Tab B – Appendices

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Excerpt from SFFAS 5, *Accounting for Liabilities of the Federal Government*

Contingencies

35. A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm a gain (i.e., acquisition of an asset or reduction of a liability) or a loss (i.e., loss or impairment of an asset or the incurrence of a liability).[17]

36. This Statement does not deal with gain contingencies or measurement of contingencies that involve impairment of nonfinancial assets. When a loss contingency (i.e., contingent liability) exists, the likelihood that the future event or events will confirm the loss or the incurrence of a liability can range from probable to remote. The probability classifications are as follows:

- Probable: The future confirming event or events are more likely than not to occur, with the exception of pending or threatened litigation and unasserted claims. For pending or threatened litigation and unasserted claims, the future confirming event or events are likely to occur.
- Reasonably possible: The chance of the future confirming event or events occurring is more than remote but less than probable.
- Remote: The chance of the future event or events occurring is slight.

[17]Contingencies are different from "subsequent events." Subsequent events are events or transactions that affect the basic information or required supplementary information (RSI) and occur subsequent to the end of the reporting period but before the financial report is issued. Some of those transactions and events (referred to as recognized events) require adjustments to the basic information or RSI while others (referred to as nonrecognized events) may require disclosure in the basic information or RSI. A subsequent event may affect a contingency by providing information that resolves an uncertainty related to a contingent liability and confirm the impairment of an asset or incurrence of a liability as of the end of the reporting period.

Excerpt from SFFAS 5 (contd.)

37. The following are some examples of loss contingencies:

- collectability of receivables,
- pending or threatened litigation, and
- possible claims and assessments.

Criteria For Recognition Of A Contingent Liability

38. A contingent liability should be recognized when all of these three conditions are met:[18]

- A past event or exchange transaction has occurred (e.g., a federal entity has breached a contract with a nonfederal entity).[19]
- A future outflow or other sacrifice of resources is probable (e.g., the nonfederal entity has filed a legal claim against a federal entity for breach of contract and the federal entity's management believes the claim is likely to be settled in favor of the claimant).
- The future outflow or sacrifice of resources is measurable (e.g., the federal entity's management determines an estimated settlement amount). [See SFFAS 12.]

39. The estimated liability may be a specific amount or a range of amounts. If some amount within the range is a better estimate than any other amount within the range, that amount is recognized. If no amount within the range is a better estimate than any other amount, the minimum amount in the range is recognized and the range and a description of the nature of the contingency should be disclosed.

[18]The unit of analysis for estimating liabilities can vary according to the reporting entity and the nature of the transaction or event. The liability recognized may be the estimation of an individual transaction or event; or a group of transactions and events. For example, SFFAS Number 2, "applies to direct loans and loan guarantees on a group basis, such as a cohort or a risk category of loans and loan guarantees. Present value accounting does not apply to direct loans or loan guarantees on an individual basis, except for a direct loan or loan guarantee that constitutes a cohort or a risk category." Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees*. par. 21. See the standard on Insurance and Guarantees in this document for a description of incurred but not reported (IBNR) claims.

[19]In the case of government-acknowledged events giving rise to nonexchange or exchange transactions, there must be a formal acceptance of financial responsibility by the federal government, as when the Congress has appropriated or authorized (i.e., through authorization legislation) resources. Furthermore, exchange transactions that arise from government-acknowledged events would be recognized as a liability when goods or services are provided. For nonexchange transactions, a liability would then be recognized at the point the unpaid amount is due. Therefore, government-acknowledged events do not meet the criteria necessary to be recognized as a contingent liability.

Excerpt from SFFAS 5 (contd.)

