FASB STAFF POSITION

No. FTB 85-4-1

Title: Accounting for Life Settlement Contracts by Third-Party Investors

Date Posted: March 27, 2006

Introduction

1. This FASB Staff Position (FSP) provides initial and subsequent measurement guidance and financial statement presentation and disclosure guidance for investments by third-party investors in life settlement contracts. This FSP also amends certain provisions of FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance,* and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

Background and Scope

2. A life settlement contract for purposes of this FSP is a contract between the owner of a life insurance policy (the policy owner) and a third-party investor (investor) and has the following characteristics:

   a. The investor does not have an insurable interest (an interest in the survival of the insured, which is required to support the issuance of an insurance policy).
   b. The investor provides consideration to the policy owner of an amount in excess of the current cash surrender value of the life insurance policy.
   c. The contract pays the face value of the life insurance policy to an investor when the insured dies.

This FSP addresses both transactions in which a broker facilitates settlement transactions between the policy owner and the investor, and transactions that do not involve a broker.

3. Prior to the issuance of this FSP, an investor in a life settlement contract accounted for the investment in accordance with Technical Bulletin 85-4, which requires that the amount that could be realized under the insurance contract be reported as an asset. Application of Technical Bulletin 85-4 results in the investor expensing, on the date of purchase, the excess of the purchase price of the life settlement contract over the cash surrender value of the underlying insurance policy.

Issue

4. Questions have arisen as to the appropriateness of applying the guidance in Technical Bulletin 85-4 to life settlement contracts. An owner of a life insurance policy may enter into a life insurance contract for a variety of reasons including estate planning, compensation arrangements, and investing purposes. However, many constituents

believe that for life settlement contracts acquired for investing purposes, using the cash surrender value fails to reflect the economic substance of the investing activities.

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5. An investor may elect to account for its investments in life settlement contracts using either the investment method or the fair value method. The election shall be made on an instrument-by-instrument basis and is irrevocable. The election shall be supported by concurrent documentation or a preexisting documented policy for automatic election.

Investment Method

6. Under the investment method, an investor shall recognize the initial investment at the transaction price plus all initial direct external costs. Continuing costs (policy premiums and direct external costs, if any) to keep the policy in force shall be capitalized. The investor shall not recognize a gain until the insured dies, at which time the investor shall recognize in earnings (or other performance indicators for entities that do not report earnings) the difference between the carrying amount of a life settlement contract and the life insurance proceeds of the underlying life insurance policy.

7. An investor shall test an investment in a life settlement contract for impairment if the investor becomes aware of new or updated information that indicates that the expected proceeds from the insurance policy will not be sufficient to recover the carrying amount of the investment plus anticipated undiscounted future premiums and capitalizable direct external costs, if any, when the insured dies. Factors include, but are not limited to, a change in expected mortality and a change in the creditworthiness of the issuer of the underlying insurance policy. A change in interest rates would not of itself require an investment in a life settlement contract to be tested for impairment. An investor shall recognize an impairment loss if the expected undiscounted cash inflows (typically, the insurance proceeds) are less than the carrying amount of the investment plus anticipated undiscounted future premiums and capitalizable direct external costs, if any. If an impairment loss is recognized, the investment shall be written down to fair value. The fair value measurement shall consider current interest rates.

Fair Value Method

8. Under the fair value method, an investor shall recognize the initial investment at the transaction price. In subsequent periods, the investor shall remeasure the investment at fair value in its entirety at each reporting period and shall recognize changes in fair value in earnings (or other performance indicators for entities that do not report earnings) in the period in which the changes occur. The investor should account for premiums paid and life insurance proceeds received on the same financial reporting line as the changes in fair value are reported.

Financial Statement Presentation

Presentation on the Statement of Financial Position

9. An investor shall report its investments that are remeasured at fair value on the face of the statement of financial position separately from those accounted for under the investment method. To accomplish that separate reporting, an investor may either:

a. Display separate line items on the statement of financial position for the fair value method and investment method carrying amounts; or
b. Present the aggregate of those fair value method and investment method carrying amounts and parenthetically disclose the amount of those investments accounted for under the fair value method included in the aggregate amount.

Presentation in the Income Statement

10. An investor shall report the investment income from its investments in life settlement contracts that are remeasured at fair value on the face of the income statement separately from the investment income from those accounted for under the investment method. To accomplish that separate reporting, an investor may either:

a. Display separate line items on the income statement for the investment income from the investments in life settlement contracts that are accounted for under the fair value method and investment method; or
b. Present the aggregate of the investment income in life settlement contracts and parenthetically disclose the investment income from those investments accounted for under the fair value method that are included in the aggregate amount.

Presentation in the Statement of Cash Flows

11. An investor shall classify cash receipts and cash payments related to life settlement contracts pursuant to FASB Statement No. 95, *Statement of Cash Flows* (as amended), based on the nature and purpose for which the life settlements were acquired.

