contract is modified, rather than its legal form, should determine the accounting applicable to the transaction.

An offer to add additional benefit features or coverage that requires acceptance by the contract holder may result in an internal replacement but would not trigger further evaluation until the offer has been accepted. However, unilateral endorsements that are effective without contract holder election would require an evaluation at the date of endorsement, because the benefits or coverages provided by the contract have changed.

The guidance applies to all modifications to product benefits, features, rights or coverages that occur either by contract exchange, amendment, endorsement or rider, regardless of whether a policy has an existing deferred acquisition cost balance.

Contract exchanges

The determination of whether a surrender of a contract and subsequent purchase of a new contract constitutes an internal replacement should be based on the substance of the transaction between the policyholder and insurer. While not all transactions involving the surrender of a policy and subsequent purchase by the same contract holder are necessarily "contract exchanges," we expect most of them to be linked.

A contract exchange should be evaluated by applying the internal replacement framework to determine whether the issued contract is an internal replacement that is substantially unchanged from the surrendered or replaced contract (in which case, deferred acquisition costs, unearned revenue and deferred sales inducement assets continue to be deferred and amortized or earned in connection with the replacement contract), or is an internal replacement that is substantially changed.

Common indications of a contract exchange include a replacement contract that contains similar or enhanced benefits, is purchased within a relatively short period of time after surrender of the replaced contract (i.e., assuming a reasonable amount of time between surrender and subsequent issuance of the new contract for operational delays), and/or contains terms that are fixed and guaranteed at the time the replaced contract is surrendered.

If evidence exists to suggest the surrender and subsequent purchase represent a contract exchange, the newly issued contract should be characterized as an internal replacement and evaluated to determine whether the replacement contract is substantially changed or unchanged based on the criteria in ASC 944-30-35-37. Given that there are various statutory policyholder disclosures and tax preferential transfer procedures that are already required for certain contract replacements (e.g., "1035" exchanges where the Internal Revenue Service allows policyholders to exchange certain insurance policies without paying taxes on investment gains), we expect most companies to have mechanisms, through their administrative systems or other procedures, to identify policies that are in the process of being exchanged.

Free-look period

We generally believe that changes made during the "free-look" period are not modifications but a continuation of the defining of the original contract's terms as the buyer continues to weigh the initial purchase decision. For example, assume a variable annuity contract is sold without a guaranteed living benefit, but the policyholder is permitted to add it during the first contract year and subsequently makes this election. By its nature, the addition of a guaranteed living benefit is a significant change, but because it was made during a period reasonably determined to be a free-look period, the addition is not considered a modification. Modifications made after the free-look period (including during the first year) require evaluation under ASC 944-30.

Adjustments to premiums on long-duration insurance contracts

Determining whether a premium adjustment to a long-duration insurance contract constitutes a modification depends on the facts and circumstances. Individual and group insurance contracts that are guaranteed renewable (at the option of the insured) or collectively renewable (individual contracts within a group are not cancelable), are generally considered long-duration contracts under ASC 944-20-55-5. The *AICPA Audit and Accounting Guide: Life and Health Insurance Entities* defines guaranteed renewable contracts as those whereby the insured has the right to continue the contract in force by the timely payment of premiums and the insurer has the right to make changes in premium rates by classes. We believe premium adjustments for group long-duration contracts would generally not meet the characteristics of a contract modification, provided each of the following conditions are met:

- The right to adjust premium rates is provided for under the terms of the insurance contract
- The change to premium rates for a contract holder is the same change in premium rates that is applicable to the entire class of contract holders
- Changes to premium rates do not involve consideration by the insurer of specific experience of the contract holder
- No other changes in benefits or coverages occur

In addition, premium adjustments would generally not be considered modifications if the determination of rates is based on a formula specified in the contract, rather than the insurer's discretion. Conversely, premium or benefit adjustments that are based on a judgmental review of the contract holder's actual experience or on a renegotiation with the contract holder generally would be considered modifications even if no reunderwriting has occurred.

This interpretation is particularly relevant for group health and group long-term disability coverage where premiums are periodically adjusted for increases in medical inflation or other factors, which will likely result in many contracts being characterized for accounting purposes as replacement contracts that are substantially changed, due to the adjustment of premium rates based on historical experience or the renegotiation of rates with the contract holder in conjunction with adjustments to benefits or other features within the contract.

For example, modifications to a long-duration group health insurance contract to extend the elimination period, reduce the benefit period, lower the percentage of salary benefit or reduce the death benefit coverage will mitigate the cost to both the insurer and the contract holder but generally be considered a judgmental review of actual experience, resulting in a change in the mortality or morbidity risk that will need to be evaluated under ASC 944-30-35-37. In addition, most of these modifications would appear to fail to meet criterion "a" of ASC 944-30-35-37, resulting in a contract that is substantially changed.

Contract reinstatements

A reinstatement is generally not considered a modification but a lapse of a contract and subsequent issuance of a new contract. As a result, unamortized deferred acquisition costs, unearned revenue liabilities and deferred sales inducement assets related to the terminated contract should not be reestablished for the newly issued contract.

2.2 Modifications not considered internal replacements

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Glossary

Original Contract

A contract that was initially entered into by the contract holder before any potential internal replacement activity.

Internal Replacement Transactions

Subsequent Measurement

944-30-35-26

Modifications (other than partial withdrawals, surrenders, or reductions in coverage [see paragraph 944-30-35-29]) that result from the election by the contract holder of a benefit, feature, right, or coverage that was within the original contract are not internal replacements subject to this guidance as long as all of the following conditions are met:

a. The election is made in accordance with terms fixed or specified within narrow ranges in the original contract.

b. The election of the benefit, feature, right, or coverage is not subject to any underwriting.

c. The insurance entity cannot decline to provide the coverage or adjust the pricing of the benefit, feature, right, or coverage.

d. The benefit, feature, right, or coverage had been accounted for since the inception of the contract.

944-30-35-27

Examples of (d) in the preceding paragraph include both of the following:

a. The option to elect the feature is an embedded option within the contract that is required to be accounted for under Subtopic 815-15.

b. The existence of the option to elect a feature was assessed in the classification of and accounting for the contract, such as the classification of the contract as an insurance contract under Section 944-30-15.

944-30-35-28

The payout phase of a contract is separate and distinct from and shall not be accounted for as a continuation of the accumulation phase, even if annuitization is in accordance with terms fixed in the original contract.

In developing the guidance on contract modifications, the FASB was concerned that, given the flexibility and discretion of many insurance contract features, the benefit or coverage elections in the contract could be designed to substantially change the contract. The FASB ultimately concluded that a modification resulting from the election of a benefit, feature, right or coverage based on terms that are explicitly stated in the original contract does not represent a new negotiation between the contract holder and the insurer and is not subject to the guidance for internal replacements, provided that the election is not subject to further underwriting and the insurance entity may not deny the benefit or coverage. In addition, the feature subject to potential contract holder election had to be accounted for by the insurer since the inception of the contract as an embedded derivative under ASC 815-15 or an insurance liability under ASC 944 using a benefit ratio liability model (formerly known as the SOP 01 liability).

Terms that are fixed or specified

The guidance is not explicit on what constitutes a "narrow range." When an insurance entity is determining whether this criterion is met, the terms that are specified as a range should be narrow enough to provide a meaningful guarantee to the contract holder. Provisions that allow the contract holder to add coverage in the future at then-current rates, subject to a stated range, generally would not be specific enough to meet this requirement, unless the difference between the rate at contract inception and either end of that range is narrow. For example, when the rates are expressed as a percentage of account value, we believe that range would need to be no more than a few basis points. Additionally, broadly defined provisions that allow for a policyholder to convert to a whole life policy from a term life policy generally would not meet this requirement.

Pricing for an elective benefit feature based on issue age would generally be considered fixed if the pricing is, in fact, fixed and that information is made available to the policyholder, for instance, in a table or exhibit (attached to the original contract) that summarizes the prices at various issue ages.

Adjustments to premiums on group health and workers compensation contracts to reflect changes in the insured population as employees are hired and terminated are typically specified in the original contract at inception as a set rate per covered life or per $1,000 of payroll. Changes to periodic premiums that reflect changes in the insured population in accordance with contractually defined terms would not be considered internal replacements. A similar insurance contract where the insured population typically is adjusted in accordance with contractual terms is a commercial automobile contract providing coverage for a fleet of cars. Again, this change in premium as a result of changes in the insured population does not result in an internal replacement.

An increase in rates at any step-up date is not considered a modification as long as the step up occurs automatically in accordance with terms that are fixed or specified within narrow ranges outlined in the contract. Additionally, if the original contract specifies that the policyholder has the right to reject the step up and related rate increase and keep the "old" benefit level and rates, there would not be a modification when the policyholder makes that choice. However, if the step up is not automatic (i.e., a policyholder election) and rates are not fixed or specified within a narrow range in the original contract (e.g., may be determined at the discretion of the insurer based on rates in effect at the time the election is made), the step up and associated rate increase would result in a modification requiring an evaluation under ASC 944-30-35-37 to determine whether it results in a substantially changed contract.

If the contract does not specify the terms by which the policyholder can reject an automatic step up and related rate increase, permitting the policyholder to reject the step up would result in a modification requiring evaluation. The example in ASC 944-30-55-52 and 53 analyzes the modification to a long-term care product that results when the policyholder is permitted to elect to accept reduced coverage instead of increased premiums and, we believe would, by analogy, provide an appropriate framework to analyze this modification.

Definition of underwriting: performance of limited examination procedures

Underwriting can be defined as the examination of the insurance risk of the entire contract for purposes of acceptance or rejection or for rating the risk for pricing purposes. In some instances, limited examination procedures are performed with respect to individual risks or components of a contract such as procedures used to verify a change from smoker to nonsmoker status and income verification procedures undertaken as part of a benefit step-up in a disability policy (i.e., procedures that simply confirm or corroborate facts). Such procedures generally do not represent underwriting as long as the procedures do not involve judgment or discretion as to acceptance or price.

Accounting by the insurer since the inception of the contract

The election of a feature at a later time generally should not result in a change in the accounting for the contract. When the first three criteria in ASC 944-30-35-26 are met, the existence of the feature effectively represents an option that should be evaluated at contract inception to determine whether it is a derivative requiring recognition under ASC 815-15, or, if not a derivative, whether it should be given accounting recognition under other relevant literature.

With the exception of annuitization guarantees, the election of existing contract features would not be expected to change the contract classification and accounting if appropriately assessed at contract inception. Annuitization guarantees during the accumulation phase of an annuity contract are not considered to result in the continuation of the existing contract if exercised; rather, the payout phase is to be accounted for as a separate and distinct contract.

Nonforfeiture provisions, such as extended term insurance (ETI), generally meet criteria a, b and c of ASC 944-30-35-26. It is less clear whether the criterion in ASC 944-30-35-26d is met. One could argue that the existence of the nonforfeiture option was considered and that there was no incremental liability necessary because of the existence of ETI as an immaterial nonforfeiture option. There is also the possibility that the movement to ETI or reduced paid-up under the nonforfeiture option would fall under the guidance in ASC 944-30-35-29 as a partial withdrawal, surrender or reduction in coverage.

2.3 Partial withdrawals, surrenders or reductions in coverage

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Internal Replacement Transactions

Subsequent Measurement

944-30-35-29

Partial withdrawals, surrenders, or reductions in coverage (for example, reduced face amount on a life insurance contract or higher deductibles on a property casualty contract), as allowed by terms that are fixed and specified at contract inception either in the contract or other information available to the contract holder or, if required by state law or regulation, at terms in effect when the reduction is made for that benefit, feature, right, or coverage, whether or not surrender charges or other termination charges are assessed, are not internal replacements subject to this guidance, as long as there are no reunderwriting or other modifications to the contract, at that time, that would require evaluation under paragraph 944-30-35-37.