Criteria For Disclosure Of A Contingent Liability	40. A contingent liability should be disclosed if any of the conditions for liability recognition are not met and there is at least a reasonable possibility that a loss or an additional loss may have been incurred. "Disclosure" in this context refers to reporting information in notes regarded as an integral part of the basic financial statements.
	41. Disclosure should include the nature of the contingency and an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made.
	42. In some cases, contingencies may be identified but the degree of uncertainty is so great that no reporting (i.e., recognition or disclosure) is necessary in the general purpose federal financial reports. Specifically, contingencies classified as remote need not be reported in general purpose federal financial reports, though law may require such disclosures in special purpose reports. If information about remote contingencies or related to remote contingencies is included in general purpose federal financial reports (e.g., the total face amount of insurance and guarantees in force), it should be labeled in such a way to avoid the misleading inference that there is more than a remote chance of a loss of that amount.
	See SFFAS 7, par. 36b, for guidance on losses on contracts for goods made to order or services produced to order

Excerpt from SFFAS 5, Basis for Conclusions (BfC)

Conclusion On Contingencies

144. In the Exposure Draft the Board asked the following question. "When an estimated [contingent] liability is a range of amounts and no amount within the range is a better estimate than any other amount, should either the midpoint or, alternatively, the 'expected value' (as the term is used in statistics) be recognized as a liability instead of the minimum amount?" The majority of respondents preferred the expected value and the second preference was the minimum amount.

145. The Board further considered all of the options. Based on the Board discussions it was noted that it would be difficult to use "expected value" to pinpoint an estimate within a range. The expected value method would assign a probability percentage to each of the numbers within the range, but these probabilities would usually be difficult to estimate.

146. After much discussion the majority of the Board preferred the minimum amount because of its established use in other accounting standards. The Board decided that liabilities arising from nonexchange transactions would be recognized for any unpaid amounts due as of the reporting date. This includes amounts payable from the federal entity to pay for benefits, goods, or services[58] provided under the terms of the program, as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity (for example, estimated Medicaid payments due to health providers that will be financed by the federal entity but have not yet been reported to the federal entity).

147. In the case of government-acknowledged events giving rise to nonexchange or exchange transactions, there must be a formal acceptance of financial responsibility by the federal government, as when the Congress has appropriated or authorized (i.e., through authorization legislation) resources. Furthermore, exchange transactions that arise from government-acknowledged events would be recognized as a liability when goods or services are provided. For nonexchange transactions a liability would then be recognized at the point the amount is due. Therefore, government-acknowledged events do not meet the recognition criteria necessary to be recognized as a contingent liability. The government is acting in its sovereign capacity when it assumes financial responsibility and makes income transfer payments or provides other nonexchange benefits. The Board does not believe that accounting recognition should anticipate sovereign actions in advance of occurrence.

Excerpt from SFFAS 5, *Accounting for Liabilities of the Federal Government*

Insurance And Guarantees

Nature Of Federal Insurance And Guarantee Programs[47]

97. Insurance and guarantee programs are federal programs that provide protection to individuals or entities against specified risks. Many of these programs were established to assume risks that private sector entities are unable or unwilling to assume [at least at prices that beneficiaries of the program can afford (in some cases) or want to pay (in other cases)] or to subsidize the provision of insurance to achieve social objectives. Program participants pay fees or premiums for specific services. These funds are commonly held in revolving funds within the federal government; losses sustained by participants are paid from these funds. Many of these programs receive appropriations to pay excess claims and/or have authority to borrow from the Treasury.

98. For accounting purposes, private sector insurance and guarantee contracts are customarily divided into two types. The first type provides insurance protection for a fixed period. The insurer may cancel the coverage or adjust the provisions of coverage at the end of any coverage period, for example, by adjusting the amount of premiums charged or changing the conditions under which coverage is provided. Most property insurance and health insurance offered by private insurers is of this type.

99. The second type of insurance or guarantee contract is one in which the insurer cannot cancel the insurance or the insured is guaranteed the ability to renew it. The insurer must provide coverage for an extended period until the insured event occurs or can no longer occur, or when the insured party allows the policy to lapse. Examples of this type of insurance offered by private insurers include whole and guaranteed renewable term life insurance, annuities, and title insurance.

100. Federal programs provide protection against many types of risk for individuals and entities. These include life insurance; medical insurance; and insurance against damage to property (homes, crops, and airplanes) or other assets (deposits and pension benefits) caused by perils such as flooding and other natural disasters, war-risk, and insolvency.

[47] In the federal government, the aspects of insurance and guarantees are frequently commingled within the same program. Therefore, this Statement treats the terms as a single type of activity.

Excerpt from SFFAS 5 (contd.)

