AALU WASHINGTON REPORT

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Subject: **Valuation of Life Insurance Policy Separate Accounts for Financial Reporting Purposes**

Major References: ***Financial Accounting Standards No. 157, Fair Value Measurements (FAS157)***

Prior AALU Washington Reports: *08-48; 07-73; 06-140; 06-119; 06-46*

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Current audit interests in the valuation of separate account COLI and BOLI policies is raising potentially difficult accounting issues which may generate future problems not yet fully foreseeable.

Investors in COLI and BOLI have grown accustomed to the convention of recording policies on financial balance sheets at cash surrender value. However, since many such policies are separate account variable products, a substantial percent of which (particularly involving BOLI) are modified endowment contracts, that cash surrender value will, by the contract terms, typically depend on separate account valuations. Recently, we are informed, some audit firms have insisted on verifying the "fair value" of separate accounts maintained under COLI and BOLI. A large bank's recent write down of more than $300 million in BOLI losses and the advent of FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("FAS 157") (discussed below), may account for some auditors' interest in the valuation of COLI and BOLI separate accounts (see our Bulletins Nos. 08-51 and 08-48 respecting the recent *Fifth Third* litigation).

The auditors are not challenging the recording of policies at cash surrender value which, by the policies' terms, will in all likelihood independently invoke separate account valuation. However, they are challenging the separate account values on which the policy cash surrender values are established.

Investors in separate account policies should be prepared to provide appropriate data supporting the valuation of the underlying investments. They should also be prepared for the fact that the process of confirming valuations may prove challenging when separate accounts hold illiquid or thinly traded investments.

FAS157

Fair value accounting is not new; for many years various items, not necessarily including general account life insurance policies, have had to be accounted for at fair value rather than historical cost.

Relatively new, however, is FAS 157. This pronouncement does not expand the universe of situations requiring fair value accounting. It also does not eliminate exceptions to fair value accounting such as special rules for measuring post-retirement benefit liabilities and associated plan assets. Where, however, accounting pronouncements, aside from FAS 157, require fair value measurements, it is FAS 157 which defines fair value, establishes a framework for measuring it, and expands required disclosures about fair value measurements. FAS 157 generally applies for fiscal years beginning after November 15, 2007, including quarterly reporting.

FAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." "Market participants" are knowledgeable, able, and willing buyers and sellers independent of the reporting entity.

Depending on the circumstances (including the nature of an asset or a liability), one or more valuation techniques must be employed to measure the item's fair value. FAS 157 prescribes three valuation techniques:

- Market approach: using prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

- Income approach: converting future amounts (for example, cash flows or earnings) to discounted present amounts.

- Cost approach: using the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost).

In applying these valuation techniques to value a particular asset or liability, entities are to rely on "inputs," *i.e.*, assumptions that market participants would make in pricing the item including, assumptions about risk. FAS 157 prioritizes inputs into a hierarchy consisting of three levels:

- Level 1: quoted prices in active markets for identical assets or liabilities (i.e., prices at which the same assets or liabilities actively trade).

- Level 2: inputs other than quoted prices included within Level 1 (i.e., prices at which similar assets or liabilities trade in active or inactive markets) that are directly or indirectly observable. Essentially, inputs are "observable" if they are based on market data obtained from sources independent of the reporting entity.

- Level 3: unobservable inputs. Essentially, inputs are unobservable if they reflect the reporting entity's own assumptions rather than market data obtained from independent sources. The fair value of an item must be determined under Level 3 to the extent that observable inputs are not available, thereby enabling the fair value of an asset or liability to be determined even though little, if any, market activity for the item exists.

In each quarterly and annual report, an entity reporting items at fair value must disclose information enabling users of the financial statements to assess fair value measurements. Information that must be disclosed includes the fair value measurements themselves, the levels within the fair value hierarchy of the measurements (segregating items measured under each of Level 1, 2, and 3), and (in annual reports) the valuation techniques used to measure fair values. For recurring fair value measurements under Level 3, a reporting entity also must disclose how the measurement has affected earnings (or changes in net assets) for the reporting period.

Intertwined with FAS 157 is FASB Statement of Financial Accounting Standards No. 159, *The Fair Value Option For Financial Assets and Financial Liabilities Including An Amendment of FASB Statement No. 115* ("FAS 159"). Under this pronouncement, entities may elect to measure at fair value many financial instruments and certain other items even though the items are not *required* to be measured at fair value. FAS 159 generally applies as of the beginning of an entity's first fiscal year beginning after November 15, 2007.