As indicated above, a reduction in the face amount of a life insurance contract or the increase in a collision deductible of an automobile contract (which essentially represents a reduction in coverage provided) is accounted for as a continuation of the original contract. It is not considered an internal replacement, provided that the amounts refunded are determined based on terms specified in the original contract or by applicable law or regulation.

3 Integrated and nonintegrated contract features

Once identified, internal replacements may involve contract features, benefits or coverages that are either integrated or nonintegrated with the base contract. Contracts may include both integrated and nonintegrated features either at the inception of the contract or by subsequent modification to the contract. Insurers should separately evaluate whether each of the features or coverages is integrated or nonintegrated, both at contract inception and when contracts are subsequently modified, and account for them accordingly. The concept of integrated and nonintegrated features is distinguished separately in the guidance for long-duration and short-duration contracts, due to the inherent differences in the types of products. Nonintegrated features are accounted for as separately issued contracts (see section 4), while the accounting for integrated features depends on whether the contract has substantively changed as a result of the modification (see section 5).

3.1 Characteristics of integrated and nonintegrated features of long-duration contracts

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Internal Replacement Transactions

Integrated and Nonintegrated Contract Features

Subsequent Measurement

944-30-35-30

For long-duration contracts, integrated contract features are those for which the benefits provided by the feature can be determined only in conjunction with the account value or other contract holder balances related to the base contract, and nonintegrated contract features are those for which the determination of benefits provided by the feature is not related to or dependent on the account value or other contract holder balances of the base contract. Underwriting and pricing for nonintegrated contract features typically are executed separately from other components of the contract, and it is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided.

Depending on the contract terms, some features may be classified as either integrated or nonintegrated. For example, if a waiver of premium benefit is added to the contract (a waiver of premium benefit provides that a contract holder who is disabled retains coverage under the contract without having to pay premiums or cost of insurance charges), it may be characterized as either integrated or nonintegrated depending on how the premium is determined. When the waiver of premium feature is based on a contractually specified dollar amount, it is considered nonintegrated contract feature because the determination of the amount to be waived is set at contract inception and is not impacted by the current account value or other contract holder balances. However, when this feature waives the cost of insurance charges, it is considered an integrated contract feature because the amount to be waived is a function of the contract account value at the time the benefit is utilized.

Insurers generally should be able to determine whether a contract feature is integrated or nonintegrated. However, if a feature does not clearly fit the definition of nonintegrated, the company should evaluate if it were integrated.

Nonintegrated features

Some long-duration contract features exhibit characteristics clearly categorized as nonintegrated, and several examples are listed below. In each example, the addition or election of the contract feature is in substance equivalent to the issuance of an additional contract, as the new contract feature is not interrelated with or dependent on the balances of the original contract. Whether offered with the original contract or added subsequently, these features generally are nonintegrated contract features and should be accounted for in the same manner as a separate contract.

- *Option to purchase additional insurance rider (ASC 944-30-55-35)*: Typically, policyholders can increase the face value of their policy for the same type of coverage with no additional underwriting required. The additional premium is based on established rates, independent of the original contract, and is generally commensurate with the additional coverage provided.

- *Long-term care rider added to a universal life-type or disability contact (ASC 944-30-55-68)*: Benefits under long-term care coverage, determined independently of other universal life-type or disability contracts to which they are associated, result in nonintegrated contract features. However, if the long-term care benefit varies as a function of the contract account balance or other contract balances, it would be considered an integrated contract feature.

- *Term life rider added to an annuity contract:* Term life contracts and annuity contracts are fundamentally different contracts for which the benefits would be determined independently.

- *Paid up additions to a life insurance contract*: A paid-up addition is guaranteed permanent paid-up life insurance. This option provides the policyholder with a growing cash value and death benefit that is guaranteed once purchased. Under this option, each year as dividends are declared more paid-up additions are purchased. The additional premium is based on established rates, independent of the base contract, and is generally commensurate with the additional coverage provided. Furthermore, paid-up additions funded by dividends on participating policies are also deemed nonintegrated features.

- *Spousal or child rider:* A spousal or child rider typically would be a nonintegrated feature assuming the underwriting and pricing for the feature are not dependent on the account value or other contract holder balances of the base contract and the additional premium for the rider is based on established rates, independent of the base contract, and is commensurate with the incremental coverage provided.

Integrated features

In some instances, the premium or benefit associated with a contract feature that is added to an existing contract by amendment or rider cannot be determined independently of the base contract. Following are examples of contract features that would be characterized as integrated:

- *Guaranteed minimum death benefit (ASC 944-30-55-64)*: A common feature in variable annuities is a GMDB, with some guarantees providing more extensive benefits than others. A return of premium death benefit is simply equal to the total deposits made by the contract holder less withdrawals. A ratchet death benefit is a "richer" benefit determined based on the highest account balance among specified anniversary dates adjusted for deposits less partial withdrawals since the specified anniversary date. As the benefit is determined based on the account value, it is considered an integrated contract feature.

- *Guaranteed minimum income benefit (ASC 944-30-55-74)*: A guaranteed minimum income benefit (GMIB) specifies the manner in which an annuitization benefit is determined should the contract holder elect to annuitize. For example, a GMIB may provide a guaranteed amount upon annuitization (i.e., guaranteed periodic annuity benefit payment to be received or guaranteed account balance to be used in the calculation of the periodic annuity benefit payment) based on a 5% annual rollup of contract value. This is an example of an integrated contract feature, as the guarantee is determined based on the account value of the base contract.
- *Guaranteed minimum accumulation benefit (ASC 944-30-55-73)*: A guaranteed minimum accumulation benefit (GMAB) provides a guarantee that the accumulated account value of an annuity contract available for withdrawal by the contract holder will reach a specified amount at a specific date, for example, a 5% annual rollup of contract value in 10 years. As the benefit is dependent on the account value of the base contract, it is considered an integrated contract feature.
- *Guaranteed minimum withdrawal benefit (ASC 944-30-55-75)*: A guaranteed minimum withdrawal benefit (GMWB) provides a contract holder a guarantee that a minimum amount (usually a percentage of premiums) will be available for withdrawal over a stated period. The GMWB results in a minimum investment return provision (i.e., minimum return on the base contract), and, as such, is considered an integrated contract feature.
- *No lapse guarantee on a universal life or annuity contract (ASC 944-30-55-40)*: A universal-life type contract may contain a no-lapse guarantee feature that provides for continuing coverage in the event the account value drops to a level that cannot cover the contract charges. As the benefit under a contract with a no-lapse guarantee is determined in relation to the account value, it is considered an integrated contract feature.
- *Second-to-die feature associated with a universal life contract (ASC 944-30-55-41)*: A second-to-die feature incorporates multiple mortality events within a single contract, as payment to the beneficiary is made, assuming the contract remains in force, only after both insured individuals die. This is an integrated contract feature because the mortality status of the other insured is critical to determining whether and when a benefit payment is due as a result of the death of the insured under the universal life contract.

For additional information regarding the evaluation of integrated contract features and related accounting (including a more detailed discussion of the features listed above), refer to section 5.2, "Determining Substantial Changes."

3.2 Characteristics of integrated and nonintegrated contract features of short-duration contracts

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Internal Replacement Transactions

Integrated and Nonintegrated Contract Features

Subsequent Measurement

944-30-35-31

For short-duration contracts, nonintegrated contract features are those that provide coverage that is underwritten and priced only for that incremental insurance coverage, and do not result in the explicit or implicit reunderwriting or repricing of other components of the contract. It is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the

incremental insurance coverage provided. Additional coverage provided by a nonintegrated contract feature would be considered nonintegrated even though the entire coverage provided by the short-duration contract may be subject to only one deductible or limit in the event of an insured loss. For short-duration contracts, integrated contract features are those where there is explicit or implicit reunderwriting or repricing of existing components of the base contract.

A common characteristic of many short-duration property and casualty insurance contracts is that the contract is made up of several coverages or contract features that share both a deductible and limit in the event of a common loss. For example, a personal articles floater that provides coverage for jewelry may be attached to a homeowner's contract but share a common deductible and limit in the event of a single loss event (e.g., burglary, fire, etc.). In this instance, the sharing of a common deductible generally does not result in the repricing or reunderwriting of the existing components of the base contract. The premium charged generally does not change, and the benefit provided under the original contract is subject to the same deductible amount regardless of whether a loss occurs under the personal articles floater. Pricing of the personal articles floater is generally based on the incremental coverage provided. Thus, the sharing of a deductible generally does not present an issue when determining whether an added contract feature is integrated or nonintegrated.

Another common characteristic in some short-duration contracts is for insurers to offer discounts on additional coverage (e.g., multiple car discounts). A frequent question is whether the discounts represent implicit repricing of the original contract and, therefore, indicate an integrated contract feature under ASC 944-30-35-31. Charging less for additional coverage than the amount that would be otherwise charged on a standalone basis is generally not viewed as indirectly repricing the original contract.

Nonintegrated features

Given the nature of most short-duration contracts, many common modifications involve nonintegrated contract features. Examples of nonintegrated contract features are:

- *Addition of a new vehicle to an automobile contract (ASC 944-30-55-42)*: The addition of a new vehicle to an automobile contract is a nonintegrated contract feature as, generally, the underwriting and pricing for coverage of that additional vehicle is determined independently of the existing contract (i.e., based on established rates or rate tables).
- *Addition of a new driver to an automobile contract (ASC 944-30-55-45)*: The underwriting and pricing for the addition of a new driver to an existing automobile contract is typically determined independently from the base contract (and does not result in reunderwriting of the base contract). As such, the addition of a new driver would be considered a nonintegrated contract feature.
- *Addition of a personal articles floater to a homeowner's contract (ASC 944-30-55-49):* A personal articles floater provides coverage for losses on property (for example, jewelry or coins) not covered under a homeowner's contract. The addition of a personal articles floater for various pieces of jewelry represents additional nonintegrated contract coverage that should be accounted for separately as the underwriting and pricing for the coverage is determined independently of the base homeowner's contract.
- *Addition of a layer of coverage on a homeowner's contract (ASC 944-30-55-50)*: A policy holder may increase the coverage on a homeowner's contract for a new addition worth $150,000. As long as the premium charged for the additional coverage is not in excess of an amount commensurate with the incremental insurance coverage provided and does not result in reunderwriting any of the components of the original homeowner's contract, this addition would be considered a nonintegrated contract feature.

- *Increase in limits for an umbrella contract (ASC 944-30-55-51):* A policyholder may request an increase in liability coverage under an umbrella contract from a limit of $5,000,000 to $10,000,000. As long as the premium charged for that additional layer of insurance coverage is not in excess of an amount that would be commensurate with the additional coverage provided and there is no reunderwriting of the base contract, the addition would be considered a nonintegrated contract feature.

Integrated features

An example of an integrated contract feature for a short-duration contract is an experience refund provision in a workers' compensation contract. The modification of an insurance contract to add such a provision would be characterized as the addition of an integrated contract feature, because the provision is based on the balances related to the contract (i.e., on the premiums and loss experience of the base contract). As described in section 5, any contract modification resulting from integrated features would then need to be evaluated to determine whether the replacement contract is "substantially changed."

4 Accounting for contract modifications involving nonintegrated contract features

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Internal Replacement Transactions

Contract Modifications Involving Nonintegrated Contract Features

Subsequent Measurement

944-30-35-32

If a contract feature or coverage is nonintegrated, the addition or election of that feature or coverage, in and of itself, does not change the existing base contract and, as a result, further evaluation of the base contract under paragraph 944-30-35-37 is not required.

944-30-35-33

The nonintegrated contract feature or coverage shall be accounted for in a manner similar to a separately issued contract.

944-30-35-34

Subsequent modifications made only to the nonintegrated contract feature or coverage shall be evaluated under paragraphs 944-30-35-26 through 35-37 separately from the base contract, and any deferred acquisition costs related to the nonintegrated contract feature or coverage accounted for accordingly.