101. For federal insurance and guarantee programs, there often is no explicit contract. For example, the federal government, acting through the Pension Benefit Guaranty Corporation (PBGC), functions as an insurer of pension benefits, but the "contract" with employers and pension plans is implicit in federal law, not explicit in contracts between PBGC and employers. Moreover, the PBGC itself has no power to set premiums or to change the terms of coverage, though it may recommend changes to the Congress. The Congress has occasionally raised premiums and changed other factors, such as pension plan funding requirements, in an effort to achieve the statutory intent that the program be self-financing without appropriations from general revenue.[48] Companies with defined benefit pension plans must participate, but may (and sometimes do) elect to terminate their defined benefit pension plans.

102. Federal insurance programs also differ from private insurance in that they are not subject to the same market forces (e.g., competition for business and for capital) and regulatory requirements (e.g., for capitalization) that apply to privately owned insurers. In particular, federal insurance, unlike private insurance, is not extended with the intent of earning a profit. Some programs operate deliberately at a loss, as when disabled veterans are offered life insurance at premiums set for healthy participants. Other programs offer insurance covering catastrophic or systemic risks, where large losses can occur all at once, as in war-risk or deposit insurance. At most, federal insurance programs are expected just to meet anticipated costs, leaving them vulnerable to unfavorable surprises.

103. For this reason, the issue in accounting for federal insurance and guarantee programs is when to recognize net expected losses. In this respect, federal insurance programs are similar to federal credit programs. The federal government extends credit on terms and conditions designed to subsidize particular borrowers or encourage particular activities for social policy reasons. As soon as a federal direct loan or loan guarantee is obligated, the federal government is committed to bear whatever loss, through defaults or interest subsidies, is inherent in the terms and the conditions under which the credit is extended. The government is likewise committed when

[48] Further details on PBGC may be found in Controlling Losses of the Pension Benefit Guaranty Corporation, Congressional Budget Office, January 1993.

Excerpt from SFFAS 5 (contd.)

federal insurance is extended to additional policyholders, either for an additional fixed period, or to cover additional amounts of assets.

Accounting For Liabilities Of Federal Insurance And Guarantee Programs

104. All federal insurance and guarantee programs (except social insurance and loan guarantee programs[49]) should recognize a liability for unpaid claims incurred, resulting from insured events that have occurred as of the reporting date. The standard requires recognition of the liability that is known with certainty plus an accrual for a contingent liability recognized when an existing condition, situation, or set of circumstances involving uncertainty as to possible loss exists and the uncertainty will ultimately be resolved when one or more probable future events occur or fail to occur; a future outflow or other sacrifice of resources is probable; and the future outflow or sacrifice of resources is measurable. Insurance and guarantee programs should recognize as an expense all claims incurred during the period, including, when appropriate, those not yet reported and contingencies that meet the criteria for recognition. Life insurance programs should recognize a liability for future policy benefits (a liability to current policyholders that relates to insured events, such as death or disability) in addition to the liability for unpaid claims incurred. (See Contingencies section for the criteria for disclosure of a contingent liability.)

105. Risk assumed information is important for all federal insurance and guarantee programs (except social insurance, life insurance and loan guarantee programs) and will be considered in the context of the Stewardship reporting. Risk assumed is generally measured by the present value of unpaid expected losses net of associated premiums, based on the risk inherent in the insurance or guarantee coverage in force. [See SFFAS 25, par. 4.]

Additional Disclosures For Insurance And Guarantee Programs Administered By Government Corporations

106. When financial information pursuant to FASB's standards on federal insurance and guarantee programs conducted by government corporations is incorporated in general purpose financial reports of a larger federal reporting entity, the entity should report as RSI what

[49]Social insurance is considered to be a different type of program not included within insurance and guarantee programs. See social insurance discussion in the FASAB ED, *Supplementary Stewardship Reporting*. Accounting for all federal loan guarantee programs should follow the Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees* (August 23, 1993).

Excerpt from SFFAS 5 (contd.)

amounts and periodic change in those amounts would be reported under the "risk assumed" approach referred to in this section (see par. 105). In other words, in addition to the liability for unpaid claims from insured events that have already occurred (including any contingent liability that meets criteria for recognition), such reporting entities should also report as RSI risk assumed information.

