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Split-Dollar Accounting: Agreements to Maintain a Policy

Part 4 of a 4-Part Series

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Split-dollar is a compensation arrangement involving a cash value life insurance policy. The employer and an executive agree to share the policy's death proceeds and sometimes the premiums, cash value, or both. While split-dollar was a very popular form of benefit at one

time, legislative,¹ tax,² and accounting changes³ have made it much less popular. New plans are almost⁴ nonexistent, and employers continue to terminate existing plans.

This is the last in a series of four articles on the topic of split-dollar accounting. It presumes that the reader has read the first article, “Categorizing Split-Dollar Arrangements,” and determined that the appropriate category for a particular arrangement is an agreement to maintain a policy. Agreements to maintain a policy are the most common of the three categories of postretirement split-dollar arrangement. The other two categories are loan arrangements and agreements to pay a benefit.

The appropriate accounting treatment for an agreement to maintain a policy is to accrue the “cost of the insurance policy.” The difficulty is that companies often misinterpret the Emerging Issues Task Force’s (EITF’s) intended meaning of the “cost of the insurance policy” because of the lack of guidance in Subtopic 715-60. Applying the EITF’s intended meaning is inherently complex, and presumes an unusually high level of understanding of life insurance. However, there is an alternative approach. Agreements to maintain a policy and agreements to pay a benefit are closely related, and the accounting methodologies for both types of arrangements lead to substantially similar results. The statements of financial position are usually identical, and although the distinction between insurance gains and losses and benefit gains and losses differs between the two forms of split-dollar benefit obligations, net income is the same for both arrangements when recognizing benefit gains and losses immediately. The only major difference between the two is that the methodology for agreements to pay a benefit is far less complex than that of an agreement to maintain a policy.

Consequently, the authors of this article recommend treating agreements to maintain a policy as agreements to pay a benefit for accounting purposes. The relative simplicity and virtually identical results of the accounting methodology for agreements to pay a benefit make it an appropriate substitute for the accounting methodology for an agreement to maintain a policy. Most retirement actuaries are fully capable of valuing split dollar agreements to pay benefits after gaining an understanding of the basics of split-dollar.

Readers who are short on time and inclined to trust the expertise of the authors have the option to stop reading now and apply the methodology of accounting for agreements to pay a benefit to their agreements to maintain a policy. Those who have interest in the topic and/or need more exhaustive explanations will find that the remainder of this article provides substantial support for why the two methods lead to similar results. The article achieves this by dispelling seven common myths about accounting for agreements to maintain a policy, including:

Myth #1: The EITF intended “cost of the insurance policy” in an agreement to maintain a split-dollar policy to mean the future cash outlays for premiums.

Myth #2: The future COI rates within a split-dollar life insurance policy are readily available.

Myth #3: The benefit obligation for accounting purposes can always reflect the same cost of insurance rates used for tax purposes.

Myth #4: The expected cost of an insured benefit is lower than the expected cost of a self-insured arrangement.

Myth #5: Charging the adjusted cost of insurance incurred against the benefit obligation results in a benefit obligation that differs from a self-insured benefit obligation under an agreement to pay a benefit.

Myth #6: Postretirement life insurance gains are the same in an insured arrangement and a self-insured arrangement when cash values and premiums of the arrangements are identical.

Myth #7: Categorizing a split-dollar arrangement as an agreement to maintain a policy leads to different accounting results than categorizing a split-dollar arrangement as an agreement to pay a benefit.

If the authors succeed in their objectives, readers will come away from this article embracing the relative simplicity of accounting for agreements to pay a benefit, with the assurance that the end result is usually identical.

ARRANGEMENT CLASSIFICATION

As explained in the first article of this series, the three types of postretirement split-dollar arrangements are loan arrangements, agreements to pay a benefit, and agreements to maintain a policy. By process of elimination, agreements to maintain a policy are the most common type of arrangement.

Loan arrangements apply only to collateral assignment arrangements in which the employer has both the ability and intent to

recover the loan balance and the executive bears the risk of policy performance. There are situations in which an arrangement previously classified as a loan arrangement becomes an agreement to maintain a policy. For example, falling interest rates frequently cause policy performance to deteriorate relative to projections. This less-than-expected policy performance raises the risk of lapse in certain cases and causes some employers to consider paying unexpected premiums. An employer's payment of postretirement premiums in these circumstances may indicate an agreement to maintain a policy rather than a loan arrangement.

Agreements to pay a benefit are even more unusual than loan arrangements because few employers are the primary obligors in postretirement split-dollar arrangements. Instead, most employers depend on the insurance company to pay benefits. The benefit accounting for an agreement to pay a benefit does *not* reflect the use of life insurance, which is accounted for separately. This article will sometimes label agreements to pay a benefit as "self-insured benefit obligations" only to emphasize the distinction between the benefit obligation and the life insurance financing. In contrast, the benefit accounting for an agreement to maintain a policy *does* reflect the use of life insurance, and this article will sometimes label these arrangements as "insured arrangements" only to emphasize the subtleties of accounting differences between self-insured and insured arrangements.

