FASB Emerging Issues Task Force

Issue No. 06-4

Title: Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements

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Previously distributed EITF materials: Issue Summary No. 1, dated February 20, 2006, Issue Summary No. 1, Supplement No. 1, dated May 31, 2006

References:

FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FAS 88)

FASB Statement No. 95, *Statement of Cash Flows* (FAS 95)

FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FAS 106)

FASB Statement No. 109, *Accounting for Income Taxes* (FAS 109)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6)

FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance* (FTB 85-4)

APB Opinion No. 12, *Omnibus Opinion—1967* (APB 12)

International Accounting Standard 19, *Employee Benefits* (IAS 19)

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* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Background

1. At the June 15, 2006 EITF meeting, the Task Force reached a tentative conclusion on this Issue and directed the staff to proceed with the issuance of a draft abstract for public comment. The draft abstract was posted to the FASB website on July 6, 2006, for a 30-day comment period that ended August 4, 2006.

2. Comment letters received on the draft abstract have been distributed to Task Force members and have been analyzed by the FASB staff. At the September 7, 2006 EITF meeting, the Task Force will have the opportunity to consider those comment letters as it redeliberates the tentative conclusion in the draft abstract and addresses additional issues raised in this Supplement. The Task Force will then be asked to affirm its tentative conclusion on this Issue as a consensus. Based on the FASB staff's research on the comments received, an additional alternative view (View A' of Issue 1) has been added to the Issue that has not been previously deliberated by the Task Force. The alternative view differs from View A of Issue 1 in that the employer would accrue the present value of the postretirement cost of insurance for the death benefit to be realized by the employee over the employee's service period, rather than the present value of the specified death benefit.

Summary of Comment Letters

3. The FASB staff received comment letters on the Issue from 119 (as of August 18, 2006) separate organizations and individuals.[1] Of the total received, 91 were from banks, 14 were from benefit consultants, 11 were from various associations and professional organizations, and 2 were from CPA firms. Eighty-five of the letters received were one of four separate "form" letters that were circulated by various organizations. All but two of the letters disagreed with the Task Force's tentative conclusion.

4. The staff has identified and analyzed the significant comments in the section that follows. While the staff believes that the Task Force considered a majority of the comments below during

[1] The FASB staff received a total of 156 comment letters, however, 37 of these letters were duplicative in nature and from different persons within the same organization.

its initial deliberations on the Issue, the Task Force should nevertheless consider these comments in its redeliberations of this Issue.

Comment 1 – Transition and Effective Date

5. Over 50 respondents commented that the application of the tentative conclusion reached by the Task Force could result in the retained earnings for certain entities to be reduced below minimum regulatory requirements. Secondly, bank regulations generally limit the amount of bank owned life insurance (such as endorsement split-dollar life insurance arrangements) to an amount not to exceed 25 percent of retained earnings. Respondents believe that the reduction of capital caused by the application of this issue may affect the ratio of bank owned life insurance to retained earnings and result in banks exceeding the mandatory 25 percent limit. In addition, these respondents also believe that the proposed effective date does not provide sufficient time for entities to evaluate their existing arrangements and identify alternative solutions to increase retained earnings above the minimum regulatory requirements. They also believe that if the Task Force does not delay the effective date, then it should provide for prospective application of the consensus.

6. Since the tentative conclusion presented in the draft abstract may have a significant impact on entities, (and, specifically, community banks) the FASB staff believes that the Task Force should consider delaying the effective date (see Issue 2 of this Supplement). The staff does not believe, however, that the Task Force should allow for prospective application of this consensus. The staff believes that it would be unlikely that this method would improve financial reporting since these arrangements typically extend a number of years into the future and, therefore, arrangements within an entity would not be consistently reported nor would information be comparable among entities. As a result, the staff does not recommend that the Task Force redeliberate this aspect of its tentative conclusion.

Comment 2 – Definition of a Liability

7. A total of 52 respondents indicated that they believed that an entity should not be required to record an obligation for a postretirement benefit when there will be no future outflow of cash after the initial premium payment. These respondents believe that the consensus reached on this

issue in the draft abstract is inconsistent with the definition of a liability included in paragraph 36 of CON 6. In the staff's view, the Task Force discussed this concern extensively during the initial deliberations of this Issue; however, the staff believes that Issue 1 of this Supplement provides further analysis in response to this comment.

Comment 3 – Participating Insurance Contracts Can Settle the Obligation

8. A total of 41 respondents explicitly indicated that the consensus reached in the draft abstract is inconsistent with guidance in FAS 106 as it relates to the settlement of a postretirement benefit obligation. Specifically, they believe that the Task Force is incorrect in its assertion that only a nonparticipating contract can constitute a settlement. They refer to paragraph 94 of FAS 106, which states:

> If the purchase of a <u>participating</u> insurance contract constitutes a settlement (refer to paragraphs 67 and 90), the maximum gain (but not the maximum loss) shall be reduced by the cost of the participation right before determining the amount to be recognized in income. [Emphasis added.]

9. Additionally, these respondents pointed out that in many cases, participating insurance contracts contain minimum guaranteed interest rate credits and maximum guaranteed mortality costs. Therefore, the employer's exposure to the variable attributes of these types of policies are mitigated, and, as such, the downside participation in these policies is limited.

FASB Staff Analysis

10. The staff acknowledges that the draft abstract implied that a participating policy could not settle a postretirement benefit obligation. In order to qualify as a settlement, however, the insurance policy would need to satisfy each of the criteria in paragraphs 67 and 68 of FAS 106, which state, in part:

> 67. For purposes of this Statement, an insurance contract is defined as a contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a **fixed consideration or premium**; an insurance contract is **irrevocable** and involves the transfer of significant risk from the employer (or the plan) to the insurance company….