944-30-35-35

Subsequent termination of a nonintegrated contract feature or coverage shall be accounted for as an extinguishment of only the balances related to the nonintegrated contract feature or coverage.

Nonintegrated features should be accounted for as if they were separate contracts and acquisition costs associated with such nonintegrated features should be deferred and amortized over the associated coverage period. Subsequent modifications made only to the nonintegrated feature should be evaluated separately (i.e., should be evaluated in relation to the nonintegrated feature only, not the base contract).

For example, an individual may purchase a variable annuity contract with a long-term care (LTC) rider. At contract inception, the LTC rider would be treated as if it were a separate contract as it is considered a nonintegrated contract feature (i.e., in this example the LTC coverage is separate and distinct from the variable annuity and the determination of benefits under the LTC rider is in no way related to or dependent on balances associated with the base contract). Acquisition costs associated with the variable annuity and LTC rider would be determined separately and deferred and amortized over the expected life of the respective contracts. If in subsequent years a GMDB rider is added to the annuity contract and an experience refund rider is added to the LTC contract, the addition of the GMDB and experience refund riders would be separately evaluated under ASC 944-30-35-26 through 37 in relation to the variable annuity and LTC rider, respectively.

5 Accounting for contract modifications involving integrated contract features

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Internal Replacement Transactions

Subsequent Measurement

Contract Modifications Involving Integrated Contract Features

944-30-35-36

For contract modifications involving integrated contract features or coverages (other than those contract modifications described in paragraphs 944-30-35-26 through 35-29) the insurance entity shall review the conditions set forth in the following paragraph to determine whether the contract has changed substantially as a result of the modification. As a result of that review, either of the following actions shall be taken:

a. Continuation. A contract modification meeting all of the conditions in the following paragraph results in a replacement contract that is substantially unchanged from the replaced contract, and shall be accounted for as a continuation of the replaced contract in accordance with paragraphs 944-30-35-38 through 35-60.

b. Extinguishment. A contract modification that fails any of the conditions in the following paragraph results in a replacement contract that is substantially changed from the replaced contract, and shall be accounted for as an extinguishment of the replaced contract in accordance with paragraphs 944-30-40-1 through 40-4.

Determining Substantial Changes

944-30-35-37

An internal replacement (other than those described in paragraphs 944-30-35-26 through 35-29) is determined to involve contracts that are substantially unchanged only if all the following conditions exist:

a. The insured event, risk, or period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.

b. The nature of the investment return rights (for example, whether amounts are determined by formulas specified by the contract, pass through of actual performance of referenced investments, or at the discretion of the insurer), if any, between the insurance entity and the contract holder has not changed.

c. No additional deposit, premium, or charge relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract, is required to effect the transaction; or if there is a reduction in the original benefit or coverage, the deposit, premiums, or charges are reduced by an amount at least equal to the corresponding reduction in benefits or coverage.

d. Other than distributions to the contract holder or contract designee or charges related to newly purchased or elected benefits or coverages, there is no net reduction in the contract holder's account value or, for contracts not having an explicit or implicit account value, the cash surrender value, if any.

e. There is no change in the participation or dividend features of the contract, if any.

f. There is no change to the amortization method or revenue classification of the contract.

After an insurance entity identifies a contract modification involving the addition of or changes to an integrated contract feature, it assesses whether the modification meets the six criteria in ASC 944-30-35-37 to determine whether it has resulted in a replacement contract that is either "substantially changed" or "substantially unchanged."

For example, a term life contract with a broadly defined feature allowing the holder to convert the contract to a whole life contract (e.g., it can be converted to any other permanent life policy at prevailing rates) generally would be considered an integrated contract feature that results in a substantially changed replacement contract. That is because the period of coverage is different (limited period versus whole of life), and the investment return rights may also be different (none in the term contract versus fixed or discretionary, depending on the form of the replacement contract).

The substantially changed concept was incorporated into the guidance for contract modifications involving integrated features to be consistent with existing guidance related to the accounting for financial instruments. ASC 470-50, *Debt — Modifications and Extinguishments,* requires substantive modifications of terms to be accounted for and reported in the same manner as an extinguishment. This treatment is based on the conclusion that a debtor could achieve the same economic effect by making a substantive modification to the terms of an existing debt instrument. Substantive modifications of debt terms materially affect the present value of future cash flows related to the debt, requiring the abandonment of current amortization assumptions and new accounting for the contract. ASC 470-50 bases the determination of the significance of a modification on changes to the present value of future cash flows.

The FASB concluded that in the case of modifications to insurance and investment contracts issued by insurance entities, determining significance based solely on changes to the present value of future cash flows was not an effective or appropriate way to differentiate between significant and insignificant modifications to the contracts and instead developed the criteria in ASC 944-30-35-37. Therefore, ASC 944-30 incorporates the underlying concepts of ASC 470-50 but not the specific criteria.

Contract modifications that result in replacement contracts that are substantially changed should be accounted for as an extinguishment in accordance with ASC 944-30-40-1 through 40-4. This guidance requires the write-off of unamortized acquisition costs and other balances associated with the replaced contract. If contract modifications result in a replacement contract that is substantially unchanged, the replacement contract would be accounted for as a continuation of the replaced contract in accordance with ASC 944-30-35-38 through 35-60. In that instance, the replacement contract would be treated as a revision to the replaced contract. Unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets associated with the replaced contract would continue to be deferred and amortized or earned based on the incorporation of revised assumptions derived from the replacement contract.

The criteria for determining whether a replacement contract is substantially changed under various scenarios are discussed in the following sections.

5.1 Determining substantial changes

5.1.1 Determining substantial changes — mortality, morbidity or other insurance risk

Mortality, morbidity or other insurance risk has always been a defining component in existing authoritative literature for determining the classification of a contract (i.e., whether it is an insurance or investment contract). For this reason, the FASB states in ASC 944-30-35-37a that a significant change in the kind or degree of mortality, morbidity or other insurance risk, results in a replacement contract that is substantially changed from the replaced contract. Companies will need to carefully evaluate changes in mortality or morbidity risk to determine whether such changes are deemed "significant."

Methods of determining the change in risk

There are a number of approaches that may be used in assessing the significance of a change, and companies should consider the facts and circumstances in determining which approach or combination of approaches is most appropriate. Companies might choose to look at changes in:

- The actuarially estimated costs for a particular benefit feature (i.e., simply the cost associated with the change in benefits provided)
- The benefit ratio related to that benefit feature delineated in ASC 944-20-15-24 (i.e., the relationship between actuarially estimated costs of the benefit feature and total future fees to be charged for the contract as a whole)
- The change in the relationship between the expected cost of the benefit feature and the specific charge for that benefit feature, using stochastic analysis
- The change in the net amount at risk before and after the modification

While all these approaches are acceptable in some situations, they may yield different results under the same set of facts and circumstances and, therefore, it may be necessary to consider multiple approaches in evaluating the substance of the contract modification.

Illustration 5-1: Evaluating mortality, morbidity or other insurance risk for substantial changes

Different approaches utilized to assess the significance of a change in the degree of mortality, morbidity, or other insurance risk could result in different conclusions. Therefore, it may be necessary to consider multiple approaches to evaluate the significance of a change. For example, a change from a 20-pay life insurance contract to a 10-pay life insurance contract, where the two premiums are determined to be actuarially equivalent amounts, is an internal replacement that may or may not result in the replacement contract being determined to be substantially changed from the replaced contract.

Using actuarially estimated cost before and after the modification would not result in a significant change (for example, the death benefit remains the same, only the premium payment period is changing). Comparing the relationship of the present value of estimated cost and the present value of the actuarially equivalent premiums also would not result in a significant change. However, if one used the net amount at risk as the basis for comparison, the change could be considered significant, given that the net amount at risk would differ for contracts with different premium collection periods.

Not all approaches for evaluating mortality, morbidity or other insurance risk would be appropriate in all circumstances. For instance, while a comparison of the expected costs of a GMDB added to a variable annuity contract to the expected charges for that benefit may indicate that the net cost is zero, it generally would not be appropriate to analyze the change in a GMDB using this method because the

addition of the GMDB by its nature exposes the insurer to an entirely new combination of risks (i.e., a combination of investment and mortality risks). The fact that the insurer has assessed what it believes to be an appropriate charge for the GMDB is not conclusive that it should not be viewed as a significant change to the contract.

We believe analyses of changes in actuarial estimated costs, or the benefit ratio delineated in ASC 944-20-15-24 that is determined using stochastic techniques, are approaches that likely will appropriately capture the substance of these types of changes. Companies should use the approach (or approaches) that most appropriately reflects the substance of the change in the contract between the insurance entity and the contract holder (not just the economics to the insurance entity) and apply it consistently in analyzing similar types of modifications for similar contracts.

Reunderwriting

Reunderwriting the entire contract, including existing coverage, is generally an indication there is a significant change in the mortality, morbidity or other insurance risk of the contract. Insurers generally would not incur the effort and costs associated with the underwriting process if no potential change in the assumed insurance risk was generated by the contract modification. For example, reunderwriting associated with re-entry term would result in a substantially changed contract if the reunderwriting results in the risk classification and associated premium being lowered from the premium guaranteed in the absence of reunderwriting.

However, additional consideration may be required for contracts that provide multiple death benefit options. For example, assume a universal life contract includes one option that provides for a level face amount (Death Benefit Option A), and another option that provides a level face amount plus the existing cash value at death (Death Benefit Option B). The contract indicates that the policyholder can elect to change the death benefit type with a commensurate change in the monthly charges. Reunderwriting is involved to move from Death Benefit Option A to Death Benefit Option B but not in the other direction. In both instances, the death benefit is an integrated contract feature.

The change in death benefit type is analyzed in a manner similar to an increase in the face of amount of a universal life contract as discussed in ASC 944-30-55-39. If only the additional coverage has been underwritten, and the additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage provided, the change from Death Benefit Option A to Death Benefit Option B would likely result in the replacement contract being substantially unchanged, because all six criteria in ASC 944-30-35-37 have been met.

Spousal continuations

Many tax-qualified fixed and variable annuity contracts permit a spouse to step into or continue a contract on the death of the original owner. In this circumstance, the insurer should determine whether the spousal continuation meets the criteria in ASC 944-30-35-26 and, if not, whether there is any mortality risk present in the contract. If the terms are fixed and specified within narrow ranges in the original contract, and the change in ownership is not subject to any underwriting with respect to any mortality risk, the modification would not be considered an internal replacement subject to ASC 944-30 and would not require evaluation as a contract modification.

For typical annuity contracts that do not include a death benefit, the spousal continuation is specified in the contract and simply results in a change in ownership on the death of the original owner. However, if the contract includes a death benefit, such as a GMDB, and the terms for the substitution permit continuation of the GMDB with a new insured, the spousal continuation would change the insured event, risk and period of coverage. That is, the condition of ASC 944-30-35-37a would not be met, and the internal replacement would result in a substantially changed contract.

Period of coverage

A consistent theme in many questions about ASC 944-30-35-37a relates to the period over which a company evaluates the significance of a change in mortality, morbidity or other insurance risk. For example, a continuation of coverage benefit is sometimes offered to policies in which the insured is at an advanced age (i.e., age 95+). Another example is an exchange of a term life policy for another term life policy with a different period of coverage. When evaluating changes in insurance risk, companies should perform their evaluation based on a comparison of the remaining insurance coverage of the replaced contract to the remaining insurance coverage of the replacement contract.

Illustrative examples

ASC 944-30-55 provides examples of contract modifications or exchanges, a selection of which will be discussed throughout this section.