AGREEMENT TO MAINTAIN A POLICY: DEFINING COST OF INSURANCE

Myth #1: The EITF intended "cost of the insurance policy" in an agreement to maintain a split-dollar policy to mean the future cash outlays for premiums.

Reality: Even single premium split-dollar policies incur cost of insurance within the policy each year.

Most companies that sponsor agreements to maintain a policy correctly identify their arrangements as such, but misinterpret the requirement to accrue the "cost of the insurance policy."⁵ The limited guidance in Subtopic 715-60 opens the door for such companies to rationalize that the postretirement cost of their insurance policy is zero because no future premiums are required. These companies sometimes record no benefit obligation for what is often a material benefit. This rationalization is consistent with the fact that

52⁶ of the 119⁷ respondents to FASB's EITF Issue 06-04, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*, "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." The EITF did not agree,⁸ but as noted, the lack of guidance in Subtopic 715-60 on the definition of the "cost of the insurance policy" has led to diversity in applying such guidance.

"Cost of the Insurance Policy"

Understanding the EITF's intended meaning of the "cost of the insurance policy" requires careful reading of the published Issue Summaries that preceded FASB's ratification of the EITF consensus. "The cost of the insurance policy" first appeared in print in the September 7, 2006 EITF meeting minutes.⁹ The August 18, 2006 Issue Summary (prepared less than a month earlier) discussed the requirement to accrue the "cost of insurance" (COI).¹⁰ The EITF gives no clue as to why the wording changed, and the change may have been unintentional. Although the two terms appear to be similar, the former is vague, while the latter has a specific meaning within the life insurance industry. Some companies interpret the "cost of the insurance policy" to mean future premium outlays, while other possibilities include the opportunity cost of investing in life insurance or the future insurance expense as measured by changes in cash value. Understanding these interpretations of the "cost of the insurance policy" is less important than understanding that the term is vague and that different interpretations create diversity in accounting practice.

The fact that the first Issue Summary of EITF 06-4 stated that a single premium arrangement was typical of endorsement split-dollar indicates that the EITF never considered future premiums to be an indicator of a benefit obligation.¹¹ Instead, the EITF deliberated over whether the postretirement obligation should reflect the benefit received by the executive's beneficiary or the company's cost of providing that benefit.¹² Either way, a company with a postretirement endorsement split-dollar arrangement (or a collateral assignment arrangement treated as one) must record a benefit obligation. For agreements to maintain a policy, the benefit obligation reflects the cost of the insurance policy even when no future premiums will be paid.

Accrual of COI Presumes High Level of Insurance Expertise

Whereas the vagueness of the terminology, "cost of the insurance policy," creates diversity in its interpretation, the term COI has a

precise meaning within the life insurance industry, as reflected in the example in Exhibit B of the August 18 EITF Issue Summary. Within the arcane world of life insurance, COI refers to the mortality charges within the life insurance product.

Example 1: A company purchases a life insurance policy with a death benefit amount of \$1M with a single premium of \$300K. The crediting rate is 4%. The cash value grows each year, but at a rate less than the 4%. The difference between the premium compounded at 4% and the actual cash value reflects insurance charges, including the COI.

Policy Year	Premium Beg of Yr	Cash Value End of Yr	Future Value of Premium at 4%	Implied Annual Insurance Charges
1	\$300,000	\$306,000	\$312,000	\$6,000
2	0	312,120	324,480	12,360
3	0	318,362	337,459	19,097
4	0	324,730	350,958	26,228
5	0	331,224	364,996	33,772
6	0	337,849	379,596	41,747
7	0	344,606	394,780	50,174
8	0	351,498	410,571	59,073
9	0	358,528	426,994	68,466
10	0	365,698	444,073	78,375

Insurance charges include premium loads and policy fees, but the most significant insurance charge during the postretirement years is COI, which reflects the insurance company's cost of paying death proceeds in excess of the cash value. The life insurance industry refers to this excess of the death benefit over the cash value as the net amount at risk (NAR) or, less formally, as the "pure insurance" portion of the death benefit. The following table shows two policies on the same insured with the same initial cash value. The higher death benefit (and higher resulting NAR) of Policy B increases implied COI charges and lowers cash value growth.

Example 2: Policies A and B start with the same cash value of \$365,698 and receive no future premiums. Policy A has the

higher death benefit but the lower cash value. Policy B has the lower death benefit but the higher cash value. Higher death benefits (and the resulting COI charges) reduce cash values.

COI charges reflect both the amount of the NAR and mortality factors such as age. As the insured ages, the COI charge per \$1,000 of NAR increases. Note that the COI charge is entirely separate from the premium, as is particularly evident in a single premium policy. Some combination of the premium and interest on the cash value could be considered a prepayment of the COI charges.