> 68. Some insurance contracts (participating insurance contracts) provide that the purchaser (either the plan or the employer) may participate in the experience of the insurance company. Under those contracts, the insurance company ordinarily pays dividends to the purchaser, the effect of which is to reduce the cost of the plan**. If the participating insurance contract causes the employer to remain subject to all or most of the risks and rewards associated with the benefit obligation covered or the assets transferred to the insurance company, that contract is not an insurance contract for purposes of this Statement,** and the purchase of that contract does not constitute a settlement pursuant to paragraphs 90-95. [Emphasis added.]

11. Based on the Task Force's discussion at its June 15, 2006 meeting, most members were concerned about the sample fact pattern of a typical endorsement split-dollar life insurance arrangement discussed previously in Issue Summary No. 1 and in Supplement No. 1, since the participation feature essentially results in a payment that is a single premium in name only. The Board shared that concern in the Basis for Conclusions in paragraph 366 of FAS 106, which states, in part:

> that, except for single-premium life insurance contracts, there are few, if any, contracts at the present time that unconditionally obligate an insurance company to provide most forms of postretirement benefits.

12. The Task Force also indicated that it did not believe that the purchase of the typical endorsement split-dollar life insurance arrangement constituted a settlement because the employer could cancel it at any time, thus making it revocable. Additionally, some members indicated that since the employer retained full rights to the policy, including the cash surrender value, it had not transferred all of the risks and rewards related to the assets to the insurance company.

13. The staff believes that the draft abstract was unclear in articulating views of the Task Force expressed above and, therefore, the draft abstract attached to this Supplement as Exhibit 06-4C has been amended to better reflect those comments. Additionally, while the respondents appear to have focused their argument on the downside risk of the policy resulting from participation features, FAS 106, on the other hand, explicitly includes rights that participate in the upside of an insurance policy as a participating insurance contract.

Comment 4 – Accounting Results in Misleading Financial Statements

14. Over 80 respondents commented that the tentative conclusion reached by the Task Force in the draft abstract will result in distorted financial statements as a result of the following:

a. Recognition of a liability when no future assets will be sacrificed (see Comment 2 above)
b. Double recognition of expense
c. Recognition of a gain when the liability is reversed.

15. ***Liability*** – Many respondents indicated that it would be misleading to investors if an employer were to accrue a liability on the balance sheet when there will be no future sacrifice of assets. Some counter this assertion by noting that the employer has in fact sacrificed future assets by providing employees with a benefit that they would not otherwise be entitled to. That is, the employer could have purchased a key-man life insurance policy on an executive and received the entire death benefit, rather than endorsing a portion over to that executive (see Issue 1 for further discussion).

16. ***Double Recognition of Expense*** **–** Seventy-three respondents indicated that accruing for the postretirement death benefit obligation results in a double recognition of the expense for endorsement split-dollar life insurance arrangements. That is, these respondents believe that the cost of these policies is properly reflected through the cost of insurance. Consider the following example:

> Company A enters into a $500,000 face amount endorsement split-dollar life insurance arrangement with a key executive. The endorsement provides that the employee will receive $100,000, which will extend into retirement if the employee provides 20 years of service. At inception of the policy the employer pays a single premium payment of $100,000, which results in a cash surrender value of $90,000. At the end of the first year, the cash surrender value has increased to $95,000. This increase represents the credited interest of $8,000 less $3,000 for the cost of insurance associated with changes in mortality rates and recovery of excess administrative expenses.

17. These respondents believe that in the above example, the company has properly recorded the expense associated with the arrangement. That is, $10,000 of expense would be recorded at inception of the arrangement ($100,000 cash payment less $90,000 cash surrender value) and $3,000 would be recorded for the additional cost of insurance at the end of the first year (typically recognized as an offset to the investment earnings on the policy of $8,000). They believe that accruing an additional amount for the postretirement benefit obligation results in an overstatement of an expense related to the cost of the arrangement. In order to minimize what they believe to be financial reporting that may be misleading, many respondents noted that entities should not be limited to recording the cash surrender value as the insurance asset. They believe that entities should be able to record the present value of the contingent gain that will be received by the company upon the death of the employee (the present value of $400,000 in the above example). The staff notes, however, that there is currently no ability to record this contingent gain based upon the authoritative accounting guidance in this area.

18. Opponents to these respondents believe that the Task Force's tentative conclusion does not result in a double counting of expenses associated with endorsement split-dollar life insurance arrangements. They believe that expenses noted by the respondents above are related to separate accounting events: (a) the current period cost of insurance charges deducted by the insurer ($3,000 in the example above) relates to the purchase and maintenance of an insurance policy during an employee's active service period and (b) the recognition during the employee's active service period of the present value of the cost of insurance charges expected to be incurred to provide for postretirement benefits (that is, the cost of insurance in the postretirement period). Additionally, they note that the cost of insurance in subsequent years will typically not be recorded directly in the income statement since it will be netted against the investment income, which in most instances will result in the recording of net income. Proponents of View A' of Issue 1 believe that this amount represents the cost of the insurance that will be paid by the employer (generally indirectly through reductions in the growth of the cash surrender value) during the employee's retirement. Throughout the employee's retirement, the cost of insurance recognized by the employer will typically be zero since the employer had previously accrued for this amount during the employee's service period. The postretirement liability will be offset each

year against the cost of insurance such that the net impact on the income statement is zero.[2] Proponents of View A of Issue 1 believe that the death benefit represents the postretirement benefit and, therefore, the employer should accrue an amount that equals the present value of the death benefit at the full eligibility date. This amount would then be reversed into income upon the death of the employee (or settlement by other means). See Exhibit 06-4B for a sample fact pattern and journal entries that illustrate the accounting under both View A and View A' of Issue 1.

