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Nonqualified Plans and Executive Compensation

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Disclosure Relief for Separate Account COLI Reported at Fair Value

Effect of Accounting Standards Update (ASU) No. 2015-07, *Disclosures for Investments in Certain Entities That Calculate Net Asset Value Per Share (or Its Equivalent)*, on Corporate Owned Life Insurance (COLI)

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COLI AND FAIR VALUE DISCLOSURE RELIEF

Corporate Owned Life Insurance (COLI) is cash value life insurance designed to avoid income tax on investment income. Well-managed COLI programs usually emphasize cash value growth over death benefits, but the tax-free nature of COLI depends on the receipt of death proceeds. Most COLI is reported at cash surrender value,[1] but certain COLI policies are reported at fair value.[2] Policies reported at fair value are the focus of this article. Although the surrender value and the fair value of COLI are usually the same amount, the concepts and disclosure requirements are different. Whereas fair value represents a hypothetical transaction between a willing buyer and willing seller, surrender value is a contractual value that the insurance company is obligated to pay upon the policyholder's request. More important in the context of this article, fair value reporting increases the disclosure requirements in the notes to the financial statements. When COLI policies are separate account (also referred to as variable) policies, Accounting Standards Update

(ASU) No. 2015-07, *Disclosures for Investments in Certain Entities That Calculate Net Asset Value Per Share (or Its Equivalent)*, provides some disclosure relief by allowing companies to exclude the amounts from their fair value hierarchy disclosures.

GENERAL ACCOUNT VS SEPARATE ACCOUNT LIFE INSURANCE

Cash value is generally divided into two categories: general account and separate account. General account life insurance allows the insurance company to use its discretion in declaring a dividend scale or interest crediting rate. Policy holders of general account policies compete with other creditors in the event of the insurance company's insolvency. Separate account life insurance allows the policy owner to allocate cash value among various separate accounts, each with a different investment objective. Separate account values are dedicated to separate account policy holders and not available to general creditors of the insurance company. This article focuses on how separate account COLI meets the criteria for limited relief from the fair value disclosures discussed later in this article. General account COLI is not eligible for this relief.

WHEN IS COLI REPORTED AT FAIR VALUE?

COLI reported at fair value is the exception to general rule of reporting COLI at surrender value and usually falls into one of three categories. The first category is cash value as a plan asset under Topic 715. This cash value formally funds postretirement benefits and is not subject to the claims of general creditors. Topic 715 requires plan assets to be reported at fair value.[3] Voluntary Employee Benefit Association Trust[4] Owned Life Insurance (VEBA TOLI) is an example of life insurance reported at fair value. The second category is cash value reported under International Financial Reporting Standard 9.[5] The third category is COLI initially reported at fair value under the fair value option, which is generally an irrevocable election.[6] We assume that an election to record COLI at fair value when the COLI is neither a plan asset under Topic 715 nor subject to IFRS 9 is unintentional, because there is no obvious advantage to the fair value disclosure requirements when fair value equals the cash surrender value.

An exception to the general rule regards life settlement companies.[7] These companies intentionally elect the fair value option so that they can record an asset in excess of the cash surrender values. Life settlement policies are not considered COLI in the traditional sense of the term[8] and therefore are outside the scope of this discussion.

Valuation of COLI at Fair Value

Although Subtopic 820-10 includes a variety of approaches and techniques to measuring fair value in general, the fair value of COLI is usually the cash surrender value. There is no secondary market for COLI because insured employees and retirees are generally reluctant to authorize the release of medical information without a financial incentive. Also, companies are reluctant to create the potential for an economic windfall for unrelated investors when employees and retirees die. Surrender value usually forms the minimum fair value because the insurance carrier is contractually obligated to pay it. Surrender value is often also the maximum fair value because potential investors usually have no access to medical records that would support a sooner-than-expected date of death.