Illustrations Of The Application Of The Standard

107. Table 9 illustrates the application of the liability recognition, disclosure, and supplementary reporting standards for six federal insurance and guarantee programs. Two of these, flood and crop insurance, offer fixed period annual insurance. A third, deposit insurance, also can be said to offer fixed period annual insurance, though in practice it is continually renewed at the option of the insurer.[50] A fourth program listed, overseas private investment insurance, offers a fixed period multi-year written contract. The fifth program, life insurance, offers coverage that in practice is noncancelable by the insurer and guaranteed renewable by the insured, continuing until the insured event has occurred or the policy is cancelled by the insured. Finally, the pension benefit guarantee program is included as an example of noncancelable insurance. Pension insurance is characterized here as noncancelable with respect to vested guaranteed benefits earned by covered employees to date, on the assumption that this coverage would remain in effect even if the Congress ended the program.

108. The column numbered (3) in the table shows the point at which the standard requires a liability to be recognized for insurance and guarantee programs except life insurance. Column (3) recognizes all unpaid claims and expected claims resulting from insured events that have already occurred, whether floods, crop damage, overseas investment losses, bank closures and insolvencies, deaths, or pension plan terminations. The liability for unpaid claims is the estimated amount needed to settle claims relating to insured events that have occurred on or before the reporting date. This liability includes a contingent liability recognized when an existing condition, situation, or set of circumstances involving uncertainty as to possible loss exists and the uncertainty will ultimately be resolved when one or more probable future events occur or fail to occur; a future outflow or other

[50] In effect, FDIC's options are to renew the insurance coverage or to assume losses of the institution; only Congress can reduce or eliminate the deposit insurance program.

Excerpt from SFFAS 5 (contd.)

sacrifice of resources is probable; and the future outflow or sacrifice of resources is measurable.

109. The liability at the end of any period should be the expected unpaid net loss inherent in insured events that have occurred, including any claims –both claims reported and when appropriate, claims incurred but not reported (IBNR)– and any contingent liabilities that meet the criteria for recognition. When payments and losses extend beyond the current year, net losses should be calculated on a present value basis to reflect the time value of money. The expense for claims incurred in the reporting period should be recognized in that period. Changes in estimates of claim cost resulting from the present value calculations, the continuous review process, and differences between estimates and actual payments for claims should be recognized as charges against operations of the period in which the estimates are changed or payments are made.

110. Liability recognition for life insurance programs spans over columns (3) and (4). The column numbered (4) in the table shows the point at which the standard requires liability recognition for life insurance and supplementary reporting for other insurance and guarantee programs. The supplementary reported amounts represent the present value of unpaid expected losses based on the risk assumed as a result of insurance coverage net of associated premiums.

Excerpt from SFFAS 5 (contd.)

Table 9 [Note: The below underlined items are recognized liabilities.]