19. **Recognition of a Gain –** Over 30 respondents indicated that accruing an expense for the postretirement benefit obligation during the employee service period and reversing this amount into income upon the death of the employee (or settlement by other means) results in misleading financial statements that may be misleading (see Exhibit 06-4B for journal entries of an example fact pattern). Specifically, they note that regulatory capital will be reduced during the employee service period only to increase upon the death of an employee.

20. Opponents of those respondents do not believe that the tentative conclusion reached by the Task Force in the draft abstract results in misleading financial reporting. Specifically, they believe that accrual of the postretirement benefit obligation and subsequent reversal into income represents the economics of the arrangement. That is, the reversal into income reflects the settlement of the benefit obligation with the employee in accordance with FAS 106. Proponents of View A' of Issue 1 note that a gain will only be recorded if the employee dies sooner than was projected in the mortality assumptions used for the insurance policy or the cost of insurance charges realized in the postretirement period are below the level assumed. That is, if the employee lives until, or past, the estimated mortality date, then the liability will have been reduced down to zero and no gain would be recorded (see Exhibit 06-4B).

Comment 5 – Income Tax Accounting and Statement of Cash Flows

21. A total of 15 respondents indicated that the Task Force should provide guidance on both the income tax accounting and classification in the statement of cash flows for these arrangements.

[2] To the extent that actuarial assumptions for the insurance policy change, there may be income or expense related to the policy in any given year.

As it relates to accounting for income taxes, the staff does not believe that endorsement split-dollar life insurance arrangements create a situation that is not addressed in FAS 109. Therefore, the staff does not believe that it is necessary for the Task Force to provide specific guidance in this area.

22. As it relates to classification within the statement of cash flows, the FASB staff is currently researching numerous issues related to the application of FAS 95 to certain situations. This research could result in a formal project being added to the Board's agenda to address these practice issues. Accordingly, the staff does not believe that the Task Force should provide guidance on classification in the statement of cash flows as part of this Issue.

Redeliberation of Issue

23. Due to the significant number of comments received that disagreed with the Task Force's tentative conclusion, the staff believes that the Task Force should redeliberate the Issue in its entirety. If the Task Force reaffirms the original consensus reached in the draft abstract, the staff will ask the Task Force whether it agrees with the staff recommendation on Comment 5 above to exclude guidance on the income tax accounting and classification in the statement of cash flows for these arrangements. If the Task Force then reaches a tentative conclusion of View B on Issue 1, there would be no further need to discuss Comment 5 above.

24. Other than Comments 1 and 5 previously described, the staff does not believe that any new issues were raised in the comment letters that were not previously considered by the Task Force. However, based on the FASB staff's research, an additional alternative view (View A') has been identified for Issue 1. Accordingly, the staff has included Issue 1 (with its related background information included in Exhibit 06-4A) and its previously deliberated alternative views from Issue Summary No. 1, Supplement No. 1, dated May 31, 2006, along with the discussion of View A', in the section of this Supplement that follows the Summary of Comment Letters. The staff has added alternative views related to the effective date (see Issue 2, which also follows) that were not included previously, to address certain comments received by constituents. Additionally, the staff has marked the draft abstract (which reflects the tentative conclusion previously reached by the Task Force) for wording changes suggested by respondents.

Accounting Issue and Alternatives

Issue 1: Whether the postretirement benefit associated with an endorsement split-dollar life insurance arrangement is effectively settled in accordance with either FAS 106 or APB 12 upon entering into such an arrangement.

View A: An employer should recognize a liability for future benefits based on the substantive agreement with the employee, since the postretirement benefit obligation is not effectively settled. For example, if the arrangement is to provide the employee with a death benefit, the employer should recognize a liability for the future death benefit in accordance with either FAS 106 or APB 12 (depending on whether the arrangement is considered a "plan" in accordance with FAS 106).

25. Proponents of View A believe that entering into an endorsement split-dollar life insurance arrangement with an employee is a postretirement benefit that must be accounted for in accordance with FAS 106 or APB 12. Proponents of View A refer to paragraph 163 of FAS 106, which states, in part, "The Board concluded that the obligation to provide postretirement benefits meets the definition of a liability…." Therefore, the Board decided that if an employer has incurred an obligation to provide postretirement benefits, then it must record a liability. These proponents further note that once a postretirement benefit obligation has been incurred by an employer it may only be relieved through a *settlement*, which is defined in the Glossary of FAS 106 as follows:

> An **irrevocable** action that relieves the employer (or the plan) of primary responsibility for a postretirement benefit obligation and **eliminates significant risks related to the obligation and the assets used to effect the settlement**. Examples of transactions that constitute a settlement include (a) making lump-sum cash payments to plan participants in exchange for their rights to receive specified postretirement benefits and (b) purchasing **nonparticipating insurance contracts** for the **accumulated** postretirement benefit obligation for some or all of the plan participants. [Emphasis added.]

26. Proponents of View A believe that purchasing a typical endorsement split-dollar life insurance policy does not qualify as a settlement under FAS 106. Paragraphs 67-71 of FAS 106

and the definition of settlement above indicate that purchasing *nonparticipating* insurance contracts can qualify as a settlement if certain criteria are met.

27. The FASB staff has been informed that a significant number of endorsement split-dollar life insurance arrangements are structured as universal life policies. As such, the insurer generally has the right to recover unexpected increases in the cost of insurance due to changes in mortality or increased administrative costs. For example, if the policy is structured as a single premium policy, the insurer will either bill the owner of the policy directly for this amount or deduct it from the cash surrender value of the policy. Proponents of View A believe that universal life policies would not qualify as *nonparticipating* insurance contracts under FAS 106. They believe that these are actually *participating* insurance policies, which are defined in the glossary of FAS 106, as follows:

> An insurance contract that provides for the purchaser to participate in the investment performance and possibly other experience (for example, morbidity experience) of the insurance company.