Some products include explicit COI charges, while other products only imply COI charges. Universal life and variable universal life product designs reflect explicit COI charges in annual policyholder statements that reconcile beginning of year cash values to end of year cash values. Whole life product designs often only imply COI charges. Policyholders can infer charges by comparing actual cash value growth to dividend scales or by comparing cash value growth under a variety of death benefit patterns. Examples 1 and 2 reflect implied insurance charges.

Age	Policy A			Policy B		
	Premium	Death Benefit	Cash Value	Premium	Death Benefit	Cash Value
			\$365,698			\$365,698
65	\$0	\$1,000,000	372,476	\$0	\$731,397	375,800
66	0	1,000,000	378,836	0	751,601	385,719
67	0	1,000,000	384,761	0	771,437	395,417
68	0	1,000,000	390,185	0	790,834	404,828
69	0	1,000,000	395,064	0	809,656	413,899
70	0	1,000,000	399,204	0	827,799	422,475
71	0	1,000,000	402,454	0	844,951	430,431
72	0	1,000,000	404,422	0	860,863	437,470
73	0	1,000,000	404,956	0	874,940	443,479
74	0	1,000,000	403,889	0	886,958	448,350

EITF Example

The EITF was clearly thinking of COI as the life insurance industry understands the term in its Issue Summary dated August 18, 2006.

Exhibit 06-4B of that Issue Summary gave an example of a policy with a face amount of \$300K and a single premium of \$60K.¹³ This simplified example assumed that the cash value increased by \$8K each year and that this \$8K reflected \$11K in interest crediting and \$3K in “cost of insurance” charges. The insured executive was expected to live 20 years after retirement, so the obligation at retirement was \$60K (20 years of COI at \$3K per year with no discounting for simplicity). However, the minutes of the EITF September 7 meeting state that the example in Exhibit 06-4B, “should not be considered authoritative guidance in accounting for an endorsement split-dollar life insurance arrangement since it was included only to illustrate the differences between the application of the individual views.”¹⁴ Nevertheless, the message was clear: postretirement obligations for split-dollar exist in spite of the lack of future premiums, and obligations for agreements to maintain policies reflect the cost of insurance as the term is understood by the life insurance industry.

DETERMINING FUTURE COI RATES

Myth #2: The future COI rates within a split-dollar life insurance policy are readily available.

Reality: The future COI rates are not readily available, even for life insurance products with explicit COI charges.

Adjusted COI

Because the COI is based on the NAR, accruing for the COI charge as a benefit payment implies that the executive’s beneficiary will receive death proceeds equal to the NAR.

Example 3: Consider the following detail of COI charges.

a	Cash value	\$344,606	
b	Death benefit	\$1,000,000	
c	Net amount at risk	\$655,394	=b-a
d	COI per \$1000	\$54.56	
e	COI	\$35,755	=c/1000*d

Company A agrees to maintain a split-dollar life insurance policy and claims death proceeds equal to the cash value. The executive dies and his beneficiary receives the NAR, which is the excess of the \$1M in total death benefit over the \$345K claimed by the Company, or \$655K. The cost of insurance

for the \$655K benefit is \$36K. The actuarial value of the \$36K COI charge is included in the postretirement benefit obligation.

Although some split-dollar arrangements do reflect the endorsement of the exact amount of the NAR to the executive's beneficiary, many arrangements do not. The EITF August 18, 2006 Issue Summary of 06-4 describes View A³ (pronounced A "prime") as accruing a post-retirement benefit obligation for the "the cost of insurance during the employee's retirement for the portion of the death benefit that is endorsed over to the employee."¹⁵ If the endorsed death benefit exceeds the NAR for a given year, the COI for benefit accrual purposes will exceed the actual COI. Conversely, if the NAR exceeds the endorsed death benefit for a given year, the COI for benefit accrual purposes will be less than the actual COI. To distinguish the actual COI from the COI for benefit accrual purposes, we will refer to the latter as the *adjusted* COI.

Some arrangements endorse a flat amount of postretirement coverage or some other amount that never equals the NAR. In this situation, the adjusted COI reflects the COI rate per \$1,000 of coverage times the benefit payable to the executive's beneficiary.

Example 4: Same as Example 3, but the Company endorses a flat \$600K of the death benefit to the executive's beneficiary. The adjusted COI should reflect the endorsed death benefit of \$600K times the age related COI rate of \$54.56 per thousand. In other words, the adjusted COI included in the benefit obligation should be \$32,736, not \$35,755, because the benefit is only \$600K, not \$655K.

COI Rate

Accruing the postretirement COI charges for the portion of the death benefit that is endorsed over to the employee requires a schedule of projected COI rates, which are likely to be much lower than guaranteed COI rates. Because most insurance companies do not release projected unit COI rates, COI charges must be estimated even for products with explicit COI charges such as universal life and variable universal life. As a result, accruing the adjusted COI charges for agreements to maintain a policy requires the use of estimated COI charges.