Liability Recognition, Supplementary Information And Disclosure			
(1) Type of insurance	**(2) Example of program**	**(3) Insured event has occurred**	**(4) Risk assumed**
Fixed period, annual	National Flood Insurance	CLAIMS + IBNR FOR FLOODS TO END OF PERIOD	The present value of unpaid expected losses net of associated premiums, based on the risk assumed as a result of insurance or guarantee coverage.
Fixed period, annual	Federal Crop Insurance	CLAIMS + IBNR FOR DAMAGE TO END OF PERIOD	The present value of unpaid expected losses net of associated premiums, based on the risk assumed as a result of insurance or guarantee coverage.
Fixed period, annual	Federal Deposit Insurance	CLAIMS + PV OF COST FOR DEPOSITORIES IN PROCESS OF CLOSURE BY THE END OF THE REPORTING PERIOD; AND THE ESTIMATED LOSS FOR THE PROBABLE COST FOR INSTITUTIONS THAT HAVE NOT YET FAILED BUT THE REGULATORY PROCESS HAS IDENTIFIED AS EITHER EQUITY INSOLVENT OR IN-SUBSTANCE EQUITY INSOLVENT OR LIKELY TO BECOME IN-SUBSTANCE EQUITY INSOLVENT WITHIN THE FORESEEABLE FUTURE.	The present value of unpaid expected losses net of associated premiums, based on the risk assumed as a result of insurance or guarantee coverage.
Fixed period, Multi-year	Overseas Investment Insurance	CLAIMS + IBNR FOR LOSSES TO END OF PERIOD	The present value of unpaid expected losses net of associated premiums, based on the risk assumed as a result of insurance or guarantee coverage.
Noncancelable or renewable	Pension Benefit Guarantee	CLAIMS + IBNR; PV OF UNFUNDED GUARANTEED BENEFITS FOR PLANS TERMINATED OR MORE LIKELY THAN NOT TO BE TERMINATED	The present value of unpaid expected losses net of associated premiums, based on the risk assumed as a result of insurance or guarantee coverage.
Noncancelable or renewable	VA Life Insurance	CLAIMS + IBNR (PLUS RESERVE FOR CURRENT CASH VALUE, IF NECESSARY)	*LIABILITY FOR FUTURE POLICY BENEFITS (NET APV OF POLICIES IN FORCE).* All components of the liability for future policy benefits should be separately disclosed in a footnote with a description of each amount and an explanation of its projected use and any other potential uses (e.g., reducing premiums, determining and declaring dividends available, and/or to reducing federal support in the form of appropriations related to administrative cost or subsidies).

Present Value (PV)

Actuarial Present Value (APV)

Note: Liability recognition includes any contingent liability that meets the criteria for recognition.

This example is intended to illustrate examples of various programs and how the various liabilities would be determined. This table is not to be considered authoritative.

Excerpt from SFFAS 5 (contd.)

111. Insurance programs are on-going and may be viewed as having long term characteristics. Thus, from a broader, longer term perspective, the liability to be recognized (column 3), and the amount to be reported as supplementary information (column 4) may be conceptually different and materially different from each other. From the broader perspective column (4) could be a longer term measure and a probabilistic estimate of future costs of these programs.

112. For noncancelable or guaranteed renewable insurance also, a difference arises between columns (3) and (4). Thus, for pension guarantees, column (3) shows the net present value of losses arising from plans that have already been terminated or that are more likely than not to be terminated. This is the amount to be recognized as a liability. Column (4) shows the net present value of the expected loss inherent in the risk assumed as a result of coverage on the guaranteed and vested benefit amounts. This number should be reported as supplementary information. It will generally be larger than the liability because it includes a provision for the additional losses that are expected to arise because some plan sponsors currently in good financial condition will in the future face bankruptcy with pension assets too small to cover the vested benefits that were guaranteed.

113. The liability for life insurance includes both the liability for unpaid claims, including IBNR (i.e., column 3), and a liability for net future policy benefit outflows (i.e., column 4). The liability for future policy benefits represents the expected present value of future outflows to be paid to, or on behalf of, existing policyholders, less the expected present value of future net premiums to be collected from those policyholders. The liability is estimated using appropriate financial or actuarial methods that include assumptions, such as estimates of expected investment yield, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made and in accordance with existing law and related policy (see specific whole life insurance standard below). Changes in the liability for future net policy benefit outflows that result from periodic re-estimations would be recognized as expense in the period in which the changes occur. The effects of changes in relevant law or policy would be recognized when those changes occur.

Excerpt from SFFAS 5 (contd.)

114. The assessments of losses expected based on the risk assumed may be made by appropriate actuarial or financial methods that include information and assumptions applicable to the economic, legal, and policy environment in force at the time the assessments are made. Since all future events are uncertain, indicators of the range of uncertainty around expected estimates, including indicators of the sensitivity of the estimates to changes in major assumptions, should also be reported.

Whole Life Policies

115. Some VA life insurance programs are whole life policies.[51] These programs operate in a manner similar to private sector mutual life insurance enterprises,[52] except that the regulations and market forces that control the private sector are different for these federal programs. VA life insurance policyholders are issued participating policies, and a portion of the earnings from those policies is returned to policyholders in the form of dividends. The following paragraphs specifically address the accounting required for federal whole life insurance programs.