28. Proponents of View A believe that the Board's intent in FAS 106 is that if an owner of a policy is exposed to experience losses of the insurer, then a settlement has not occurred. They refer to paragraph 373 of FAS 106, which states, in part:

> The Board also is aware that some participating contracts may require or permit payment of additional premiums if experience is unfavorable. The Board concluded that if a participating contract requires or permits payment of additional premiums because of experience losses, or if the substance of the contract is such that the purchaser retains all or most of the related risks and rewards, the purchase of that contract does not constitute a settlement.

29. Additionally, these proponents point to a number of other factors as evidence that the liability has not been settled. These factors include, but are not limited to:

a. ***Irrevocability***—*Irrevocable* is defined by *Black's Law Dictionary*, Seventh Edition, as "unalterable, committed beyond recall." However, an employer can either outright cancel these types of arrangements or switch to a different insurance carrier. Therefore, it does not appear that an employer has entered into an irrevocable arrangement.

b. The employer is the owner and part beneficiary of the policy and therefore has not transferred most of the risks and rewards associated with the assets used to effect the settlement. That is, the employer records an asset for the cash surrender value of the policy (depending on the policy's structure) and will receive a portion of the death benefit upon the death of the covered employee. By recognizing this asset, the employer is demonstrating that it is sharing in the benefits of the insurance arrangement. Additionally, the employer remains subject to the risks related to the assets used to effect the settlement, since if the insurance company were to default on the policy the company would not recover the cash surrender value.

c. In order to settle an *accumulated* postretirement benefit obligation, a liability would need to have been already recognized. That is, because no benefits have accumulated at the date the policy is entered into, the arrangement represents a pre-funding of the postretirement benefit, rather than a settlement. Proponents believe that the pre-funding should not impact the recognition of the liability and refer to paragraph 150 of FAS 106, which states, in part:

> The decision of how or when to fund the obligation is not an accounting issue. It is a financing decision that is properly influenced by many factors (such as tax considerations and the availability of attractive investment alternatives) that are unrelated to how or when the postretirement benefit obligation is incurred.

30. Under these arrangements, proponents believe that the employer has clearly given value to the employee in the form of a postretirement benefit. For example, the company could have derived additional value (that is, received the entire death benefit) by purchasing a key-man life insurance policy. These proponents believe that by entering into the endorsement split-dollar arrangement with the employee, the employer is providing benefits to the employee that the employer would otherwise have been entitled to and, therefore, has sacrificed the right to future economic benefits.[3]

[3] Paragraph 35 of CON 6 defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as the result of past transactions or events" (footnote references omitted).

View A': An employer should recognize a liability during the employee's active service period for the future cost of insurance to be incurred during the employee's retirement. The employer has effectively agreed to maintain an insurance policy in force for the benefit of the employee during retirement.

31. Proponents of this view agree with proponents of View A that entering into an endorsement split-dollar life insurance arrangement does constitute a postretirement benefit obligation since the employer has effectively agreed to maintain an insurance policy in force for the benefit of the employee during retirement. Proponents of this view disagree, however, with the description of the postretirement benefit that has been provided to the employee. They believe that, regardless of the stated death benefit that is endorsed over to the employee, the postretirement benefit obligation relates to the cost of insurance during the employee's retirement for the portion of the death benefit that is endorsed over to the employee. Proponents note that the benefit that has been provided to the employee is the purchase of insurance during retirement and not the proceeds from the actual death benefit. Therefore, an employer would be obligated to accrue an amount over the employee's service period that would equal, at the full eligibility date, the present value of the cost of maintaining an insurance policy for the death benefit to be realized by the employee until the employee's estimated date of death.

32. Under this view, the accounting during the employee's active service period may be similar to that of View A; however, the actual dollar amounts accrued may be different. During retirement, however, the accounting will differ under this view in that the liability would be relieved against the periodic cost of insurance. This is in contrast to View A under which the liability will not be relieved until the employee dies (or the obligation is settled by other means). See Exhibit 06-4B for an illustrative example that compares the accounting under View A to the accounting under View A'.

View B: An employer should not recognize a liability for future benefits or premiums because the purchase of the endorsement split-dollar life insurance policy effectively settles the obligation.

33. Proponents of View B believe that for a typical endorsement split-dollar arrangement (as described in Exhibit 06-4A), all of the risks of providing a death benefit to an employee have been transferred to the insurance company. Therefore, the employer has effectively settled its obligation with the employee and should not be required to recognize a liability for postretirement benefits. These proponents believe that recognizing an obligation for this postretirement benefit would be inconsistent with the characteristics of a liability described in paragraph 36 of CON 6, which states:

> A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.

34. Proponents of View B note that in the typical endorsement split-dollar life insurance arrangement an employer has no obligation to fund the death benefit. This benefit will be paid by the insurance company and, therefore, the employer will not sacrifice any future assets after the premiums are paid under the policy. For example, should the insurance company fail to fulfill its obligation under the insurance policy, the employer is under no legal obligation to pay for the benefit that would otherwise have been paid by the insurance company. Accordingly, they do not believe that the obligation described in View A satisfies either characteristic (a) or characteristic (b), above, for purposes of recognizing a liability.