If projected COI rates are not available, IRS Table 2001 is a reasonable rate to use in the absence of anything more definitive. Many

split-dollar arrangements use IRS Table 2001¹⁶ to measure the value of coverage for tax purposes. If a retirement actuary is performing the valuation under Subtopic 715-60, he or she will probably suggest the use of a variation of a mortality table called RP-2000 and not see any need to differentiate between cost of insurance and $q(x)$ rates, which represent the probability that an individual age x will die within the year. For example, if the actuary uses 110% of male rates under RP-2000 projected, the RP-2000 rates range from 90% of Table 2001 at age 70 to 130% of Table 2001 at age 90. The 110% factor assumes a 10% load, which may make the RP-2000 table more comparable to a cost of insurance charge. The selection of a male rate reflects the typical situation in split dollar arrangements. The projected table reflects the expectation of ongoing improvements in mortality. A reasonable alternative to using either Table 2001 or RP-2000 is to use Table 2001 as an approximation of the COI rate and to use RP-2000 to calculate the probability of incurring the adjusted COI.

Example 5: Company A agrees to maintain a split-dollar arrangement postretirement. The insurance company will not provide the current cost of insurance rates per \$1,000 of NAR. Company A uses Table 2001 rates instead.

Examples of Table 2001 Rates	
Attained Age	COI for \$1000 of Coverage
65	11.90
70	20.62
75	33.05
80	54.56
85	88.76
90	144.30
95	228.35

DETERMINING FUTURE COI RATES

Myth #3: The benefit obligation for accounting purposes can always reflect the same cost of insurance rate used for tax purposes.

Reality: The rate used for tax purposes can materially understate the company's cost of insurance in certain circumstances.

The cost of insurance does not reflect that rate at which the executive could purchase fully underwritten term insurance, but the rate at which the employer incurs the charges within the insurance contract. These mortality charges are often incurred many years after policy issue. By this time any underwriting information collected at time of issue is stale. Further, the rate used to measure the imputed term cost for tax purposes in a grandfathered split-dollar arrangement may significantly understate the cost of insurance. Split-dollar arrangements entered into before (and not materially modified after) January 28, 2002, may be permitted to use a very low rate published by the carrier but not necessarily sold on a regular basis.¹⁷ The purchase of such a low premium term product requires thorough underwriting and does not reflect the company's cost of insurance in the policy many years after the issue date.

Example 6: Company A entered into an agreement to maintain a split-dollar policy with an executive in 1990. The executive is now retired and 80 years old. Company A uses the carrier's published one year term rate to measure the executive's imputed income for tax purposes. The published unisex annual rate for an individual 80 years old is \$11.40 per \$1000 of coverage. Regardless of whether this 80 year old executive would qualify for new coverage at such a rate, Company A's cost of insurance for this executive is closer to \$54.56 per \$1000 of coverage because the policy was issued over twenty years ago.

Contributory Plans

Contributory plans in which participants contribute amounts that reflect the actual cost of insurance result in no benefit obligation.¹⁸ For example, a postretirement split-dollar arrangement that requires employee contributions based on Table 2001 might result in a zero benefit obligation, because the employee contributions fully reflect the adjusted cost of insurance. However, the use of a below-cost contributory rate that may be permissible for tax purposes reduces, but does not eliminate, the obligation.

STATEMENT OF FINANCIAL POSITION

Once a company settles on its interpretation of the "cost of the insurance policy," the next step is accruing that cost. The statement of financial position (balance sheet) reflects agreements to maintain a life insurance policy through three accounts:

- Benefit liability
- Cash value asset
- Retained earnings

Arrangements with prior service cost will reflect a portion of the benefit liability in a fourth account, accumulated other comprehensive income. Companies that follow the authors' recommendation to recognize all benefit gains and losses immediately will have retained earnings that are identical to agreements to pay a benefit. This next section explains that the benefit liability and the cash value asset are usually identical for the two forms of split-dollar benefit obligations—agreements to maintain a policy and agreements to pay a benefit.

Myth #4: The expected cost of an insured benefit is lower than the expected cost of a self-insured arrangement.

Reality: The expected cost of an insured benefit is higher than the expected cost of a self-insured arrangement because of insurance costs.

Benefit Liability

Accruing the cost of the insurance policy starts with calculating the present value of the expected adjusted cost of insurance. This process usually requires the services of a retirement actuary. The actuary determines the pattern of postretirement death benefits payable to the executive's beneficiary and multiplies the coverage each year by the assumed COI rate to calculate the adjusted COI. The actuary uses a mortality table to determine the probability of incurring each cost of insurance charge. As a retiree ages, the probability of reaching each age decreases, while the COI per \$1000 of coverage increases. The actuary discounts the postretirement adjusted COI charges to the date of the financial statements.¹⁹

Example 7: Company A maintains a split-dollar policy for an executive retiring at age 65 and expects the executive's beneficiary to receive \$1M in split-dollar proceeds if he dies at age 80. A mortality table shows that the current probability of paying the \$54,560 adjusted COI charge at age 80 is 67% (the probability of surviving from age 65 to age 80). The discounted amount of \$17,609 is included in the benefit liability at age 65. This calculation is completed for each postretirement age, with the sum of the present values of

adjusted COIs resulting in the benefit liability at the age of retirement (age 65 here).