116. The premiums collected by the insurer are used to pay benefits and other cost, and the balance is usually invested to yield additional income. These assets would be fund balances with Treasury or investments. Encompassed in the liability (also referred to as policy reserves) is cash surrender value and the liability for future policy benefits. The cash surrender value is the portion of premiums paid or other amount recoverable on an insurance policy if immediately canceled. The liability for future policy benefits is the present value of future outflows to be paid to (or in behalf of) policyholders, less the present value of future related premiums. In general, for whole life policies, the liability for future policy benefits should be no less than the cash surrender value that accrues to the benefit of policyholders.

[51] Whole life policies provide insurance over the insured's entire life and the proceeds (face amount) are paid only upon death of the insured. A level premium is usually paid for policies of this type. The premium may be paid annually or more frequently.

[52] A mutual company is an incorporated entity without private ownership interests which operates for the benefit of its policyholders and their beneficiaries. With limited exceptions, mutual companies issue only participating policies. In a mutual company, participating policyholders have the right to vote for members of the company's board of directors or trustees. In some states, the insurance laws provide that upon liquidation of a mutual insurance company, the net assets are distributed among the existing policyholders of the company, and the prior policyholders have no claim against such assets.

Excerpt from SFFAS 5 (contd.)

Accounting for Liabilities of Federal Whole Life Insurance Programs

117. All federal reporting entities with whole life insurance programs should follow the standards as prescribed in the private sector standards (and as these private sector standards are amended) when reporting the liability for future policy benefits, in addition to the required disclosures described below.[53] The U.S. government-wide financial statements need not follow the required disclosures described below.

118. A liability for future policy benefits relating to participating life insurance contracts should be equal to the sum of:

    a. the net level premium reserve for death and endowment policy benefits,

    b. the liability for terminal dividends, and

[53]The applicable private sector standards are as follows, FASB SFAS 60 *Accounting and Reporting by Insurance Enterprises*, FASB SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and FASB SFAS 120 *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts* and AICPA Statement of Position (SOP) 95-1 *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*.

For those federal entities with "mutual enterprise-type" whole life insurance programs, FASB SFAS 120 should be followed. SFAS 120 states that mutual life insurance enterprises shall apply SFAS 60 or 97, as appropriate, to participating life insurance contracts unless those contracts meet both of the following conditions:

- The contracts are long-duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurer.

- Annual policyholder dividends are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the contribution principle).

If the participating life insurance contracts meet the above conditions SOP 95-1 should be followed.

Excerpt from SFFAS 5 (contd.)

c. any premium deficiency.[54]

119. An assessment should be made to compare the liability for future policy benefits using actuarial assumptions applicable at the time the contract is made (contract assumptions) with the liability for future policy benefits using assumptions that consider current economic conditions and experience (current conditions). Actual mortality, morbidity, and termination rates should be used when determining experience. For economic conditions, the nature and the mix of current and expected investments should be considered with expected long-term yields.

120. A premium deficiency occurs if the liability for future policy benefits using current conditions exceeds the liability for future policy benefits using contract conditions; the difference should be recognized as a charge to operations in the current period.

Additional Whole Life Insurance Disclosure

121. All components of the liability for future policy benefits (i.e., the net level premium reserve for death and endowment policy and the liability for terminal dividends) should be separately disclosed in a footnote with a description of each amount and an explanation of its projected use and any other potential uses (e.g., reducing premiums, determining and declaring dividends available, and/or reducing federal support in the form of appropriations related to administrative cost or subsidies). The U.S. government-wide financial statements need not separately report or disclose all components of the liability for future policy benefits with a description of each amount and an explanation of its projected use and any other potential uses.