Examples of other contract modifications or exchanges that generally would result in a significant change in the kind or degree of mortality or morbidity risk include:

> *Universal Life-Type Contract to Universal Life-Type Contract with a No-Lapse Guarantee (ASC 944-30-55-40):* A universal-life type contract may contain a no-lapse guarantee feature that provides for continuing coverage in the event that the account value drops to a level that cannot cover the contract charges. A no-lapse guarantee is an integrated benefit. The contract exchange of a universal life-type contract for a universal life-type contract that contains a no-lapse guarantee would result in the replacement contract being substantially changed from the replaced contract as the addition of the no-lapse guarantee is presumed to result in a significant increase in the period of coverage of the contract as well as an introduction of additional mortality and investment risk. Modification of a universal life contract to add a no-lapse guarantee would represent a substantial change to the contract regardless of whether executed through a contract exchange or amendment to an existing contract.
>
> *Universal Life-Type Contract to Universal Life-Type Contract with a Second-to-Die Feature (ASC 944-30-55-41):* A second-to-die feature incorporates multiple mortality events within a single contract, as payment to the beneficiary is made, assuming the contract remains in force, only after both insured individuals die. The contract exchange of a universal life-type contract for a universal life-type contract that contains a second-to-die provision results in the replacement contract being substantially changed from the replaced contract because the addition of the second-to-die feature changes the insured event, which now requires that two mortality events must occur for the beneficiary to obtain the proceeds.
>
> *Variable Annuity with Return of Premium Death Benefit Guarantee to Variable Annuity with Ratchet Death Benefit Guarantee (ASC 944-30-55-65):* A ratchet death benefit is determined based on the highest account balance among specified anniversary dates adjusted for deposits less partial withdrawals since the specified anniversary date, whereas a return of premium death benefit is simply equal to the total deposits made by the contract holder less withdrawals. The exchange of a variable annuity with a return of premium guarantee for a variable annuity that contains a ratchet death benefit guarantee would likely result in the replacement contract being substantially changed from the replaced contract, as the change in death benefits substantively changes the degree of mortality risk. While the actual mortality event itself (death of the contract holder) is the same in the return of premium and ratchet GMDBs, the risk has changed because of the combined effect of the change in mortality and investment risk.

An example of a modification that could, depending on specific facts, result in an insignificant change in the degree of mortality risk could include:

> *Variable annuity with rollup death benefit guarantee to variable annuity with ratchet death benefit guarantee (ASC 944-30-55-66):* A roll up death benefit is a benefit equal to the total of deposits made to the contract less an adjustment for partial withdrawals, accumulated at a specified interest rate. An internal replacement of a variable annuity with a roll up death benefit to a variable annuity with a ratchet death benefit (if determined to have similar relative expected cost that would not materially change the overall economics) would not result in a substantial change to the mortality benefit, as both variable annuities contain significant and similar levels of mortality risk related to premature death.

The following is an example of a modification that generally would result in the replacement contract being substantially unchanged from the replaced contract:

> *Increase in Face Amount of a Universal Life-Type Contract (ASC 944-30-55-39):* Policyholders may elect to increase the face amount of a universal life-type contract through an amendment to the original contract. This would be considered an integrated contract feature as the death benefit is equal to the excess of the face amount over contract value. Generally, only the additional face amount is underwritten and it is separately priced. Assuming the additional cost of insurance is commensurate with the additional insurance coverage obtained, an amendment to increase the face amount of a universal life-type would result in the replacement contract being substantially unchanged from the replaced contract as the modification does not result in a change in mortality risk (i.e., no change in insured event, risk or period of coverage), and none of the other criteria in ASC 944-30-35-37 would be violated. The same would likely be true of a reduction in face value.

5.1.2 Determining substantial changes — investment return rights

A change in the nature of investment return rights (e.g., discretionary, formulaic, pass-through) can significantly alter the overall economics of an insurance or investment contract. As a result, the FASB states in ASC 944-30-35-37b that such a change is always considered significant. For pass-through contracts such as variable annuities, the addition of a floor or a cap of returns to avoid passing through actual returns (net of fees and charges) to the contract holder is expressly considered a significant change to the contract.

Defining nature of investment return rights

Many questions have been raised regarding the application of ASC 944-30-35-37b, in particular, what is meant by the term "nature" of investment return rights. Some have interpreted "nature" to only mean the specific type/category of investment return (i.e., discretionary, formulaic, or pass through). Others believe that changes to investment returns within a particular category (e.g., formulaic) could be significant and may result in a substantially changed contract.

Ultimately, the nature of the investment return rights encompasses the manner in which the contract's investment return is determined. If the contract is referenced to a pool of assets or otherwise indexed (for example, S&P 500 or LIBOR), the underlying referenced pool of assets or index is an inherent component of the nature of investment return rights, and changes in these provisions would result in a change to the nature of investment return rights between the insurance entity and the contract holder under FASB ASC 944-30-35-37(b). This differs from a contract holder reallocation of funds among multiple investment alternatives provided for in the contract in which the investment performance of the investments passes through to the contract holder.

Contract holder liquidity rights related to investment guarantees are inherent components of the nature of investment return rights, and the addition of a different investment guarantee with substantively different timing of cash flow accessibility to the contract holder would result in a change to the nature of investment return rights. For example, by exchanging a GMAB rider for a GMWB rider, investment returns are altered from guaranteeing minimum accumulation benefits to guaranteeing minimum withdrawal benefits based on specified formulae. This exchange results in a change in the risks and rewards to both the contract holder and insurer. The liquidity rights relative to the guarantees also have changed (i.e., each guarantee provides the contract holder with different accessibility to cash flows under the contract). Other changes to investment returns that have also raised questions, such as a step up of a GMAB to the current account balance, need to be evaluated based on facts and circumstances.

Changes to a component (or components) of an investment return formula (for example, the strike price of the guarantee for a variable annuity with a GMAB or other modification to an existing investment guarantee) should be evaluated in a manner similar to changes in minimum crediting rate guarantees for contracts subject to periodic discretionary declaration.

Changes in other investment return rights

Other changes that are not related to the nature of investment return rights, such as a change in the minimum guarantee for a contract subject to discretionary crediting rates, may be considered significant, depending on the facts and circumstances. Changes to minimum guarantees for contracts subject to discretionary crediting rates will need to be evaluated in light of the current interest rate environment, as well as expectations regarding future interest rates, in determining whether the change is significant.

One approach to evaluating whether a change to a minimum guarantee or investment return formula (e.g., variable contracts) results in a contract that has substantially changed is to compare the present value of the cash flows (projected returns) before and after the change over a range of scenarios. For example, if the modification involves a change to the strike price of a guarantee on a variable annuity contract, a company might use a stochastic approach to compare the investment return based on the new strike price (or guarantee) to the investment return based on the old guarantee.

Investment management fees and other administrative charges

Another issued raised in connection with evaluating changes in investment return rights is whether changes in investment management and other administrative fees (for example, changing from a combination of a flat fee and asset-based charge to only an asset-based charge) results in a contract that is substantially changed. Changes in accordance with terms and within ranges specified in the contract, without any other change in benefits or coverages, are not modifications to the contract. Changes in investment management fees and charges (for example, between flat fee, sliding scale or percentage of assets) that are not in accordance with terms specified in the contract should be evaluated under ASC 944-30-35-37(b) based on the substance of the fees and whether they are significant in the context of the overall investment return rights.

While each change is evaluated based on the facts and circumstances, generally, we don’t expect changes in investment management fees in and of themselves to result in a significant change in overall investment return rights.

Persistency bonuses

Persistency bonuses generally are regarded as enhancements to the investment returns realized under an insurance or investment contract. In assessing whether the addition of a persistency bonus results in a substantially changed contract, consideration should be given to whether it violates the criterion in ASC 944-30-35-37b. Generally, we believe that the addition of a typical persistency bonus, in and of itself would not change the overall nature of the investment return rights. However, that determination can only be made based an evaluation of the specific facts and circumstances of the entire contract.

Illustrative examples

ASC 944-30-55 provides examples illustrating the differences in the nature of investment return rights among various types of insurance and investment contracts. Although the examples involve contract exchanges, the conclusions on significance would be the same for similar contract modifications (i.e., both are evaluated against the internal replacement framework).

The following are some examples of internal replacements that result in a change in the nature of investment return rights:

Single Premium Deferred Annuity (SPDA) to Equity-Indexed Annuity (ASC 944-30-55-58): An SPDA is a general account fixed deferred annuity with a guaranteed minimum crediting rate. The crediting rate may exceed the guaranteed minimum at the discretion of the insurer and is generally declared in advance for a specified period (for example, one or three years). An equity-indexed annuity is a deferred annuity contract with a guaranteed minimum crediting rate and a contingent return that is contractually determined by reference to a pool of assets, an index, or other specified formula. The exchange of an SPDA for an equity-indexed annuity results in the replacement contract being substantially changed from the original contract as the nature of the investment return rights changed from discretionary to a formulaic return.

Single Premium Deferred Annuity to Multi-Bucket Annuity (ASC 944-30-55-60): As indicated in the previous example, the interest rate of an SPDA is declared at the discretion of the insurance entity whereas, in the case of a multi-bucket annuity, the interest rate is determined by reference to a specific category of assets or an investment strategy selected by the contract holder as defined in the contract. An exchange of an SPDA for a multi-bucket annuity results in the replacement contract being substantially changed from the replaced contract as the nature of the investment return rights changed from discretionary to formulaic.

Fixed-Interest Rate Guaranteed Investment Contract to Variable-Interest Rate Guaranteed Investment Contract (ASC 944-30-55-62): A fixed-interest rate guaranteed investment contract (GIC) has a stated fixed crediting rate guaranteed for a specified period, whereas a variable-interest rate GIC is a contract with a credited interest rate that is typically based on the London Inter Bank Offer Rate (LIBOR) plus a specified spread. The contract exchange of a fixed-rate GIC for a variable-rate GIC results in the replacement contract being substantially changed from the replaced contract as the nature of the investment return rights changed from a fixed to a floating-interest-rate return.

Variable Annuity to Variable Annuity with Guaranteed Minimum Accumulation Benefit (GMAB) (ASC 944-30-55-73): A variable annuity is a contract in which a contract holder's deposits are used to purchase units of various investment allocation alternatives within a separate account. The contract holder's account value at any given time is determined based on the performance of those investment alternatives (i.e., the contract holder bears the investment risk), and the contract can be surrendered at the account value less applicable surrender charges. A GMAB provides a guarantee that the accumulated account value will reach a specified amount, for example, a 5% annual rollup of contract value in 10 years. The exchange of a variable annuity contract for a variable annuity with a GMAB, results in the replacement contract being substantially changed from the replaced contract because of the introduction of a minimum guarantee.

Variable Annuity to Variable Annuity with Guaranteed Minimum Income Benefit (GMIB) (ASC 944-30-55-74): The contract exchange of a variable annuity for a variable annuity that contains a GMIB (for example, a 5% annual roll up of contract value) results in the replacement contract being substantially changed from the replaced contract as the addition of the GMIB results in a minimum investment return provision.

Variable Annuity to Variable Annuity with Guaranteed Minimum Withdrawal Benefit (GMWB) (ASC 944-30-55-75): A GMWB provides a contract holder a guarantee, regardless of the contract value, that a minimum amount (usually a percentage of premiums) will be available for withdrawal over a stated period. The contract exchange of a variable annuity for a variable annuity that contains a GMWB, results in the replacement contract being substantially changed from the replaced contract because the addition of a GMWB results in a minimum investment return provision.

Certain modifications are not viewed as changes to the general nature of the investment return rights and, therefore, would not be considered a substantial change. Such examples could include:

Variable Annuity With New Investment Alternatives Added (ASC 944-30-55-71): The addition of new investment allocation alternatives to variable life and annuity contracts does not result in a significant change to the original contract as long as the contractual rights and provisions for the determination of the contract holder's investment return do not change when such alternatives are added.