Death benefit at age 80	\$1,000,000	a	
COI charge per \$1000	54.56	b	
Adjusted COI charge at age 80	\$54,560	c	=a/1000*b
Probability of payment	0.6710	d	
PV of \$1 in 15 years at 5%	0.4810	e	
PV of Adj COI at age 80	\$17,609	f	=c*d*e

Comparing Benefit Liabilities

The benefit liability for an agreement to maintain a policy reflects the cost of an insured benefit, whereas the benefit obligation for an agreement to pay a benefit reflects the cost of paying the benefit directly under a self-insured arrangement. In its August 18, 2006 Issue Summary, the EITF acknowledged that the accounting for the two forms of split-dollar obligations during the executive's active service period may be similar.²⁰ Absent a premature death, the cost of an insured agreement exceeds the cost of a benefit paid directly because of insurance costs in excess of the actuarial risk. A simple example may help explain the difference between an insured arrangement and a self-insured arrangement.

Example 8: 100 individuals each face a potential loss of \$100,000 and want to insure the risk. Actuaries estimate that two of the individuals will experience the loss this year and that the resulting claims will be \$200,000. Each of the 100 individuals has the same risk of loss. The insurance company proposes a premium of \$2,000 and total premiums received from all 100 policy holders equal \$200,000. From the individuals' points of view, 98 will pay \$2,000 and receive no payout. The other two will pay \$2,000 to receive \$100,000.

From the insurance company's point of view, the \$200,000 in total premiums covers the \$200,000 in total claims, but the premiums are too low to cover premium taxes, distribution expenses, administration, and profit. Assume that such costs equal 5% of premiums. The premium to reflect such costs is \$2,105 ($\$2,000/(1-0.05)$). In reality, premiums are often received many years before claims are paid. This allows the insurance company to earn interest on the premium and charge a lower premium than they would have to charge

otherwise. Of course, policyholders know that too and expect premiums to reflect time value of money.

As Example 8 illustrates, insurance costs more in the aggregate than the underlying risk. At the individual level, insurance costs less than the underlying risk for those who are unfortunate enough to make a claim and costs more for the rest. Because no one knows which policyholders will suffer the loss and make the insurance claim, insurance can spread the risk over the entire pool.

Mortality risk is the risk of dying prematurely. Mortality risk and life insurance differ from Example 8 in that the risk of death generally increases with each passing year, and everyone eventually dies. As noted earlier, the expected cost in an insured arrangement is the discounted COI for each future year, times the probability of the executive's survival to that year. In a self-insured arrangement, the expected cost is the expected death benefit for any given year, times the probability of the executive's survival to that year, times the probability of dying during that year. When the cost of insurance equals the attained age probability of death within that year, the costs of an insured and a self-insured arrangement are equal.

Example 9: The expected costs under a self-insured arrangement and an insured arrangement are the same when the probability of dying during the year equals the cost of insurance. The probability of the executive's survival to a given year is the same, because life insurance does not affect life expectancy.

	Self-Insured	Insured
Benefit at age 80	\$1,000,000	\$1,000,000
Probability of an 80 year old dying at 80	5.456%	
COI per \$1000 at age 80		\$54.56
Expected payment	\$54,560	\$54,560

The expected adjusted COI is at least equal to the expected cash flows under a self-insured arrangement. Because the company cannot predict the date of death and we assume no incremental cost for insurance for the sake of simplicity, we will assume that the expected cost of the two arrangements is the same in all years.

Some insurance brokers have claimed to offer products with low COI charges to help reduce split-dollar benefit obligations for agreements to maintain a policy. Actuaries respond by pointing out that they are not limited to a particular mortality table for the accounting

valuation. If an insurance actuary can rationalize the use of a particular COI table, the valuation actuary can usually rationalize the use of an even lower mortality table.

Situations Where Benefit Liabilities Differ

Two situations justify a benefit obligation in an agreement to maintain a policy that is lower than a promise to pay a benefit:

- *The company expects the policy to lapse.* The expected adjusted cost of insurance after a policy lapse is zero. A current in-force projection of the policy can provide information on the timing of such an expected lapse.