[54]The liability for future policy benefits is consistent with the liability required by SOP 95-1. Net level premium reserve is the excess, if any, of the present value of future guaranteed death endowment benefits over the present value of future net premiums. The net level premium reserve should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contracts. The dividend fund interest rate is the interest rate determined at policy issuance used to determine the amount of the dividend fund. It is the rate used to credit interest to the dividend fund, and against which experience is measured to determine the amount of the interest portion of dividends paid to individual policyholders. Terminal dividends are dividends to policyholders calculated and paid upon termination of a contract, such as on death, surrender, or maturity. If the payment of terminal dividends is probable and the amount can be reasonably estimated, the liability should be recognized. [AICPA SOP 95-1, Glossary, p. 33]

Excerpt from SFFAS 5, Basis for Conclusions (BfC)

Conclusion On Insurance And Guarantees

185. The Board considered two possible bases for recognizing the liability of federal insurance programs. One would recognize as a liability the unpaid expected present value (PV) cost of insured events that had occurred. The second would recognize as a liability the unpaid expected PV cost of risks that had been assumed (i.e., the unpaid expected PV cost inherent in insurance extended or in force). This second approach would be similar to that taken by the Congress in budgeting for direct loans and loan guarantees and by FASAB in accounting for these transactions. (See Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees*).

186. Several Board members believe that this second approach has merit from a conceptual standpoint. However, the Board has concerns about the measurability of the risk assumed, particularly in the context of pension guarantees. There may also be some question as to the exact nature or categorization of some assumed risks in the absence of written contracts. The Board concluded that it would continue the traditional practice of recognizing the effect of events that had occurred on the face of the financial statements. However, it also decided to require reporting as RSSI the estimated PV cost of the risk assumed for all programs, except social insurance, life insurance, and loan guarantee programs.

187. Accrual accounting for insurance programs attempts to report the expenses of operations for each period and the unpaid liability at the end of the period. Projections of future claims, including renewed, expanded, and new business, also provide important information for policy decisions about what rates should be charged to cover all expected future losses, what additional insurance should be extended, and similar decisions. Management of reporting entities may wish to include such projections in financial reports as other accompanying information, and may do so on a voluntary basis, but the Board is not presently making any specific recommendations about this, beyond those required by this Statement and those to be further considered in *Supplementary Stewardship Reporting*.

188. During the Exposure Draft stage of the Liability Standard, the Board asked respondents whether the Standard provided sufficient guidance on how the risk assumed amount should be measured. Two of the fifty five respondents asked for additional guidance but did not mention measurement possibilities.

Excerpt from SFFAS 5, BfC (contd.)

189. At the discussion stages of the final Statement the Board contemplated two possible measurement perspectives for reporting the risk assumed. The Statement requires that all federal insurance programs (except social insurance, life insurance, and loan guarantee programs) report the risk assumed amount as supplementary information. The risk assumed calculation as presented in the Exposure Draft measured the cost of the coverage outstanding during the reporting year. For annual term insurance programs, under this approach the risk assumed amount might not be significantly different from the sum of recognized liabilities and contingent liabilities reported on the Balance Sheet. However, the Board believes that requiring disclosure or supplementary reporting of a risk assumed number that is similar in concept and amount to the liability recognized could be confusing and would not add informational value.

190. In the second perspective, the risk assumed amount would be a broader and longer term measure of the government's potential cost for on-going insurance programs. Under some measures, this second approach to risk assumed could be regarded as an indicator of the "fair" or "full cost" premium that should be charged if taxpayers are not to subsidize the program. This measure would be a probabilistic estimate of the expected cost under certain assumed economic factors. The Board found merits in this calculation, and believes it can provide important additional information beyond that contained in the accrual. Although they believe the measure to be important, proponents of this approach acknowledge that the measure may be difficult to measure precisely. Accordingly, they would treat it as RSSI. The Board currently has a project at the Exposure Draft stage, *Supplementary Stewardship Reporting*, that will provide further details on the measurement and reporting of "risk assumed" in its final statement.

191. The Board also considered the liability recognition of whole life insurance programs. The federal government has a small number of whole life insurance programs that are administered by federal entities. The most significant programs (mutual enterprise-type whole life insurance) are through the Department of Veteran Affairs (VA).

192. At the time the exposure draft on liabilities was issued, there were no established accounting standards for mutual enterprise-type whole life insurance within the federal government, state and local government, or the private sector. Therefore VA followed the statutory requirements for accounting purposes as well as statutory insurance reporting.

Excerpt from SFFAS 5, BfC (contd.)