Valuation of COLI and BOLI Policies

In general, COLI and BOLI policies should be recorded on balance sheets at their cash surrender values (technically, the amount that could be realized upon surrendering the policy, taking into account all terms of the insurance contract). FASB Technical Bulletin 85-4, *Accounting for Purchases of Life Insurance* ("FTB 85-4"), as interpreted by EITF Issue No. 06-5; see our Bulletins Nos. 06-119 and 06-140. As previously stated here, in the case of separate account policies (often the typical COLI or BOLI policy) it is necessary by the policy terms to rely on valuation of the accounts to arrive at cash surrender value. Furthermore, fair value theoretically could be elected under FAS 159 for COLI and BOLI policies to reflect the value of mortality gains, presumably by reference in some circumstances to the life settlement market. However, the relatively small number of COLI and BOLI policies in the life settlement market makes it hard to use the available data generated by that market to establish benchmarks for fair value. See our Bulletin No. 07-73.

Under limited exceptions to FTB 85-4, some cash value life insurance must be specifically reported at fair value. For example, although excluded from the scope of FAS 157, VEBA Trust-Owned Life Insurance ("TOLI") must be valued under FASB Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* Fair value accounting under FAS 157 also is required for policies owned by life settlement companies that elect fair value under FASB Staff Position No. FTB 85-4-1, *Accounting for Life Settlement Contracts by Third-Party Investors*. See our Bulletin No. 06-46.

Fair Value Accounting for Separate Accounts

Auditors of COLI and BOLI investors' financial statements are not, to AALU's knowledge, challenging the convention of recording the policies at cash surrender value under FTB 85-4. Where, however, separate accounts are maintained under a COLI or BOLI policy, some auditors have insisted on satisfying themselves that the separate accounts have properly been valued under FAS 157. In effect, these auditors have insisted on verifying the values within the separate accounts in order to sign off on the cash surrender values of the relevant policies under FTB 85-4.

The following simplified example illustrates this approach:

> A company ("Company") purchases a variable COLI policy. The separate accounts available under the variable contract invest in financial assets. Company reports financial results using the calendar year as its fiscal year. In preparing its draft balance sheet for the quarter ending June 30, 2008, Company records an asset of $10 million (as reported to it by the issuing company) reflecting the COLI policy's cash surrender value. Company's auditor makes an independent review of the separate account values and concludes that the total of those values is $8,500,000. If Company cannot satisfactorily reconcile these valuation discrepancies, the auditor may hesitate to sign off on recording the COLI policy on Company's balance sheet at $10 million.

Where auditors insist on examining the valuation of life insurance policy separate accounts under FAS 157, they will focus on the nature of the underlying investment assets. Valuation discussions with auditors about separate accounts have addressed primarily sub-advised funds, including some investment managers' proprietary offerings. One example might include fixed income funds that use alpha strategies with swaps or other derivatives, especially when a portion of the holdings are illiquid. Sub-advised funds or other proprietary offerings, where there may not be a large secondary market for buying and selling fund shares, may also receive closer examination. These types of underlying assets will prove more challenging to value than separate account options that simply mirror the investment strategy of an existing mutual fund because reliance will have to be placed on Level 3 or, in some cases, Level 2 inputs.

FAS 157 requires reporting entities not only to determine fair value under the pronouncement's framework but also, as we have stated, to disclose various information. Auditors who scrutinize values of assets held within separate accounts can be expected to require investors in COLI and BOLI to so disclose that information in their financial statements.

While investors in COLI and BOLI may find the previously described investment strategies attractive alternatives for some portion of their holdings, they should be prepared for scrutiny from their auditors regarding asset valuation. If the investments held in separate accounts consist solely of publicly traded securities, then satisfying an auditor's inquiries about valuation should not prove onerous. Under Level 1 of FAS 157, the inputs should consist of quoted market prices for those securities. However, where a policyholder instead must rely on inputs under Level 3 or, in some cases, Level 2, satisfying auditors' inquiries may present more formidable challenges.

The main point of this Washington Report is to advise that reliable advance documentation of separate account valuations will help ensure that policyholders are prepared to discuss their COLI or BOLI holdings with their auditors in an accounting profession environment of heightened concern about proper valuation. The entire subject also raises a potentially more interesting observation about separate account policies. Namely, how much reliance should be placed, for accounting as well as contract purposes, on separate account COLI and BOLI policy values reported to policyholders by the issuing companies whose interests in the policies may conflict with those of the policyholders?

Any AALU member who wishes to obtain a copy of FAS157 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at ruselowski@aalu.org and include a reference to this *Washington Report*.

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