Elections of Fixed Allocation Alternatives (ASC 944-30-55-72): The addition of a fixed return or stable value fund option as an investment alternative to a variable annuity contract would not constitute an internal replacement that results in a substantially changed contract as long as the contract remains a variable annuity contract and the policy holder retains the right to reallocate amounts to other investment alternatives. It is not uncommon for insurers to place certain restrictions on the reallocation of amounts from the general account fixed return option to the separate account (for example, reallocations may be subject to a delay of six months or limited to several transfers each policy year). We believe certain limited restrictions, such as a six-month prohibition on reallocation or requiring reallocation to occur over a two- or three-year period, generally would not be considered significant.

Exchange of a Single Premium Deferred Annuity for a Market Value Adjusted (MVA) Annuity (ASC 944-30-55-54): An MVA annuity is a fixed deferred annuity that provides a return of principal and guaranteed interest if held until a specified date or a calculated market adjusted value if surrendered at an earlier date. The current interest rate guarantee period of the MVA annuity typically does not cover the entire expected life of the contract. At the end of an interest rate declaration period, a new crediting rate generally is declared by the insurer and may vary above the minimum guaranteed rate. The length of the initial and subsequent interest rate guarantee periods typically is selected by the contract holder.

Generally, the exchange of an SPDA for an MVA annuity does not change the basic investment return rights. The SPDA and MVA are both contracts where the interest rate is periodically reset by the insurer subject to a minimum interest rate guaranteed by the contract. The primary difference between the SPDA and the MVA annuity results from the manner in which the amount available to the contract holder is determined in the event the contract is terminated prematurely, not the contractual rights and provisions for the determination of the contract holder's investment return in the absence of a premature termination of the contract. Therefore, the change in investment return rights is not considered significant. However, if the declared interest rate period of the MVA annuity constituted substantially all of the expected life of the contract, the change from a contract where interest is set at the discretion of the insurer to one where the rate is set by contract would result in a substantially changed contract.

5.1.3 Determining substantial changes — other considerations

In addition to the conditions of insurance risk and investment return rights, ASC 944-30-35-37c through 35-37f provide the remaining conditions for concluding an internal replacement or modification results in contracts that are substantially unchanged.

Additional deposit, premium or charge

A requirement to make an additional deposit, or pay an additional premium or charge relating to the benefit or coverage provided under the replaced contract, in excess of amounts contemplated in the contract, whether explicit or implicit, results in a significant change to the underlying economics of the replaced contract.

Net decrease in balance available to the contract holder

A net decrease in the balance available to the contract holder is indicative of a change in the substance of the contract between the contract holder and the insurance company. In some instances, however, a surrender charge may be offset by an immediate sales inducement on the replacement contract that is equal to or greater than the surrender charge. If this occurs, the insurer should offset the immediate sales inducement against the surrender charge to determine whether there has been a net reduction in the contract holder's account balance. If the surrender charge is greater than the immediate sales inducement, the internal replacement results in a substantially changed contract.

Revising the terms of the surrender charge or extending the surrender charge period, without impacting the account balance or other provisions of the new or revised contract, would not appear, in and of itself, to be a substantial change. Consistent with ASC 944-40-30-18, which requires the use of an account balance instead of the cash surrender value when both exist, changes to surrender charge provisions (absent any other changes to the contract) generally are not subject to evaluation under ASC 944-30, because the future effect, if any, of such changes is entirely within the control of the policyholder (i.e., the policyholder controls whether a surrender charge will or will not be assessed in the future based on the length of time he or she keeps the contract in force).

However, any modification that results in a net decrease in the policyholders' account balance would effectively be the current assessment of a surrender charge and, therefore, indicate a change in the substance of the contract between the policyholder and the insurer. That is, the condition of ASC 944-30-35-37d would not be met, and the internal replacement would result in a substantially changed contract.

Change in participation or dividend features

A change in the participation or dividend features of a contract indicates a substantial change to the replaced contract. For example, the addition of an experience refund provision to a worker's compensation or long-term care contract is an integrated benefit that results in a substantially changed contract.

Change in amortization method or revenue classification

A change in the amortization method or revenue classification of an insurance or investment contract (for example, a modification that results in either a change from amortization of deferred acquisition costs in proportion to premium revenue to amortization based on the emergence of estimated gross profits or a change in revenue classification from reporting premium as revenue to reporting deposits) reflects a change in the accounting model used to account for that contract. As insurance-specific accounting models are prescriptive, not elective, the use of a different accounting model implies the replacement contract is in substance a substantially changed contract.

Modifications to group contracts

When the determination of whether an internal replacement or modification results in contracts that are substantially unchanged is applied to modifications of group contracts, all facts and circumstances should be considered in evaluating the substance of the internal replacement or modification and to determine whether it is most appropriately analyzed at the group contract level or individual participant level.

We believe any the following factors generally indicate that a modification to a group contract should be evaluated at the participant level:

- The individual participant has a choice to elect, decline, or select among the offered incremental benefits or guarantees. Implicit in this criterion is that there is no modification of the arrangement relative to the participant if the participant does not choose to modify the arrangement.
- The individual participant pays the premiums, fees, or other assessments for the elected incremental benefits or coverage.
- For contracts with choices of investment return rights, the individual participant determines the allocation of funds among investment return alternatives.
- Underwriting for any additional insurance risk is executed at the individual participant level.

Consider an example in which a group variable annuity is used by an employer to provide its employees with a 401(k) benefit plan. Employees determine the contribution amount (subject to limitations imposed by the benefit plan) and the allocation of funds among investment alternatives. The employer and insurer subsequently modify the group variable annuity contract to add a provision offering participants the opportunity to add a GMDB. The individual participant is responsible for paying the charges. The participant's election to add a GMDB is a modification that should be evaluated at the participant level because (1) the participant has the choice to elect or decline the death benefit, (2) the participant pays the incremental charge for the death benefit, and (3) the participant determines the allocation of funds among investment return alternatives. In this example, the modification resulting from the participant's election to add the GMDB would result in the contract being considered significantly changed because the contract previously contained no insurance risk.

In contrast, modifications to a group long-term disability contract that covers substantially all employees on a non-elective basis typically would be evaluated at the group contract level because (1) base provisions (e.g., elimination period and percentage of salary) are established by the employer and are not decisions controlled by the participants, (2) the employer generally pays the premiums for such benefits, and (3) the primary risk of the contract (morbidity risk) is not individually underwritten.

5.2 Accounting for contracts that are substantially unchanged

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Contract Modifications Involving Integrated Contract Features

Subsequent Measurement

Contracts that Are Substantially Unchanged

944-30-35-38

An internal replacement that is determined to result in a replacement contract that is substantially unchanged from the replaced contract shall be accounted for as a continuation of the replaced contract. However, even if both accumulation and payout phase contracts are investment contracts involving no life contingencies, the payout phase of a contract is separate and distinct from and cannot

be accounted for as a continuation of the accumulation phase of the contract. For a short-duration contract, renewal results in a separate and distinct contract that cannot be accounted for as a continuation of the previous contract. Example 1 (see paragraph 944-30-55-12) illustrates the application of this guidance.

944-30-35-39

Unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets associated with the replaced contract shall continue to be deferred and amortized or earned in connection with the replacement contract. If the replaced contract was acquired in a business combination, any present value of future profits shall be accounted for in a similar manner.

944-30-35-40

Other balances associated with the replaced contract, such as any liability for minimum guaranteed death benefits or guaranteed minimum income benefits, shall be accounted for in a similar manner, that is, as if the replacement contract is a continuation of the replaced contract.

When a long-duration contract is determined to be substantially unchanged, insurers should account for the exchange or modification as a continuation of the replaced contract and use existing guidance in ASC 944-20 or ASC 310-20 in determining the impact that any changes in cash flows or estimated gross profits have on unamortized deferred acquisition costs (associated with the replaced and replacement contract) and any other balances related to the base contract (such as unearned revenue liabilities, deferred sales inducements, and any liabilities for GMDBs, GMIBs, etc.).

Traditional long-duration Contracts and short-duration contracts

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Subsequent Measurement

Contract Modifications Involving Integrated Contract Features

Contracts that are Substantially Unchanged

Long-Duration Contracts (Traditional)

944-30-35-46

For traditional long-duration contracts, the replacement contract shall be viewed as a prospective revision of the replaced contract with future amortization of unamortized deferred acquisition costs adjusted, accordingly, on a prospective basis.

944-30-35-47

Under the prospective revision methodology, the unamortized deferred acquisition costs and benefit liability balances at the time of replacement are unchanged.

944-30-35-48

Future increases and decreases to the unamortized deferred acquisition costs and benefit reserve balances shall reflect the revised revenue expected from the replacement contract at the time of replacement.

944-30-35-49

This approach preserves the lock-in principle and is consistent with the treatment of other premium changes on indeterminate premium life insurance and guaranteed renewable health insurance contracts.

944-30-35-50

The prospective revision methodology shall be applied consistently for liabilities for policy benefits and unamortized deferred acquisition costs.

944-30-35-51

Where the modification is a reduction in benefits with a directly proportionate reduction in premiums, the modification shall result in an immediate proportionate reduction in unamortized deferred acquisition costs rather than a prospective revision.

Short-Duration Contracts

944-30-35-52

Similar to traditional long-duration contracts as discussed beginning in paragraph 944-30-35-46 a revision to a short-duration contract is viewed as a prospective revision with future recognition of unearned premium and amortization of unamortized deferred acquisition costs adjusted, accordingly, on a prospective basis.

944-30-35-53

Consistent with the guidance in paragraphs 944-30-25-1A and 944-605-25-1, unearned premium is recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided, amortization of deferred acquisition costs continues to be recognized in proportion to the premium recognized, and the revised amortization ratio is used prospectively.

944-30-35-54

If the modification is a reduction in benefits with a directly proportionate reduction in premiums, the modification shall result in an immediate proportionate reduction in unamortized deferred acquisition costs rather than a prospective revision.

The guidance for traditional long-duration contracts, which is applicable only to contract modification and changes that represent internal replacements and result in contracts that are substantially unchanged, includes the lock-in concept that was originally established by Statement 60 and is now codified in ASC 944-40. Substantially unchanged contracts are essentially accounted for as a continuation of the original contract, with any future changes to the amortization of deferred costs adjusted on a prospective basis. However, given the lock-in concept established by Statement 60, only premium changes that result in an internal replacement would allow insurers to establish new locked-in assumptions, unless the contract is subject to the premium deficiency requirements as noted below.

The guidance for short-duration contracts requires any revisions resulting from substantially unchanged contracts to be treated as prospective revisions to the amortization of deferred costs.

For both traditional long-duration and short-duration contracts, any revisions resulting in a reduction of premiums requires an immediate proportionate reduction in unamortized deferred costs. This is the only exception to prospective treatment under the guidance.

Nontraditional Long-Duration Contracts

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Contract Modifications Involving Integrated Contract Features

Subsequent Measurement

Long-Duration Contracts (Nontraditional)

944-30-35-41

For nontraditional long-duration contracts, the estimated gross profits of the replacement contract are treated as revisions to the estimated gross profits or margins of the replaced contract in the determination of the amortization of deferred acquisition costs and deferred sales inducement assets and the recognition of unearned revenues.

Pending Content:

Transition Date: *(P) December 16, 2022; (N) December 16, 2024* | **Transition Guidance:** 944-40-65-2

Editor's Note: *Paragraph 944-30-35-41 will be superseded upon transition, together with its heading:*

> > > ***Long-Duration Contracts (Nontraditional)***

Paragraph superseded by Accounting Standards Update No. 2018-12.

944-30-35-42

For contracts to which the interest method amortization methodology discussed in Subtopic 310-20 is applied, the replacement contract represents revisions to the cash flows of the replaced contract, and unamortized deferred acquisition costs and deferred sales inducement assets are adjusted accordingly.