Disclosure Requirements

12. An investor shall disclose its accounting policy for life settlement contracts including the classification of cash receipts and cash disbursements in the statement of cash flows. The disclosure requirements in paragraphs 13–19 do not eliminate disclosure requirements included in other U.S. generally accepted accounting principles pronouncements, including other disclosure requirements on the use of fair value.

Investment Method

13. An investor shall disclose the following for life settlement contracts accounted for under the investment method based on the remaining life expectancy for each of the first five succeeding years from the date of the statement of financial position and thereafter, as well as in the aggregate:

a. The number of life settlement contracts
b. The carrying value of the life settlement contracts
c. The face value (death benefits) of the life insurance policies underlying the contracts.

14. An investor shall disclose the life insurance premiums anticipated to be paid for each of the five succeeding fiscal years to keep the life settlement contracts in force as of the date of the most recent statement of financial position presented.

15. If the investor becomes aware of new or updated information that causes it to change its expectations on the timing of the realization of proceeds from the investments in life settlement contracts, the investor shall disclose the nature of the information and the related effect on the timing of the realization of proceeds from the life settlement contracts. This includes disclosing significant changes to the amounts disclosed in accordance with paragraph 13 of this FSP. However, an investor shall not be required to actively seek out new or updated information to update the assumptions used in determining the remaining life expectancy of the life settlement contracts.

Fair Value Method

16. An investor shall disclose the method(s) and significant assumptions used to estimate the fair value of investments in life settlement contracts, including any mortality assumptions.

17. An investor shall disclose the following for life settlement contracts accounted for under the fair value method based on remaining life expectancy for each of the first five succeeding years from the date of the statement of financial position and thereafter, as well as in the aggregate:

a. The number of life settlement contracts
b. The carrying value of the life settlement contracts
c. The face value (death benefits) of the life insurance policies underlying the contracts.

18. The investor shall disclose the reasons for changes in its expectation of the timing of the realization of the investments in life settlement contracts. This includes disclosing significant changes to the amounts disclosed in accordance with paragraph 17 of this FSP.

19. An investor shall disclose the following for each reporting period presented in the income statement:

a. The gains or losses recognized during the period on investments sold during the period
b. The unrealized gains or losses recognized during the period on investments that are still held at the date of the statement of financial position.

Amendment to Technical Bulletin 85-4

20. Technical Bulletin 85-4 is amended as follows: [Added text is underlined.]

a. Footnote 1:

   The provisions of this Technical Bulletin apply to all entities that purchase life insurance in which the entity is either the owner or beneficiary of the contract, without regard to the funding objective of the purchase other than life settlement contracts referred to in the last sentence of this paragraph. Such purchases would typically include those intended to meet loan covenants or to fund deferred compensation agreements, buy-sell agreements, or postemployment death benefits. Purchases of life insurance by retirement plans that are subject to FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* are not addressed by this Technical Bulletin. A purchase of a life settlement contract that meets the scope requirement of FASB Staff Position FTB 85-4-1, "Accounting for Life Settlement Contracts by Third-Party Investors," should be accounted for under FSP FTB 85-4-1 and is not addressed by this Technical Bulletin.

Amendment to Statement 133

21. Statement 133 is amended as follows: [Added text is underlined and ~~deleted text is struck out.~~]

a. Paragraph 10(g), as amended:

   Investments in life insurance. A policyholder's investment in a life insurance contract that is accounted for under FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, or FASB Staff Position FTB 85-4-1, "Accounting for Life Settlement Contracts by Third-Party Investors," is not subject to this Statement. ~~The exception in this subparagraph affects only the accounting by the policyholder; it~~ This does not affect the accounting by the issuer of the life insurance contract.

Effective Date and Transition

22. The guidance in this FSP shall be applied to fiscal years beginning after June 15, 2006. Earlier application is permitted as of the beginning of an investor's fiscal year, provided that the investor has not yet issued its first quarter financial statements for that fiscal year. An investor shall apply the guidance prospectively for all new life settlement contracts. At the date of adoption, an investor shall make a one-time irrevocable election to account for its currently held life settlement contracts on an instrument-by-instrument basis using either the fair value method or the investment method and recognize a cumulative-effect adjustment to beginning retained earnings. The disclosure requirements of this FSP shall be applied as of the most recent statement of financial position or income statement presented.

23. An investor shall disclose the following in the fiscal period of adoption in which a change in accounting principle is made:

a. The nature of and reason for the change in accounting principle
b. The cumulative effect of the change on retained earnings in the statement of financial position as of the date of adoption.

24. Financial statements of subsequent periods from the date of adoption need not repeat the disclosures required by paragraph 23 of this FSP.