Example 10: Company A has agreed to maintain a policy with a postretirement death benefit to the executive's beneficiary of \$1M. The policy is not expected to lapse, and the actuary calculates the actuarial value at age 65 of the adjusted COI as \$426K. Company B has agreed to maintain a policy with postretirement death benefit to the executive's beneficiary of \$1M, but only for as long as the cash values will support the benefit without additional employer premium payments. Written communication with the participant supports Company B's intention to let the policy lapse if necessary to avoid future premiums. A current projection of the policy with no postretirement premiums shows lapse at age 85. The actuary reduces the actuarial value of the adjusted COI to reflect the fact that no adjusted COI will be incurred after expected lapse. The reduced actuarial value at 65 to reflect lapse at age 85 is \$296K.

- *The company has evidence that the insured executive's life expectancy is materially shorter than average.* In this case, the expected adjusted cost of insurance lasts only as long as the executive is expected to live.

Example 11: Company C has also agreed to maintain a policy with a postretirement death benefit to the executive's beneficiary of \$1M. The insured executive is age 65 but expected to die within three years. The reduced actuarial value at 65 to reflect death in three years is \$40K.

While expected lapse or terminal illness reduces the actuarial value of expected adjusted COI, the expected transfer of cash values to the executive increases the benefit obligation beyond adjusted COI charges.

A “rollout” is the split-dollar industry’s term for release of an unrestricted policy to the executive or a third party designated by the executive. The term implies the corporation’s recovery of its interest just before such a release. In the case of collateral assignment split-dollar, the executive already owns the policy. The employer recovers its interest, usually equal to its cumulative premiums, and releases the collateral assignment so that the executive has unrestricted ownership of the policy. In the case of endorsement split-dollar, the company transfers ownership of the policy to the executive, who then has unrestricted ownership of the policy. Either way, the executive receives a benefit of the cash surrender value in excess of the company’s recovery. The fact that the cash value is not surrendered and that it is property rather than cash is not relevant. What is relevant is that the executive receives a significant benefit in addition to the postretirement adjusted cost of insurance that he received before the rollout. The amount and timing of the executive’s cash value received upon rollout should be included in the benefit liability of an agreement to maintain a policy.

Example 12: Company D has also agreed to maintain a policy with a postretirement death benefit to the executive’s beneficiary of \$1M, but plans to withdraw its cumulative premiums at age 68 and transfer the remaining cash value to the executive. The policy maintained by Company D is not expected to lapse and the insured has a normal life expectancy. The insured executive is age 65 and the cash value expected to be transferred in three years is \$325K. The \$320K benefit liability comprises both the \$40K in present value of expected adjusted COI for the next three years until expected transfer and the \$280K actuarial present value of the \$325K in cash value to be received by the executive.

Cash Value Asset

Just as the benefit liability for an agreement to maintain a policy usually equals the benefit liability for an agreement to pay a benefit, the cash value asset is also the same. In an agreement to maintain a policy, the company should record the entire cash value as an asset. Because a properly calculated benefit liability fully reflects the cost of any postretirement benefit, any discount of the asset below the cash surrender value overstates the benefit cost and understates the asset value. This is true in spite of the company’s expectation of receiving death proceeds less than the cash value.

Example 13: Company A has agreed to maintain a policy with a postretirement death benefit to the executive’s beneficiary of \$1M. The \$575K of policy cash value is expected

to prevent a lapse of coverage, and the actuary calculates the actuarial present value at age 65 of the adjusted COI as \$426K. Company A's share of the death proceeds equals its cumulative premiums of \$487K. Although the \$575K cash value exceeds Company A's share of the death proceeds, Company A should record the entire \$575K as cash value. That is the amount that is available to general creditors in the event of Company A's bankruptcy, and the \$426K liability fully accrues the benefit. Limiting the cash value to the expected death proceeds of \$487K overstates expenses. The entries at death will be discussed later in this article.

Retained Earnings

Because the assets and liabilities of agreements to maintain policies are usually identical to agreements to pay benefits in every year, owner's equity is also identical. The two components of owner's equity affected by split-dollar arrangements are retained earnings and accumulated other comprehensive income (AOCI). The only change in owner's equity that must flow through AOCI is prior service cost for arrangements that are part of a plan. Prior service cost is rare in split-dollar plans and beyond the scope of this article. As will be discussed in the following section, most changes in assets and liabilities related to split-dollar arrangements flow through retained earnings either by necessity or by choice. The liability for a postretirement obligation other than a pension is the accumulated postretirement benefit obligation (APBO), which represents the actuarial present value of the postretirement benefits attributable to past service.

Example 14: Company A has agreed to maintain a split-dollar policy with a \$1M postretirement benefit payable to the executive's beneficiary. Company B has agreed to pay a postretirement split-dollar benefit of \$1M to the executive's beneficiary. Other than Company B's guarantee of the benefit, the facts and circumstances are identical. The insured individuals and the life insurance policies are identical. The policies are not expected to lapse, and the insured has a normal life expectancy. The attribution period is 15 years. Life expectancy is age 85. The discount rates are identical. As explained earlier, the cash value assets and the benefit liabilities are identical. The resulting effect on owner's equity is identical. Note that the zero cumulative cash flow equals the zero cumulative effect on owner's equity. We will build on this example for the remainder of this article.