35. Proponents of View B further note that if an employer were to purchase insurance contracts to cover postretirement benefits, the benefits covered by these contracts should be excluded from the accumulated postretirement benefit obligation. Specifically, paragraph 67 of FAS 106 states, in part:

> For purposes of this Statement, an insurance contract is defined as a contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium; an insurance contract is **irrevocable** and involves the transfer of significant risk from the employer (or the plan) to the insurance company. Benefits covered by insurance contracts shall be excluded from the

> accumulated postretirement benefit obligation. [Footnote reference omitted and emphasis added.]

36. Proponents of View B believe that for purposes of determining whether or not a settlement has occurred, irrevocability must be assessed from the insurer's perspective. That is, whether the insurance company assumed the legal obligation to provide the specified benefits to the employee. They argue that as long as the employer continues to pay the premiums under the policy, the insurance company may not revoke that policy. Additionally, they note that if irrevocability must be assessed from the employer's perspective, then very few, if any, policies would qualify as an insurance contract under FAS 106, since almost all policies can be cancelled by the owner of the policy. They do not believe that this was the Board's intent, and refer to the following explicit description, from paragraph 366 of FAS 106, of a type of policy that would qualify:

> However, some insurance contracts, such as single-premium, nonparticipating life insurance contracts, do effectively transfer the primary obligation for payment of benefits from the employer (or the plan) to the insurance company. In those circumstances, the premium paid for the benefits attributed to the current period is an appropriate measure of postretirement benefit cost for that period. The Board concluded that the purchase of a nonparticipating insurance contract is a settlement of a postretirement benefit obligation rather than an investment.

37. Proponents note that many endorsement split-dollar life insurance arrangements are structured as single premium payments and, therefore, would be analogous to the above situation and qualify as insurance contracts.

38. Opponents counter that assertion with the following statement from paragraph 366 of FAS 106:

> The Board recognizes that, except for single-premium life insurance contracts, there are few, if any, contracts at the present time that unconditionally obligate an insurance company to provide most forms of postretirement benefits.

39. Opponents believe that this excerpt helps to illustrate that the Board does not believe that it would be common for an employer to be able to purchase an insurance product that effectively

settles a postretirement benefit. They believe that the single premium policy described above relates to a policy purchased for an employee whereby the employee is both the owner and beneficiary of the policy. In that situation, the arrangement would be irrevocable since the employer could not cancel the policy and the employer would not retain any risks and rewards related to the assets used to effect the settlement. Additionally, opponents believe that the purchase of these types of policies represent purchases of participating insurance contracts that do not qualify for settlement accounting under FAS 106 (see View A).

40. Finally, proponents of View B do not believe that the accounting consequence of reporting a liability for postretirement benefits for an endorsement split-dollar life insurance arrangement results in meaningful financial reporting. For example, they do not believe that an employer should have to record a liability for an amount in which cash will never be expended and then ultimately reverse that amount as a gain upon the death of the insured or when the employee retires and becomes entitled to the benefit (see Exhibit 06-4A for illustrative journal entries).

Issue 2: Whether the effective date of Issue 06-4 should be delayed to allow entities adequate time for implementation.

41. The Task Force tentatively concluded that the consensus shall be effective for fiscal years beginning after the date that the consensus is ratified by the Board. As previously indicated, a total of 30 respondents explicitly indicated that due to the significant impact on entities, and more specifically the reduction in regulatory capital for banks that would result from this consensus, the effective date should be delayed to fiscal years beginning after December 15, 2007.

FASB Staff Analysis

42. Based on the significant impact in practice, especially among community banks (a majority of which have a December 31 year-end), the FASB staff believes that the Task Force should consider delaying the effective date at a minimum for at least fiscal periods beginning after June

15, 2007. Accordingly, the staff has presented the following views for consideration by the Task Force:

View A: The Task Force reaffirms its tentative conclusion that this Issue should be effective for fiscal years beginning after the date this consensus is ratified by the Board.

View B: The consensus reached on this Issue should be effective for fiscal <u>periods</u> beginning after June 15, 2007.

View C: The consensus reached on this Issue should be effective for fiscal <u>years</u> beginning after December 15, 2007.

Exhibit 06-4A

BACKGROUND INFORMATION ON ENDORSEMENT SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

Companies purchase life insurance for various reasons that may include protecting against the loss of "key" employees, funding deferred compensation and postretirement benefit obligations, and providing an investment return. One form of this insurance is split-dollar life insurance. The structure of split-dollar life insurance arrangements can be complex and varied; however, an example of a simple structure is one in which the employer and an employee split the premiums and share the cash surrender value and/or death benefits of the insurance policy.

Endorsement Split-Dollar Life Insurance Arrangement

The following is a typical example of an endorsement split-dollar life insurance arrangement:

> An employer purchases a life insurance policy to insure the life of an employee. The employer enters into a separate agreement that splits the policy's premium and/or policy benefits between the employer and the employee. The employer owns the policy, controls all rights of ownership, and may terminate the benefits promised to the employee if the employee departs from the employer prior to retirement. The employer endorses a portion of the death benefits to the employee (the employee designates a beneficiary for this portion of the death benefits). Upon the death of the employee, the employee's beneficiary typically receives the designated portion of the death benefits from the insurance company and the employer receives the remainder of the death benefits.
>
> The employee's portion of the death benefits commonly is based on one of the following:
>
> a. Amounts that exceed the gross premiums paid by the employer
>
> b. Amounts that exceed the sum of the gross premiums paid by the employer plus an additional fixed or variable investment return on those premiums
>
> c. Amounts equal to a multiple of the employee's base salary at retirement or death (for example, twice the employee's base salary).