Net Asset Value as a Practical Expedient

Topic 820 permits separate account COLI to use net asset value (NAV) to estimate fair value as a practical expedient,[9] because separate account COLI meets both required criteria. The first criterion is that it does not have a readily determinable fair value, because the NAVs are not publicly reported.[10] Instead, only policy owners and authorized insurance agents have access to the NAVs. The second criterion is that separate account COLI is an investment in an investment company. Variable life insurance contracts are subject to the Investment Company Act of 1940,[11] which makes variable COLI an investment in an investment company within the scope of Topic 946 *Financial Services–Investment Companies*.[12]

Fair Value Disclosure Requirements

Until ASU 2015-07, fair value disclosures required the categorization of all fair values within a three-tier hierarchy of input levels. Level 1 inputs are quoted prices in active markets for identical assets. COLI does not qualify for Level 1 because each insured life is unique. Level 2 inputs are observable inputs that do not meet the criteria for Level 1. Variable life insurance has been generally categorized at Level 2, because the reporting entity has the ability to redeem the COLI for its NAV in the near term.[13] Level 3 inputs are unobservable inputs, and Level 3 values require even more extensive disclosures. General account life insurance has been often categorized as Level 3 because of the lack of any observable input. In addition to the categorization, fair value disclosures also require the explanation of transfers between levels, the valuation approaches, and the valuation techniques.[14] ASU 2015-07 now exempts investments measured at NAV as a practical expedient from this three-tier hierarchy and additional disclosures.

Accounting Standards Update 2015-07

ASU 2015-07 allows investments using NAV as a practical expedient to be excluded from the fair value hierarchy but still requires a reconciliation of the fair value hierarchy to the total assets and liabilities reported at fair value.[15] ASU 2015-07 also specifies separate disclosure requirements for such investments.[16] Under these rules, the reporting entity must describe significant investment strategies of the separate accounts and terms and conditions for redemption. For example, life insurance policies that allow the carrier to delay payment of surrender values would need to disclose this even if the carrier generally pays surrender values within two to three weeks of a surrender request. The reporting entity must also report other restrictions on otherwise redeemable investments, such as restrictions imposed by any rehabilitation or liquidation proceedings in the case of impairment of surplus or insolvency of the insurer. Finally, the reporting entity must disclose other more permanent restrictions on its ability to sell investments, for example, in a situation where the reporting entity's Human Resource department disapproves of the sale of COLI policies to unrelated investors without the consent of the insureds. When that consent is unlikely (usually the case) and payment of surrender proceeds by the carrier is the only practical way to redeem asset values before the deaths of the insureds, this would need to be disclosed because a sale to a third party may never be an option.

Effective Date

ASU 2015-07 required public companies to apply the guidance for fiscal years (including interim periods) beginning after December 15, 2015. Other companies are required to apply the guidance for fiscal years (including interim periods) beginning after December 15, 2016. Earlier application is permitted. The guidance is retrospective, meaning that all investments measured at NAV as a practical expedient should be excluded from the fair value hierarchy.

SUMMARY

Separate account COLI reported at fair value is now excluded from the three-tier disclosure hierarchy, but reporting entities still need to disclose restrictions on the availability of the cash value and restrictions on sale. ASU 2015-07 amends Topic 715 to reflect this guidance in the context of plan assets for postretirement benefits.[17] General account COLI reported at fair value continues to be subject to the more extensive disclosure requirements for investments at fair value with Level 3 inputs.

NOTES

1. ASC 325-30-35.
2. ASC 820-10-20 (glossary).
3. ASC 715-60-35-107.
4. IRC § 501(c)(9).
5. The relief provided by ASU 2015-07 does not apply to COLI reported under IFRS 9 because IFRS 9 does not provide a practical expedient to measuring fair value.
6. ASC 825-10-25-2.
7. Life settlement companies are companies that buy policies from their original owners as investments. The insured individuals are usually in poor health, and the price paid (in excess of the cash surrender value) reflects this.
8. Traditional COLI policies are institutionally priced cash value life insurance policies purchased by an employer on consenting executives, with minimized death benefits after the seventh year.
9. ASC 820-10-35-59.
10. ASC 820-10-15-5.
11. *See* Sections 26(f)(2) and 27(i)(2) of the Investment Company Act of 1940.
12. ASC 946-10-15-4.
13. Superseded ASC 820-10-35-54B(c).
14. ASC 820-10-50-2.
15. ASC 820-10-35-54B.
16. ASC 820-10-50-6A.
17. ASC 715-20-50-1(d) and 50-5(c).

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