Year	Age	Cash Flow	Change in CSV	Change in APBO	Change in Owner's Equity
1	50	-\$32,500	\$28,198	\$14,341	-\$18,642
2	51	-32,500	29,525	15,775	-18,750
3	52	-32,500	30,847	17,316	-18,969
4	53	-32,500	32,222	18,973	-19,251
5	54	-32,500	33,590	20,751	-19,662
10	59	-32,500	41,214	31,782	-23,068
15	64	-32,500	49,728	47,323	-30,095
20	69	0	22,470	15,454	7,017
25	74	0	23,275	15,993	7,282
30	79	0	22,472	15,602	6,870
35	84	0	19,122	13,857	5,265
36	85	487,500	-1,017,430	-732,249	202,319
	Sum	\$0	\$0	\$0	\$0

RECONCILING CHANGES IN THE BENEFIT LIABILITY AFTER RETIREMENT

Myth #5: Charging the adjusted cost of insurance against the benefit obligation results in a benefit obligation that differs from a self-insured benefit obligation under an agreement to pay a benefit.

Reality: The benefit obligation of a postretirement split-dollar arrangement is the same regardless of the nature of the obligation. If a difference does exist, the insured arrangement has the higher obligation, absent a reasonable expectation of premature death or lapse.

In spite of the fact that the expected cost of an insured arrangement is at least as great as that of a self-insured arrangement, the August 18, 2006 Issue Summary stated that the postretirement accounting would differ between the two forms of split-dollar benefit obligations because the obligation of an agreement to maintain a policy would be reduced each year to reflect the adjusted COI incurred.²¹ Because the EITF example did not address actuarial gains and losses, it is not clear whether the EITF understood that the benefit obligations of the two types of agreements at year-end would in fact remain equal.

Once a company accepts that the benefit liability at retirement is the same under the two forms of split-dollar benefit obligations, the next step is understanding the changes in the two forms of obligations. Postretirement benefit obligations increase each year to reflect interest on the obligation, purely from the passage of time. A self-insured obligation also reflects an actuarial gain each year that the executive survives to reflect the executive's slightly increased expected age at death. In other words, the executive's survival each year increases the likelihood that he will survive to age 100. This longer life expectancy increases the discount period for calculating the actuarial value and reduces the present value slightly. For the company obligated to pay a death benefit without the benefit of life insurance, each year of survival is good news.

However, an insured obligation reflects the payment of adjusted COI charges within the product as explained earlier. An actuarial loss is required to adjust the benefit obligation to its proper amount. For the company obligated to incur COI charges for the rest of an executive's life, each year of survival increases the total number of expected years in which the COI will be incurred. As the following example shows, this actuarial loss equals the adjusted COI incurred, less the actuarial gain recognized under the self-insured arrangement.

Example 15: As in Example 14, Company A has agreed to maintain a policy with a postretirement death benefit to the executive's beneficiary of \$1M. The policy is not expected to lapse, and the actuary calculates the actuarial value at age 65 of the adjusted COI as \$426K. Interest at 5% on \$426K benefit obligation equals \$21K, and the benefit obligation at age 66 is \$440K. Adjusted COI incurred equals \$12K.

	Agreement to Pay Benefit	Agreement to Maintain Policy
Benefit obligation at 65	\$426K	\$426K
Interest at 5%	21K	21K
Adjusted COI incurred		(\$12K)
Actuarial (gain)/loss	(\$7K)	\$5K
Benefit obligation at 66	\$440K	\$440K

Because the EITF example included no actuarial loss, the "payments" of the adjusted COI charges fully depleted the liability by the executive's life expectancy of age 85. Although an executive's life expectancy at age 65 is approximately age 85, his expected age at death as an

85 year old has extended several years. Each year of retirement should gradually reflect this increasing expected age at death.

It may seem strange that identical beginning and ending balances can create a loss in one case and a gain in another. Considering the risk element may explain the difference. Under the insured approach, the company agrees to incur adjusted COI charges for the rest of the insured executive's life. Each year that the executive lives, the longer his potential life expectancy and the greater the expected cost. The best-case scenario for benefit accounting purposes is immediate death, which eliminates the benefit obligation and creates an actuarial gain. Under the self-insured approach, the company agrees to pay a benefit whenever the executive dies. Each year that the executive lives, the later his projected age at death, and the greater the discounting period for the benefit cash flows. A longer discounting period reduces the present value of the cash flows. The best-case scenario for benefit accounting purposes is the executive's survival past age 100, which delays the benefit payment as long as possible, and creates an actuarial gain.

Valuation actuaries may better understand the dynamics of the two scenarios by considering the differences in accounting for a retirement annuity benefit versus a postretirement death benefit. Valuing the adjusted COI can be thought of as accounting for a stream of payments that is actuarially equivalent to the single sum death benefit at all points in retirement.