193. In January 1995, the FASB and AICPA issued a standard and a statement of position, respectively, that specified accounting for mutual whole life insurance enterprises. Due to the similarities between the federal programs and the insurance enterprises covered in the FASB and AICPA documents, the Board decided that the private sector standards would be appropriate for the applicable federal programs. Therefore the Board concluded that federal entities with whole life insurance programs would follow the standards as prescribed in the private sector standards (and as these private sector standards are amended) when reporting the liability for future policy benefits, along with the additional disclosures prescribed by this Statement. The Board further concluded that disclosure of the components of the liability was necessary to adequately inform the financial statement users of the projected use and any other potential uses of the liability components and associated assets.

Excerpt from SFFAS 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*, BfC

Conclusions Regarding Each Type of Stewardship Responsibility Information

19. Figure 2 on page 20 presents a list of general factors that one or more Board members considered relevant for the classification choices. Specific decisions on each of the three types of stewardship responsibility information are discussed in the remainder of this Appendix.

Risk Assumed

20. The Board agreed that information about Risk Assumed should be RSI rather than an integral part of the basic financial statements, because the amounts are not sufficiently reliable and measurement methods are still experimental. This information is potentially valuable, but it is not yet a suitable basis for recognition or disclosure.[5] The Office of Management and Budget (OMB), the Government Accountability Office (GAO), and the Congressional Budget Office (CBO) have considered the use of Risk Assumed information as a basis for budgeting for insurance programs. These agencies have concluded that more experience is needed before the measurements can be regarded as sufficiently reliable for budgeting. Similar considerations lead the FASAB to conclude that information about Risk Assumed should be included in financial reports as RSI, at least until agencies and auditors have more experience with this information.

21. The Board believes that analogies with insurance offered by private insurers, (where, for example, an expected premium deficiency on long-duration contracts such as life insurance is recognized), may be misleading due to differences in the length of the policy coverage, nature of insured risk, or other relevant variables. The Board believes that additional guidance from FASAB on definition and measurement of "Risk Assumed" would be necessary before it would be feasible to require recognition or disclosure of this information as an integral part of the basic financial statements. Developing and promulgating such guidance would require a separate project. Before the Board undertakes such a project, it is desirable to encourage continued improvement in agencies' data systems and modeling capabilities to support reporting Risk Assumed. The RSI requirement has the effect of providing this encouragement in an appropriate, cost-beneficial manner. The Board notes that the "state of the art" for such projections is constantly evolving. Should the Board in the future decide that it would be desirable to develop more specific criteria for reporting Risk Assumed, the Board will be able to learn from this ongoing experience.

[5] FASAB uses the term "disclosure" to refer to information that is not recognized on the face of the basic financial statements but is regarded as an integral part of the basic financial statements, essential for fair presentation in conformity with generally accepted accounting principles (GAAP). Normally such disclosures are presented in footnotes, but federal accounting standards published by FASAB do not currently prescribe the format for presentation of such disclosures. GAAP does not prohibit formatting or combining pieces of information in appropriate ways to direct the reader's attention, provided that the results are not misleading.

Excerpt from SFFAS 25 BfC (contd.)

Figure 2

-Low (implies RSI) < < < < < < < < < < < < < < < > > > > > > > > > > > > > > > > **+High (implies basic**)

<Relevance to fair presentation>

< Connection with elements of financial reporting >

< Use of historical financial data or financial transaction data >

<Preparers' discretion in preparing and presenting the information>

< Strength of signal Board wishes to be sent in the financial report >

< Significance, relevance or importance of the item in light of *Objectives* >

< Strength of the signal the Board wishes to be sent in the auditor's report >

< Relevance to measuring financial position or changes in financial position >

<Extent to which the information interests a wide audience (rather than specialists)>

<Extent to which there are not alternative sources of reliable information>

< Agreement on criteria that permit comparable and consistent reporting >

< Experience among users, preparers, and auditors with the information >

<Extent to which the information is aggregated (lacking in detail)>

< Benefit/cost ratio of using resources to ensure accuracy >

< Connection with basic financial statements >

< Reliability and/or precision possible >

< Reliability and/or precision needed >

-Low (implies RSI) < < < < < < < < < < < < < < > > > > > > > > > > > > > > > > **+High (implies basic**)