Pending Content:

Transition Date: *(P) December 16, 2022; (N) December 16, 2024* | **Transition Guidance:** 944-40-65-2

Paragraph superseded by Accounting Standards Update No. 2018-12.

944-30-35-43

Other balances that are determined based on activity over the life of the contract, such as a liability for minimum guaranteed death benefits (which, under this Subtopic, is determined based on assessments and benefit costs) shall be calculated considering the entire revised life of the contract, including activity during the term of the replaced contract.

Pending Content:

Transition Date: *(P) December 16, 2022; (N) December 16, 2024* | **Transition Guidance:** 944-40-65-2

Paragraph superseded by Accounting Standards Update No. 2018-12.

The following example addresses a contract modification that results in a replacement contract that is substantially unchanged and, therefore, accounted for as a continuation of the replaced contract (i.e., the estimated gross profits of the replacement contract are treated as revisions to the estimated gross profits of the replaced contract in the determination of the amortization of deferred acquisition costs and other affected balances).

Illustration 5-2: Contract modification that results in a replacement contract that is substantially unchanged – estimated gross profits

This illustration is based on the example included in the Codification beginning at ASC 944-30-55-18. Our example assumes that an insurance entity offers to replace a general account single premium deferred annuity (SPDA) contract at the end of the fifth contract year with a new, yet similar, general account SPDA contract with a crediting rate of 5.25% (compared to the current crediting rate on the original SPDA of 5.00%). No surrender charges from the original contract are imposed on contract holders who elect to have their contract replaced; however, contract holders must accept a new surrender charge period under the new contract. Also, no additional deposit premium is required.

In the example, it is assumed that 50% of existing contract holders will choose the internal replacement contract at the end of year 5. Persistency rates are assumed to improve under the replacement contracts as a result of the new surrender charge period and the higher crediting rate.

Schedule 1 provides basic information regarding the original contract before replacement (i.e., the schedule does not contemplate the expected internal replacements), including the discount rate, account value, initial deposit, acquisition costs, estimated gross profits, and the deferred acquisition cost balance (actual and projected) at the end of each year.

Schedule 1: Original contract deferred acquisition costs before replacement

Contract year	Discount rate	Account value end of year	Deposits	Acquisition costs	Estimated gross profits	Deferred acquisition cost balance end of year
	(A)	(B)	(C)	(D)	(E)	(F)
1 (Act.)	5.50%	$20,572,500	$20,000,000	$ 1,275,000	$ 301,925	$1,149,176
2 (Act.)	6.50%	20,814,227	-	-	340,192	1,003,089
3 (Act.)	7.00%	18,930,539	-	-	446,829	783,314
4 (Act.)	6.00%	15,049,779	-	-	457,066	533,677
5 (Act.)	5.00%	11,061,587	-	-	347,300	334,964
6 (Proj.)	5.00%	7,549,533	-	-	232,760	200,651
7 (Proj.)	5.00%	4,756,206	-	-	135,548	122,714
8 (Proj.)	5.00%	2,497,008	-	-	65,701	86,210
9 (Proj.)	5.00%	1,835,301	-	-	34,634	68,043
10 (Proj.)	5.00%	1,541,653	-	-	25,555	54,860
11 (Proj.)	5.00%	1,456,862	-	-	21,545	43,620
12 (Proj.)	5.00%	1,376,735	-	-	20,431	32,541
13 (Proj.)	5.00%	1,301,014	-	-	19,371	21,596
14 (Proj.)	5.00%	1,229,458	-	-	18,364	10,758
15 (Proj.)	5.00%	-	-	-	17,405	-
Present Values				$ 1,275,000	$ 1,964,565	
k-factor (Initial acquisition costs divided by present value (PV) of estimated gross profits)					0.64900	

Explanation (all amounts are rounded):

Column A: Discount rate is the rate that accrues to contract holder balances – assumed information

Column B: [Prior year B + C + interest [(Prior year F +D) * A] - fees charged (assumed information) and withdrawals (assumed information)]

Column C: Deposits at beginning of contract year – assumed information

Column D: Deferred acquisition costs, incurred as of the beginning of the year – assumed information

Column E: Estimated gross profits – assumed information

Column F: Ending deferred acquisition cost balance using estimated gross profits as the basis for amortization. [Prior year F + D + Interest ((Prior year F + D) * A) — Amortization (E * .64900)]

Schedule 2 summarizes the account balances, estimated gross profits, and discount rates for contracts for which the contract holders have elected to replace their original contract with the new SPDA contract at the end of year 5. As noted above, it is assumed that 50% of contract holders will elect to replace their existing contracts with the new SPDA.

Schedule 2: Account value and estimated gross profits of replacement contracts

Contract year	Account value end of year	Estimated gross profits	Discount rate
	(A)	(B)	(C)
At Replacement	$ 5,530,794	$ –	$ –
6 (Proj.)	5,675,631	30,608	5.25%
7 (Proj.)	5,674,922	81,814	5.25%
8 (Proj.)	5,524,891	86,635	5.25%
9 (Proj.)	5,233,453	86,123	5.25%
10 (Proj.)	4,819,683	80,496	5.25%
11 (Proj.)	4,058,173	75,656	5.25%
12 (Proj.)	3,203,421	57,501	5.25%
13 (Proj.)	2,360,120	37,114	5.25%
14 (Proj.)	2,111,422	27,452	5.25%
15 (Proj.)	2,000,045	24,650	5.25%

Explanation (all amounts are rounded):

Column A: 50% of original contracts' account value at replacement (from Schedule 1); thereafter, [prior year A + interest credited (A *C) - fees (assumed) - withdrawals (assumed)]

Column B: Estimated gross profits – assumed information

Column C: Discount rate is the rate at which contract holders' funds accumulate- assumed information

Schedule 3 illustrates the account balances and interest crediting rates for both the replacement contracts and the original contracts that were not replaced.

Schedule 3: Account value and crediting rates of original and replacement contracts

Policy year	Account value end of year original contracts	Account value end of year replacement contracts	Interest crediting rate original contracts	Interest crediting rate replacement contracts	Interest crediting rate weighted average
	(A)	(B)	(C)	(D)	(E)
At Issue	$20,000,000	$ -			
1	20,572,500	-	5.50%		5.50%
2	20,814,227	-	6.50%		6.50%
3	18,930,539	-	7.00%		7.00%
4	15,049,779	-	6.00%		6.00%
5	11,061,587	-	5.00%		5.00%
At Replacement	5,530,794	5,530,794	-		-
6	3,774,767	5,675,631	5.00%	5.25%	5.15%
7	2,378,103	5,674,922	5.00%	5.25%	5.18%
8	1,248,504	5,524,891	5.00%	5.25%	5.20%
9	917,651	5,233,453	5.00%	5.25%	5.21%
10	770,826	4,819,683	5.00%	5.25%	5.22%
11	728,431	4,058,173	5.00%	5.25%	5.21%
12	688,367	3,203,421	5.00%	5.25%	5.21%
13	650,507	2,360,120	5.00%	5.25%	5.20%
14	614,729	2,111,422	5.00%	5.25%	5.19%
15	-	2,000,045		5.25%	5.25%

Explanation (all amounts are rounded):

Column A: Account value at the end of the contract year for the original contracts (from Schedule 1). Beginning in year 6, this represents account value related to those contracts not electing replacement (assumed information)

Column B: Account value at the end of the contract year for replacement contracts (from Schedule 2)

Column C: Interest crediting rate on original contracts (from Schedule 1); beginning in year 6 this represents the interest crediting rate on those contracts not electing replacement (assumed information)

Column D: Interest crediting rate on replacement contracts (from Schedule 2)

Column E: Interested crediting rate weighted by account value

Schedule 4 combines the estimated gross profits for both the replacement contracts and the original contracts that were not replaced to come up with a revised k-factor for purposes of determining future amortization.

Schedule 4: Combined estimated gross profits and deferred acquisition costs

Contract year	Estimated gross profits original contracts	Estimated gross profits replacement contracts	Combined estimated gross profits	Deferred acquisition costs
	(A)	(B)	(C)	(D)
1 (Act.)	$ 301,925	$ -	$ 301,925	$1,275,000
2 (Act.)	340,192	-	340,192	-
3 (Act.)	446,829	-	446,829	-
4 (Act.)	457,066	-	457,066	-
5 (Act.)	347,300	-	347,300	-
6 (Proj.)	116,380	30,608	146,988	-
7 (Proj.)	67,774	81,814	149,588	-
8 (Proj.)	32,851	86,635	119,486	-
9 (Proj.)	17,317	86,123	103,440	-
10 (Proj.)	12,777	80,496	93,273	-
11 (Proj.)	10,773	75,656	86,429	-
12 (Proj.)	10,216	57,501	67,717	-
13 (Proj.)	9,686	37,114	46,800	-
14 (Proj.)	9,182	27,452	36,634	-
15 (Proj.)	8,703	24,650	33,353	-
Present Values			$2,117,614	$ 1,275,000
k-factor (initial acquisition costs divided by PV of combined estimated gross profits)				0.6021

Explanation (all amounts are rounded):

Column A: Estimated gross profits from original contracts (from Schedule 1). Beginning in year 6, this represents estimated gross profits related to those contracts not electing the replacement (assumed information)

Column B: Estimated gross profits from replacement contracts (from Schedule 2)

Column C: Combined estimated gross profits (A + B)

Column D: Deferrable acquisition costs from original contracts (from Schedule 1)

Schedule 5 illustrates the determination of the revised deferred acquisition costs for the combination of both the replacement contracts and those contracts that were not replaced.

Schedule 5: Revised amortization of deferred acquisition costs after replacement

Contract year	Acquisition costs	Weighted average interest crediting rate	Combined estimated gross profits	Interest	Amortization	Deferred acquisition costs end of year
	(A)	(B)	(C)	(D)	(E)	(F)
1 (Act.)	$ 1,275,000	5.50%	$ 301,925	$ 70,125	$(181,787)	$ 1,163,338
2 (Act.)	-	6.50%	340,192	75,617	(204,827)	1,034,128
3 (Act.)	-	7.00%	446,829	72,389	(269,032)	837,485
4 (Act.)	-	6.00%	457,066	50,249	(275,196)	612,538
5 (Act.)	-	5.00%	347,300	30,627	(209,107)	434,058
6 (Proj.)	-	5.15%	146,988	22,245	(88,500)	367,803
7 (Proj.)	-	5.18%	149,588	18,942	(90,065)	296,680
8 (Proj.)	-	5.20%	119,486	15,357	(71,941)	240,096
9 (Proj.)	-	5.21%	103,440	12,494	(62,281)	190,309
10(Proj.)	-	5.22%	93,273	9,920	(56,159)	144,070
11(Proj.)	-	5.21%	86,429	7,514	(52,038)	99,546
12(Proj.)	-	5.21%	67,717	5,189	(40,772)	63,963
13(Proj.)	-	5.20%	46,800	3,330	(28,178)	39,115
14(Proj.)	-	5.19%	36,634	2,032	(22,057)	19,090
15(Proj.)	-		33,353	992	(20,082)	-

Explanation (all amounts are rounded):

Column A:	Total deferrable acquisition costs from the original contracts (from Schedule 1)
Column B:	Weighted average interest crediting rate (from Schedule 3)
Column C:	Combined estimated gross profits (from Schedule 4)
Column D:	Interest on deferred acquisition costs [(Prior year F + A) * B]
Column E:	Deferred acquisition cost amortization [C * (k-factor from Schedule 4)]
Column F:	[Prior year F + A + D + E]

Schedule 6 summarizes the impact of the internal replacement transactions on deferred acquisition costs and related amortization at the end of year 5.