These basic arrangements often include additional provisions. For example, the employer may be contractually required to provide life insurance coverage to a specific employee for a specified period. These split-dollar arrangements may include an option-to-purchase provision and/or a comparable-coverage provision. Under an option-to-purchase provision, the employer is required to offer the insured employee the option to purchase the policy before the employer could sell, surrender, or otherwise transfer the policy. Under a comparable-coverage provision, the employer is required to maintain comparable coverage for the insured employee if the employer decides to switch the policy to a different carrier. These two provisions provide the employee with the security that its benefits will continue. Additionally, payments of insurance premiums may take a number of different forms including the payment of a single premium at the inception of the policy or a series of future payments.

Accounting Literature – Life Insurance

In 1985, the FASB issued FTB 85-4, which provides guidance on the accounting for the investment in life insurance (the asset) and requires that the amount that could be realized under the insurance contract as of the date of the financial statements be reported as an asset. Additionally, the change in the cash surrender or contract value during the period is an adjustment of premiums paid in determining the expense or income recognized for the period. Although footnote 1 in FTB 85-4 acknowledges that life insurance may be purchased to fund deferred compensation arrangements or postemployment death benefits, it does not address the recognition of compensation costs associated with those types of benefits. Proponents of both View A and View B in this Issue Summary Supplement believe that as long as the employer is entitled to 100 percent of the cash surrender value, this entire amount would be recorded as an asset in accordance with FTB 85-4.

Accounting Guidance – Deferred Compensation and Postretirement Benefits

Although neither of the following references is specific to split-dollar life insurance arrangements, APB 12 provides guidance on the accounting for deferred compensation contracts with individual employees if those contracts, taken together, do not constitute a plan. FAS 106 provides guidance on the accounting for postretirement benefits that are part of a plan for retirees, but are not part of a pension plan.

APB 12 requires deferred compensation costs to be recognized over the service period in a systematic and rational manner. At the end of the service period (the full eligibility date as defined in FAS 106[4]), the accrued amount should equal the then present value of the benefits expected to be provided to the employee and the employee's beneficiaries.

Under FAS 106, an employer should recognize and measure the obligation for postretirement benefits based on the actuarial present value of all future benefits attributed to an employee's service rendered to that date. FAS 106 requires an employer to attribute the costs of those postretirement benefits over the required service period.

For typical endorsement split-dollar arrangements (that is, the type of arrangement described above), there appears to be diversity in practice in accounting for the deferred compensation and postretirement aspects of such plans. Some believe that APB 12 or FAS 106 (if the arrangement is part of a plan, FAS 106 would be applicable, and APB 12 would be applicable otherwise) should be applied and that a liability for the postretirement benefit obligation should be recognized. However, some believe that the employer's obligation to provide the death benefit is effectively settled when the insurance policy is purchased and that, therefore, no liability for the future benefit should be recognized.

[4] FAS 106 defines *full eligibility date* as "the date at which the employee has rendered all the service necessary to have earned the right to receive all of the benefits expected to be received by that employee (including any beneficiaries and dependents expected to receive benefits)."

Exhibit 06-4B

ILLUSTRATION OF JOURNAL ENTRIES FOR A HYPOTHETICAL ENDORSEMENT SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENT UNDER VIEW A AND VIEW A'

A typical endorsement split-dollar life insurance arrangement provides the employee with a death benefit during both active employment and postretirement (once the employee has provided the requisite service to have earned the benefit). Due to the defined scope of this Issue, the following simplified example assumes that the employee only receives the benefit during postretirement. For simplicity, it assumes that the cash surrender value and postretirement benefit obligation accrue ratably throughout the service period. The journal entries are presented separately for the accounting under View A and the accounting under View A'.

<u>Facts</u>

Employer enters into an endorsement split-dollar life insurance arrangement with an employee, currently 52 years old, that will provide life insurance to the employee in postretirement periods once the employee provides 10 years of service (mandatory retirement age is 62). The amount of insurance the employee will receive is equal to the net insurance at the date of death (face amount of policy less the cash surrender value). The employer will always receive the cash surrender value. Additional features of the policy are as follows:

- Face amount of policy is $300,000
- Employer pays a single premium of $60,000 on the date the employee turns 52 years of age
- Employer is the owner of the policy and is entitled to 100 percent of the cash surrender value
- Employer can cancel coverage at any time
- Employer has no legal obligation to pay the employee's beneficiary the specified death benefit should the insurer default under its obligation
- For simplicity, assume that the cash surrender value increases ratably $8,000 per year (this represents the net amount of an interest credit of $11,000 less the cost of insurance of $3,000)
- Assume that the actuarial present value of the postretirement benefit to be recognized per year of employee service is $6,000
- Mortality assumptions estimate that the employee will die at age 82
- Assume the employee retires at age 62.

Journal Entries	Debit	Credit

VIEW A

Day 1

Insurance Asset	60,000	
Cash		60,000

(To record the purchase of the endorsement split-dollar life insurance arrangement—assume that the cash surrender value equals premium payment.)

End of year 1

Deferred compensation expense	6,000	
Postretirement benefit obligation		6,000

(To record the postretirement benefit obligation for the year—this same entry would be recorded each year until age 62, the full eligibility date. Under View A this amount relates to an accrual for the death benefit.)

Insurance asset - net	8,000	
Investment income		8,000

(To recognize the increase in the cash surrender value of the policy—this would continue until the earlier of the employee's death or surrendering of the policy.)

End of Year 10 – Full Eligibility and Employee Retirement

Total postretirement benefit obligation accrued during employee' service 60,000

End of first year after retirement

Interest expense	2,000	
Postretirement benefit obligation		2,000

(To record the accretion of the postretirement benefit obligation until settlement occurs. For simplicity, this amount is an assumption and continues ratably each year until the obligation is settled.)

Insurance asset – interest credit	11,000	
Insurance asset – cost of insurance		3,000
Investment income		8,000

(To record the interest credit and cost of insurance. The interest and cost of insurance are displayed gross in the example; however, in practice these amounts would typically be netted.)

Journal entries if employee died one day after retirement

Postretirement benefit obligation	60,000	
Income statement		60,000

(To record the settlement of the postretirement benefit obligation upon death of the employee.)

Cash	140,000	
Insurance asset		140,000

(To record the insurance proceeds received upon the employee's death.)

Journal entries if employee died five years after retirement

Postretirement benefit obligation	70,000	
Income statement		70,000

(To record the settlement of the postretirement benefit obligation upon death of the employee. The postretirement benefit obligation increased $2,000 per year after the full eligibility date.)

Cash	180,000	
Insurance asset		180,000

(To record the insurance proceeds received upon the employee's death.)

Journal entries if employee died at age 82—estimated mortality date

Cash	300,000	
Insurance asset		300,000

(To record the insurance proceeds received upon the employee's death. The postretirement benefit obligation had been reduced by $8,000 per year starting at age 73. Since the employee is only entitled to the net insurance, the employee's benefit decreases by $8,000 each year the employee lives past age 72. For simplicity, the example assumes that the cash surrender value equals the face amount of the policy at the estimated mortality date. In actuality, these amounts would likely not be equal as of this date.)

View A'

Day 1

Insurance Asset	60,000	
Cash		60,000

(To record the purchase of the endorsement split-dollar life insurance arrangement—assume that the cash surrender value equals premium payment.)

End of year 1

Deferred compensation expense	6,000	
Postretirement benefit obligation		6,000

(To record the postretirement benefit obligation for the year—this same entry would be recorded each year until age 62, the full eligibility date. Under View A' this amount relates to the cost of insurance during the employee's retirement.)

Insurance asset - net	8,000	
Investment income		8,000

(To recognize the increase in the cash surrender value of the policy—this would continue until the earlier of the employee's death or surrendering of the policy.)

End of Year 10 – Full Eligibility and Employee Retirement

Total postretirement benefit obligation accrued during employee' service 60,000

End of first year after retirement

Insurance asset – interest credit	11,000	
Postretirement benefit obligation	3,000	
Insurance asset – cost of insurance		3,000
Investment income		11,000

(To record interest credit and cost of insurance; which is offset by the postretirement benefit obligation. This journal entry would continue annually until age 82. For simplicity, this example assumes that postretirement benefit obligation is offset against the cost of insurance in a ratable manner.)

Journal entries if employee died one day after retirement

Postretirement benefit obligation	60,000	
Income statement		60,000

(To record the settlement of the postretirement benefit obligation upon death of the employee.)

Cash	140,000	
Insurance asset		140,000

(To record the insurance proceeds received upon the employee's death.)

Journal entries if employee died five years after retirement

Postretirement benefit obligation	45,000	
Income statement		45,000

(To record the settlement of the postretirement benefit obligation upon death of the employee. The obligation had been reduced by $3,000 per year for each of the last five years.)

Cash	180,000	
Insurance asset		180,000

(To record the insurance proceeds received upon the employee's death.)

Journal entries if employee died at age 82—estimated mortality date

Cash	300,000	
Insurance asset		300,000

(To record the insurance proceeds received upon the employee's death. For simplicity, the example assumes that the cash surrender value equals the face amount of the policy at the estimated mortality date. In actuality, these amounts would likely not be equal as of this date.)

Illustration of CSV, Postretirement Benefit Obligation, and Net Insurance by Year

Face Amount of Policy $300,000

View A				View A'			
Age	Cash Surrender Value	Postretirement Benefit Obligation	Net Insurance	Age	Cash Surrender Value	Postretirement Benefit Obligation	Net Insurance
53	$68,000	$6,000	$232,000	53	$68,000	$6,000	$232,000
54	76,000	12,000	224,000	54	76,000	12,000	224,000
55	84,000	18,000	216,000	55	84,000	18,000	216,000
56	92,000	24,000	208,000	56	92,000	24,000	208,000
57	100,000	30,000	200,000	57	100,000	30,000	200,000
58	108,000	36,000	192,000	58	108,000	36,000	192,000
59	116,000	42,000	184,000	59	116,000	42,000	184,000
60	124,000	48,000	176,000	60	124,000	48,000	176,000
61	132,000	54,000	168,000	61	132,000	54,000	168,000
62	140,000	60,000	160,000	62	140,000	60,000	160,000
63	148,000	62,000	152,000	63	148,000	57,000	152,000
64	156,000	64,000	144,000	64	156,000	54,000	144,000
65	164,000	66,000	136,000	65	164,000	51,000	136,000
66	172,000	68,000	128,000	66	172,000	48,000	128,000
67	180,000	70,000	120,000	67	180,000	45,000	120,000
68	188,000	72,000	112,000	68	188,000	42,000	112,000
69	196,000	74,000	104,000	69	196,000	39,000	104,000
70	204,000	76,000	96,000	70	204,000	36,000	96,000
71	212,000	78,000	88,000	71	212,000	33,000	88,000
72	220,000	**80,000**	**80,000**	72	220,000	30,000	80,000
73	228,000	72,000	72,000	73	228,000	27,000	72,000
74	236,000	64,000	64,000	74	236,000	24,000	64,000
75	244,000	56,000	56,000	75	244,000	21,000	56,000
76	252,000	48,000	48,000	76	252,000	18,000	48,000
77	260,000	40,000	40,000	77	260,000	15,000	40,000
78	268,000	32,000	32,000	78	268,000	12,000	32,000
79	276,000	24,000	24,000	79	276,000	9,000	24,000
80	284,000	16,000	16,000	80	284,000	6,000	16,000
81	292,000	8,000	8,000	81	292,000	3,000	8,000
82	300,000	0	0 *	82	300,000	0	0 *

* For simplicity, the example assumes that the employee is not entitled to a death benefit if they die on the estimated mortality date. In actuality, a death benefit to the employee would likely extend beyond this date.