Schedule 6: Summary of deferred acquisition costs as a result of internal replacement that is substantially unchanged

	Deferred acquisition costs	
Original contracts before replacement (year 5 balance from Schedule 1, Column F)	$ 334,964	
Combined contracts after replacement (year 5 balance from Schedule 5, Column F)	434,058	
	$ (99,094)	
Summary of Accounting Entries		
	Debit	Credit
Deferred Acquisition Costs	$ 99,094	
Amortization Expense		$ 99,094

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Contract Modifications Involving Integrated Contract Features

Subsequent Measurement

Long-Duration Contracts (Nontraditional)

944-30-35-44

If it is not reasonably practicable for an insurance entity to account for, in the manner described in paragraphs 944-30-35-41 through 35-43, a contract exchange that has resulted in a replacement contract that is substantially unchanged from the replaced contract, the insurance entity shall determine the balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract and utilize estimated gross profits only of the replacement contract to determine future amortization. The total balance of unamortized deferred acquisition costs before the internal replacement shall be allocated between replaced contracts and contracts remaining in the original book of business based on a reasonable and systematic allocation process. Example 1 (see paragraph 944-30-55-12) illustrates one such allocation approach.

944-30-35-45

In conjunction with the guidance in the preceding paragraph, the balance of unamortized deferred acquisition costs and other contract-related balances shall be updated based on the most current assumptions at the time of the internal replacement. All related accounting balances that use estimated gross profits or assessments as a base for amortization or recognition shall be handled in a similar manner.

In response to concerns for significant implementation and administration difficulties resulting from the initial application of the guidance in ASC 944-30 for contracts that are substantially unchanged, the Board concluded that if the accounting described in ASC 944-30-35-41 through 43 is not reasonably practicable, an insurer may use an alternate allocation method to determine an appropriate balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract. The amount allocated would be treated as deferrable acquisition costs and amortized prospectively using the estimated gross profits or premium only of the replacement contract. Other contract-related balances that are determined based on activity over the life of the contract, such as any deferred sales inducement assets, unearned revenue liability, or an additional liability for GMDB, would be handled in a similar manner.

ASC 944-30 does not prescribe an allocation methodology, and there are several approaches that would meet the criteria of "reasonable and systematic." The following illustration provides one example of an alternative allocation approach that may be used in determining the balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract. In this example, only the estimated gross profits of the replacement contract are used to determine future amortization.

Illustration 5-3: Practicability exception - alternative amortization approach

Schedule 1 below duplicates Schedule 1 in Illustration 5-2 and provides basic information regarding the original contract before replacement (i.e., the schedule does not contemplate the expected internal replacements), including the discount rate, account value, initial deposit, acquisition costs, estimated gross profits and the deferred acquisition cost balance (actual and projected) at the end of each year.

Schedule 1: Original contract deferred acquisition costs before replacement

Contract year	Discount rate	Account value end of year	Deposits	Acquisition costs	Estimated gross profits	Deferred Acquisition cost balance end of year
	(A)	(B)	(C)	(D)	(E)	(F)
1 (Act.)	5.50%	$20,572,500	$20,000,000	$1,275,000	$ 301,925	$1,149,176
2 (Act.)	6.50%	20,814,227	-	-	340,192	1,003,089
3 (Act.)	7.00%	18,930,539	-	-	446,829	783,314
4 (Act.)	6.00%	15,049,779	-	-	457,066	533,677
5 (Act.)	5.00%	11,061,587	-	-	347,300	334,964
6 (Proj.)	5.00%	7,549,533	-	-	232,760	200,651
7 (Proj.)	5.00%	4,756,206	-	-	135,548	122,714
8 (Proj.)	5.00%	2,497,008	-	-	65,701	86,210
9 (Proj.)	5.00%	1,835,301	-	-	34,634	68,043
10 (Proj.)	5.00%	1,541,653	-	-	25,555	54,860
11 (Proj.)	5.00%	1,456,862	-	-	21,545	43,620
12 (Proj.)	5.00%	1,376,735	-	-	20,431	32,541
13 (Proj.)	5.00%	1,301,014	-	-	19,371	21,596
14 (Proj.)	5.00%	1,229,458	-	-	18,364	10,758
15 (Proj.)	5.00%	-	-	-	17,405	-
Present Values				$1,275,000	$1,964,565	
k-factor (Initial acquisition costs divided by PV of estimated gross profits)				0.64900		

Explanation (all amounts are rounded):

Column A: Discount rate is the rate that accrues to contract holder balances – assumed information

Column B: [Prior year B + C + interest [(Prior year F + D)*A]- fees charged (assumed information) and withdrawals (assumed information)

Column C: Deposits at beginning of contract year – assumed information

Column D: Deferred acquisition costs, incurred as of the beginning of the year – assumed information

Column E: Estimated gross profits – assumed information

Column F: Ending deferred acquisition cost balance using EGPs as the basis for amortization.
[Prior year F + D + Interest ((Prior year F + D) * A) — Amortization (E * .64900)]

Schedule 2 illustrates the revised balance for deferred acquisition costs for contracts that were not replaced (i.e., the schedule contemplates the expected internal replacements). Account values and balances related to replacement contracts have been eliminated prospectively beginning at the end of year 5, when contracts are assumed to be replaced for purposes of this illustration. The difference in the balance for deferred acquisition costs is allocated to replacement contracts and treated as if such costs are deferrable acquisition costs incurred at the inception of the replacement contracts.

Schedule 2: Original contract deferred acquisition costs after replacement

Contract year	Discount rate	Account value end of year	Deposits	Acquisition costs	Estimated gross profits	Deferred Acquisition cost balance end of year
	(A)	(B)	(C)	(D)	(E)	(F)
1 (Act.)	5.50%	$20,572,500	$20,000,000	$ 1,275,000	$ 301,925	$ 1,127,846
2 (Act.)	6.50%	20,814,227	-	-	340,192	956,338
3 (Act.)	7.00%	18,930,539	-	-	446,829	701,724
4 (Act.)	6.00%	15,049,779	-	-	457,066	414,901
5 (Act.)	5.00%	5,530,794	-	-	347,300	185,713
6 (Proj.)	5.00%	3,774,767	-	-	116,380	111,247
7 (Proj.)	5.00%	2,378,103	-	-	67,774	68,036
8 (Proj.)	5.00%	1,248,504	-	-	32,851	47,797
9 (Proj.)	5.00%	917,651	-	-	17,317	37,725
10 (Proj.)	5.00%	770,826	-	-	12,777	30,416
11 (Proj.)	5.00%	728,431	-	-	10,773	24,184
12 (Proj.)	5.00%	688,367	-	-	10,216	18,042
13 (Proj.)	5.00%	650,507	-	-	9,686	11,974
14 (Proj.)	5.00%	614,729	-	-	9,182	5,965
15 (Proj.)	5.00%	-	-	-	8,703	0.00
Present Values				$ 1,275,000	$ 1,771,705	
k-factor				0.71965		

Explanation (all amounts are rounded):

Column A:	Discount rate is the rate that accrues to contract holder balances – assumed information
Column B:	[Prior year B + C + interest [(Prior year F + D)*A]- fees charged (assumed information) and withdrawals (assumed information, that also includes replacement contracts)
Column C:	Deposits at beginning of contract year – assumed information
Column D:	Deferred acquisition costs, incurred as of the beginning of the year – assumed information
Column E:	Estimated gross profits – assumed information
Column F:	Ending deferred acquisition cost balance using estimated gross profits as the basis for amortization. [Prior year F + D + Interest ((Prior year F + D) * A) — Amortization (E * .71965)]

Schedule 3 calculates the balance of deferred acquisition costs to be allocated or carried over to the replacement contracts.

Schedule 3: Calculation of carryover amounts

	Deferred acquisition costs balance
	(A)
Balances just prior to replacement	$ 334,964
Balances just after replacement, for contracts not electing to participate in the internal replacement program at end of year 5	185,713
Carryover amounts allocated to contracts choosing the internal replacement at the end of year 5	$ 149,251

Explanation (all amounts are rounded):

Column A:	Deferred acquisition cost balances at end of year 5 from Schedules 1 and 2.

Schedule 4 illustrates the account value, deferred acquisition costs, estimated gross profits, and discount rates of replacement contracts at the end of year 5.

Schedule 4: Account value, deferred acquisition costs, and estimated gross profits of replacement contracts

Contract year	Account value end of year	Acquisition costs	Estimated gross profits	Discount rate
	(A)	(B)	(C)	(D)
At Replacement	$ 5,530,794	$ 149,251	$ -	-
6 (Proj.)	5,675,631	-	30,608	5.25%
7 (Proj.)	5,674,922	-	81,814	5.25%
8 (Proj.)	5,524,891	-	86,635	5.25%
9 (Proj.)	5,233,453	-	86,123	5.25%
10 (Proj.)	4,819,683	-	80,496	5.25%
11 (Proj.)	4,058,173	-	75,656	5.25%
12 (Proj.)	3,203,421	-	57,501	5.25%
13 (Proj.)	2,360,120	-	37,114	5.25%
14 (Proj.)	2,111,422	-	27,452	5.25%
15 (Proj.)	2,000,045	-	24,650	5.25%
Present Values		$ 149,251	$ 462,343	
k-factor		0.32281		

Explanation (all amounts are rounded):

Column A: 50% of original contracts' account value at replacement (from Schedule 1); thereafter, [prior year A + interest credited (A * D) - fees (assumed) and withdrawals (assumed)]

Column B: Carryover deferred acquisition costs, assumed to be incurred at the beginning of year (carryover amount calculated from Schedule 3).

Column C: Estimated gross profits – assumed information

Column D: Discount rate is the rate at which contract holders' funds accumulate – assumed information

Schedule 5 illustrates the calculation of deferred acquisition costs and related amortization for the replacement contracts.

Schedule 5: Revised amortization of deferred acquisition costs after replacement

	Deferred acquisitions cost amortization			
Contract year	Acquisition costs	Interest added	Amortization	Deferred acquisition costs end of year
	(A)	(B)	(C)	(D)
6 (Proj.)	$ 149,251	$ 7,836	$ (9,881)	$ 147,206
7 (Proj.)	-	7,728	(26,411)	128,523
8 (Proj.)	-	6,748	(27,967)	107,304
9 (Proj.)	-	5,634	(27,802)	85,136
10 (Proj.)	-	4,469	(25,985)	63,620
11 (Proj.)	-	3,340	(24,423)	42,537
12 (Proj.)	-	2,233	(18,562)	26,209
13 (Proj.)	-	1,376	(11,981)	15,604
14 (Proj.)	-	820	(8,862)	7,561

Explanation (all amounts are rounded):

Column A: Carryover deferred acquisition costs (from Schedule 3 or Schedule 4)

Column B: Interest on deferred acquisition costs [(prior year D + A) * 0.525]

Column C: Deferred acquisition cost amortization (k-factor from Schedule 4 * estimated gross profit from Schedule 4)

Column D: Ending deferred acquisition costs = [prior year D + A + B + C]

Schedule 6 reflects the combined deferred acquisition costs after the internal replacement transaction. Note the total deferred acquisition costs of $334,964 at the end of contract year 5 after the replacements equals the original deferred acquisition costs balance at the end of contract year 5 before the replacements.

Schedule 6: Combined deferred acquisition costs after the internal replacement transaction

Contract year	Deferred acquisition cost original contracts	Deferred acquisition cost replaced contracts	Total deferred acquisition costs
	(A)	(B)	(C)
1 (Act.)	$1,127,846	$ -	$1,127,846
2 (Act.)	956,338	-	956,338
3 (Act.)	701,724	-	701,724
4 (Act.)	414,901	-	414,901
5 (Act.)	185,713	149,251	334,964
6 (Proj.)	111,247	147,206	258,453
7 (Proj.)	68,036	128,523	196,559
8 (Proj.)	47,797	107,304	155,101
9 (Proj.)	37,725	85,136	122,861
10 (Proj.)	30,416	63,620	94,036
11 (Proj.)	24,184	42,537	66,722
12 (Proj.)	18,042	26,209	44,250
13 (Proj.)	11,974	15,604	27,577
14 (Proj.)	5,965	7,561	13,526
15 (Proj.)	-	-	

Explanation (all amounts are rounded):

Column A: EOY deferred acquisition costs for original contracts. After year 6, deferred acquisition costs related to contracts not electing the internal replacement transaction (from Schedule 2, column F).