Exhibit 06-4C

EITF ABSTRACTS (DRAFT)

Issue No. 06-4

Title: Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements

Dates Discussed: March 16, 2006; June 15, 2006; [September 7, 2006]

References: FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*

FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*

FASB Statement No. 154, *Accounting Changes and Error Corrections*

FASB Concepts Statement No. 6, *Elements of Financial Statements*

FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*

APB Opinion No. 12, *Omnibus Opinion—1967*

International Accounting Standard 19, *Employee Benefits*

ISSUE

1. Companies purchase life insurance for various reasons that may include protecting against the loss of "key" employees, funding deferred compensation and postretirement benefit obligations, and providing an investment return. One form of this insurance is split-dollar life insurance. The structure of split-dollar life insurance arrangements can be complex and varied.

2. The two most common types of arrangements are endorsement split-dollar life insurance policies and collateral assignment split-dollar life insurance policies. Generally, the difference between these arrangements is the ownership and control of the life insurance policy. For an endorsement split-dollar life insurance ~~policy~~ arrangement, the company owns and controls the insurance policy, whereas in a collateral assignment split-dollar life insurance ~~policy~~ arrangement, the employee owns and controls the insurance policy. Diversity in practice exists primarily in accounting for the deferred compensation and postretirement aspects of typical endorsement split-dollar life insurance arrangements. A typical endorsement split-dollar life insurance ~~policy~~ arrangement may have the following terms:

> An employer purchases a life insurance policy to insure the life of an employee and pays a single premium at inception of the policy. Based on the insurance carrier's experience (for example, mortality) it can either charge or credit the policyholder for the negative or positive experience, respectively. The additional premium or credit is typically effectuated through an adjustment to the cash surrender value of the policy. The employer enters into a separate agreement that splits the policy benefits between the employer and the employee.

The employer owns the policy, controls all rights of ownership, and may terminate the insurance arrangement (and, in turn, the policy benefits promised to the employee). To effect the split-dollar arrangement, the employer endorses a portion of the death benefits to the employee (the employee designates a beneficiary for this portion of the death benefits). Upon the death of the employee, the employee's beneficiary typically receives the designated portion of the death benefits directly from the insurance company and the employer receives the remainder of the death benefits. ~~Depending on how the policy is structured, the beneficiary's proceeds are received directly either from the insurance company or from the employer (who remits the beneficiary's proportionate share once payment is received from the insurance company).~~

The employee's portion of the death benefits is commonly based on one of the following:

a. Amounts that exceed the gross premiums paid by the employer

b. Amounts that exceed the sum of the gross premiums paid by the employer and an additional fixed or variable investment return on those premiums

c. The net insurance at the date of death (that is, the face amount of the death benefit under the policy, less the cash surrender value)

d. Amounts equal to a multiple of the employee's base salary at retirement or death (for example, twice the employee's base salary).

3. The issue is whether the postretirement benefit associated with an endorsement split-dollar life insurance arrangement is effectively settled in accordance with either Statement 106 or Opinion 12 upon entering into such an arrangement.

Scope

4. The scope of this Issue is limited to the recognition of a liability and related compensation costs for endorsement split-dollar life insurance ~~policies~~ arrangements that provide a benefit to an employee that extends to postretirement periods. Therefore, this Issue would not apply to a split-dollar life insurance arrangement that provides a specified benefit to an employee that is limited to the employee's active service period with an employer.

EITF DISCUSSION

5. The Task Force reached a [consensus] that for a split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a liability for future benefits in accordance with Statement 106 or Opinion 12 (depending upon whether a substantive plan is deemed to exist) based on the substantive agreement with the employee. The Task Force believed that a liability for the benefit obligation under Statement 106 or Opinion 12 has not been settled through the purchase of an endorsement ~~type policy~~ split-dollar life insurance arrangement. The Task Force believed that the purchase of an endorsement type ~~policy~~ arrangement does not constitute a settlement since the insurance policy does not qualify as non-participating because the policyholders are subject to the favorable and unfavorable experience

of the insurance company. <u>Therefore, the employer has not purchased an insurance policy with a fixed consideration or premium as required by paragraph 67 of Statement 106.</u>

Transition

6. The Task Force reached a [consensus] that this Issue should be effective for fiscal years beginning after December 15, 2006. Entities should recognize the effects of applying the [consensus] in this Issue through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods.

7. If an entity chooses to apply the [consensus] reached in this Issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings, an entity should disclose the cumulative effect of the change on retained earnings or on other components of equity or net assets in the statement of financial position.

8. If an entity chooses to apply the [consensus] reached in this Issue as a change in accounting principle through retrospective application to all prior periods, an entity should include the recognition of:

a. The cumulative effect of the change to the new accounting principle on periods prior to those presented reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented

b. The cumulative effect of the change on retained earnings or on other components of equity or net assets in the statement of financial position

c. Adjustments to financial statements for each individual prior period presented to reflect the period-specific effects of applying the new accounting principle.

9. If an entity chooses to apply the [consensus] reached in this Issue as a change in accounting principle through retrospective application to all prior periods, the following should be disclosed:

a. A description of the prior-period information that has been retrospectively adjusted

b. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for any prior periods retrospectively adjusted

c. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

Board Ratification

10. At its [September 20, 2006] meeting, the Board ratified the [consensuses] reached by the Task Force in this Issue.

STATUS

11. No further EITF discussion is planned.