Column B: EOY deferred acquisition costs for contracts electing the internal replacement transaction at the end of year 5 (from Schedule 5, column D).

Column C: Combined EOY deferred acquisition costs [A + B]

Excerpt from Accounting Standards Codification

Contract Modifications Involving Integrated Contract Features

Costs Related to Internal Replacements that Are Substantially Unchanged

944-30-35-55

Costs incurred in connection with an internal replacement that results in a replacement contract that is substantially unchanged from the replaced contract shall be accounted for as policy maintenance costs and charged to expense as incurred.

944-30-35-56

The portion of renewal commissions paid on the replacement contract that meets the criteria for deferral under this Subtopic, limited to the amount of the future deferrable renewal commissions on the replaced contract that would have met the deferral criteria, continues to be deferrable under those provisions.

Sales Inducements Offered with Internal Replacements of Long-Duration Contracts that Are Substantially Unchanged

944-30-35-57

If an insurance entity assesses a surrender charge on the replaced contract that is offset by an immediate sales inducement to a contract holder on the replacement contract, the insurance entity shall offset any surrender charges assessed against the contract holder's account balance under the replaced contract against any stated immediate sales inducement to determine whether there has been a net reduction in the contract holder's account value in accordance with paragraph 944-30-35-37.

944-30-35-58

The liability for a sales inducement to a contract holder offered in conjunction with an internal replacement of a long-duration contract that is determined to result in a replacement contract that is substantially unchanged from the replaced contract shall be accounted for from the date of its addition to the replacement contract in accordance with the guidance in paragraph 944-40-25-12.

944-30-35-59

Sales inducements provided to the contract holder, whether for investment or universal life-type contracts, shall be recognized as part of the liability for policy benefits over the period in which the contract must remain in force for the contract holder to qualify for the inducement or at the crediting date, if earlier, in accordance with paragraphs 944-30-35-46 through 35-51. No adjustments shall be made to reduce the liability related to the sales inducements for anticipated surrender charges, persistency, or early withdrawal contractual features.

944-30-35-60

The criteria in paragraphs 944-30-25-6 through 25-7 for recognition of a related sales inducement asset cannot be satisfied in these circumstances because the sales inducement was not specifically identified in the original contract.

Contract Assessments

944-30-35-61

Front-end fees assessed in connection with an internal replacement of a long-duration contract shall be evaluated for deferral in accordance with the guidance in Subtopic 944-20.

944-30-35-62

For contracts described in paragraphs 944-20-15-4 through 15-11. Both new and existing front-end fees on an internal replacement that results in a replacement contract that is substantially unchanged from the replaced contract shall be adjusted to reflect the revisions to the estimated gross profits.

Costs and contract assessments related to internal replacements

ASC 944-30-35-55 and 56 indicates that when a contract is substantially unchanged, costs incurred in connection with the modification or replacement generally should be expensed as maintenance costs, rather than deferred. There are certain situations, however, involving contracts that are determined to be substantially unchanged, where commissions are paid as a result of an increase in insurance coverage or incremental deposits. Depending on the facts and circumstances, deferring a portion of the commissions paid may be appropriate.

For example, assume an increase in the face amount of a universal life contract results in a modification of an integrated contract feature that is determined to be substantially unchanged. The modification is an integrated feature because the universal life contract has only a single account value and the death benefit is the excess of face amount over account value. In this instance, the increased insurance coverage could easily have been effectuated through the issuance of a separate universal life-type contract and, therefore, the commission incurred on what is essentially the sale of new insurance coverage should be accounted for as acquisition costs, rather than considered a maintenance expense. The predominant characteristic of the modification in this example is the sale of additional insurance, and as such, the related commissions are more appropriately treated as acquisition costs rather than maintenance expenses.

Similarly, ASC 944-30-35-61 and 35-62 addresses contract assessments in which front-end fees may be assessed as a result of an internal replacement transaction, indicating they should also be evaluated for deferral under the requirements of Subtopic 944-20.

Sales inducements

As indicated ASC 944-30-35-57 through 35-60, if a surrender charge assessed on the replaced contract is offset by an immediate sales inducement on the replacement contract, insurance companies should offset the immediate sales inducement against the surrender charge to determine whether there has been a net reduction in the contract holder's account balance for purposes of determining substantial changes. For example, if the account balance of a variable universal life contract prior to surrender charges is $1,000 and a $60 surrender charge is imposed, the resulting $940 credited to the replacement contract account value (prior to the consideration of any surrender charges that would be assessed if the replacement contract were to be terminated) results in a substantial change to the contract. However, if an immediate bonus of $60 or more were credited to the replacement contract, there would be no net decrease to the balance available to the contract holder and the internal replacement would result in a contract that is substantially unchanged provided the other conditions of ASC 944-30-25-37 are satisfied.

Sales inducement liabilities resulting from substantially unchanged contracts should be accounted for in a manner consistent with other sales inducement liabilities, as of the date of the modification or internal replacement. However, a sales inducement asset is generally not recognized, because it was not identified in the original contract and thus would not meet the criteria for deferral under ASC 944-30-25-6.

5.3 Accounting for contracts that are substantially changed

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Internal Replacement Transactions

Recognition

944-30-25-11

The guidance applies only to replacements of traditional life insurance contracts by universal life type contracts. If surrender of a life insurance contract is associated with an internal replacement by a universal life-type contract, the entity shall not defer either of the following in connection with the replacement contract:

a. Unamortized acquisition costs associated with the replaced contract

b. Any difference between the cash surrender value and the previously recorded liability.

944-30-25-12

The accounting for other internal replacements shall be based on the circumstances of the transaction.

Contracts that Are Substantially Changed

Derecognition

944-30-40-1

An internal replacement that is determined under paragraph 944-30-35-37 to result in a replacement contract that is substantially changed from the replaced contract shall be accounted for as an extinguishment of the replaced contract.

944-30-40-2

Unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets from the replaced contract in an internal replacement transaction that results in a substantially changed contract shall not be deferred in connection with the replacement contract. If the replaced contract was acquired in a purchase business combination, any present value of future profits shall be accounted for in a similar manner.

944-30-40-3

Other balances associated with the replaced contract, such as any liability for minimum guaranteed death benefits or guaranteed minimum income benefits, shall be accounted for based on an extinguishment of the replaced contract and issuance of a new contract.

944-30-40-4

Acquisition costs related to the replacement contract shall be evaluated for deferral in accordance with Section 944-30-25.

Conceptual guidelines of financial instruments

Although ASC 944-30 does not explicitly address "in-the-money" or concepts of gains and losses in relation to internal replacement transactions, there have been interpretations on the use of the phrase "extinguishment of the replaced contract" in ASC 944-30-40-1. Fundamentally, insurance and investment contracts are financial instruments for which the insurance entity has a contractual obligation to pay, and the customer has a contractual right to receive, cash in settlement. One interpretation is that an internal replacement transaction resulting in the extinguishment of an insurance or investment contract should be accounted for in a manner similar to an exchange of debt instruments that results in an extinguishment.

Measuring consideration exchanged in an extinguishment and replacement transaction

Historically, exchanges of insurance contracts have generally been based on the cash surrender value of the replaced policy. For example, when exchanging a traditional life insurance contract for a universal life insurance policy, the cash surrender value of the life insurance contract generally has been used as the premium deposit for the new contract (ASC 944-30-25-11 prohibits any deferral of the difference between cash surrender value and the previously recorded liability in that situation).

However, as contract designs have evolved to include various guarantees and other combinations of features, the value exchanged is potentially greater than the cash surrender value of the replaced contract. This can occur if the replacement contract contains guarantees or features that were carried forward from the replaced contract or otherwise established to be more valuable than those available to a new contract holder. For example, a contract holder could exchange a variable annuity with a guarantee that is "in the money" for another variable annuity with a guarantee that is higher than the current account balance (i.e., essentially preserving the guaranteed value of the replaced contract). To the extent

the guarantee on the replacement contract is not equivalent to the guarantee on a similar newly issued contract, the guarantee associated with the replacement contract would be considered "off market" and, we believe, there is implied consideration that will need to be measured.

One approach to estimating the value of the consideration exchanged is to identify differences between terms of the replacement contract and those provided to a new contract holder for a similar newly issued contract (i.e., "off-market" terms). An example would be a guaranteed minimum accumulation benefit on a variable annuity replacement contract (as part of an internal replacement) that guarantees an amount higher than the new account balance for a fee comparable to the fee that a new contract holder would pay to guarantee an amount equal to the new account balance. The fair value of that differential (i.e., the difference in terms) would be one component of the amount of implied consideration exchanged. Utilizing this approach, the consideration for the exchange typically would be the sum of:

- the cash surrender value of the replaced contract (which represents the amount the policyholder could currently receive in cash by terminating the contract in accordance with its terms);
- surrender charges on the replaced contract to the extent the insurance entity waives such charges (either explicitly or implicitly), allowing the current policy account value, as opposed to the cash surrender value, to be used as a component of the consideration for the new policy; and
- the value of any off-market terms, including off-market guarantees, premiums, or assessments of the replacement contract. This value should reflect the "premium" the policyholder would pay for the additional "off-market" benefits provided under the contract, if that contract was purchased new.

Any difference between the recorded balances associated with the replaced contract that was extinguished and the consideration exchanged represents the gain or loss on the exchange or modification. In the case of an "in-the-money" guarantee on a variable annuity contract (as described above), the implied consideration received for the "in-the-money" guarantee would represent a liability not unlike an unearned revenue reserve resulting from an up-front fee; such liability would be amortized over the life of the replacement contract in proportion to estimate gross profits or some other reasonable basis.

Consider an additional example of an internal replacement with "off-market" terms. A new generation of an individual long-term care product with terms similar to those offered to new contract holders is offered to an existing policyholder, except that reunderwriting does not occur and the premium charged is based on the policyholder's age at issue of the replaced contract. We believe that, in this example, one approach to estimating the consideration received for the off-market premium is the present value of the expected premium differential.

Waived surrender charges

Waived surrender charges (whether explicit or implicit) should not be considered earned and, thus, should increase the amount of consideration exchanged in internal replacement transactions that result in the extinguishment of the replaced contract. An example of an implicit waiver is where the surrender charge is not waived but an immediate sales inducement equal to the surrender charge is provided on the replacement contract.

ASC 470-50 is the governing literature for internal replacement transactions (i.e., extinguished debt is replaced by a new liability to the same party) and concluded that if the original and new debt instruments are substantially different, the new debt instrument should be initially recorded at fair value and that amount should be used to determine the debt extinguishment gain or loss to be recognized. The measurement attribute is described as fair value, which should be consistent with the guidelines in ASC 820 that uses an exit value concept.

6 Contract modifications — required disclosures

Excerpt from Accounting Standards Codification

Deferred Acquisition Costs

Internal Replacement Transactions

Disclosures

944-30-50-4

The notes to financial statements shall describe the accounting policy applied to internal replacements, including whether or not the entity has availed itself of the alternative application guidance outlined in paragraphs 944-30-35-44 through 35-45 and, if so, for which types of internal replacement transactions.

The guidance requires disclosure of all accounting policies related to internal replacements, with references on whether the company has elected the alternative application for accounting for substantially unchanged replacement contracts.

Companies may also consider disclosing any differences in policies between contract types, methodologies for determining the extinguishment of a replaced contract and assumed consideration of the replacement contract, or the treatment of costs or contract assessments associated with the replacement contracts.

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