Accumulated Projected Benefit Obligation (APBO)

Our discussion so far has focused on measuring the present value of postretirement benefits. US GAAP refers to this amount as the expected postretirement benefit obligation (EPBO).²² The next step is spreading this cost over the period in which the executive earns the benefit. The accumulated postretirement benefit obligation (APBO) is the EPBO attributed to past service and represents the liability for accounting purposes.²³ After the full eligibility date, the benefit has been fully earned and the APBO equals the EPBO.

Attribution Period

The attribution period is the period of service over which the EPBO is spread. The attribution period for a postretirement split-dollar benefit begins when the executive first has coverage and ends at the full eligibility date.²⁴ For a pay-related plan in which postretirement coverage changes with changes in the executive's pay, the full eligibility date is retirement.²⁵ For non-pay-related plans, the full eligibility date is the vesting date.

Example 16: Two executives age 50 enroll in postretirement split-dollar arrangements that vest after age 55 and ten years

of service. Executive A receives a pay-related benefit of three times final pay. Her full eligibility date is expected retirement at 65. Executive B receives a flat \$1M of coverage. His full eligibility date is age 60, when he meets the vesting criteria.

Net Periodic Postretirement Benefit Cost

The annual benefit expense for a postretirement split-dollar arrangement usually comprises three elements: service cost, interest cost, and gain or loss.²⁶ A fourth element, amortization of prior service cost, is usually absent because split-dollar plans rarely attribute benefits to past service. Instead, service may be a criterion for vesting. A fifth element, return on plan assets, is not usually a component of the annual benefit expense because there are usually no plan assets. Because split-dollar cash value is usually available to general creditors of the company, it does not meet the criteria for a plan asset.²⁷ Service cost is the portion of the EPBO assigned to a year of service within the attribution period.²⁸ Interest is the interest incurred on the APBO due to the passage of time.²⁹ Gains and losses are the change in the APBO as a result of a change in assumption or experience that varies from assumptions.³⁰ These terms are well understood by retirement actuaries.

GAINS AND LOSES

Myth #6: Postretirement life insurance gains are the same in an insured arrangement and a self-insured arrangement when cash values and premiums of the arrangements are identical.

Reality: Charging the adjusted COI against the benefit liability prevents the postretirement investment element of the policy from being reduced by the adjusted COI changes. Adjusted COI charges incurred increase postretirement gains dollar for dollar.

In the context of split-dollar accounting, gains and losses are the important element of the annual expense that requires additional discussion. Most companies delay recognition of gains and losses in postretirement benefit plans in order to smooth the annual benefit expense from the effects of changing assumptions and experience. Split-dollar is different because the cash value is not a plan asset and is therefore not eligible for the delayed recognition of gains and losses. Actuaries need to understand the combined effect of benefit accounting and life insurance asset accounting in order to make an informed recommendation

on whether to delay recognition of benefit gains and losses. Benefit losses often occur simultaneously with insurance gains, and vice versa.

Postretirement gains and losses on the benefit obligation result primarily from changes in the discount rate and changing estimates of expected age at death. Each year of survival in an insured arrangement creates a loss from the expectation of incurring adjusted COI charges for a longer period. (See the agreement to maintain a policy in Example 15.) Death creates a gain from no longer expecting to pay what had already been accrued.

Life insurance gains usually equal the cash value increase in excess of any premium paid during the period.³¹ Agreements to maintain a policy artificially increase the postretirement cash value gain to reflect the adjusted COI incurred. This is not intuitive. Understanding this artificial increase in the annual postretirement insurance gain requires first understanding that the adjusted COI incurred postretirement temporarily reduces the benefit obligation. This is an accounting debit entry and the related credit entry has to go somewhere. A more complete understanding of why adjusted COI incurred increases life insurance gains requires understanding the EITF's bifurcation of the investment element of a life insurance policy from its insurance element as described earlier. In the EITF 06-4 Issue Summary dated August 18, 2006, the journal entry examples in Exhibit 06-4B View A' increase the cash value asset and insurance gains to reflect gross interest crediting and decrease the cash value asset and benefit obligation to reflect COI.³² The EITF's example below assumes \$11K of interest crediting and \$3K of COI, for which the EITF recommended the following entry for the year following retirement:

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

This EITF example assumes that the COI and adjusted COI are equal and that there is no actuarial gain or loss. In practical terms, a company that earns an \$8,000 net increase in cash value and incurs \$3,000 in adjusted COI would probably record the following entries to achieve an identical result:

Insurance asset	\$8,000	
Insurance gain		\$8,000
Postretirement benefit obligation	\$3,000	
Insurance gain		\$3,000

Preretirement, the COI charges reduce the investment gain, whereas postretirement, the adjusted COI charges are charges against the benefit liability. Because the adjusted COI charges have already been accrued, the postretirement insurance gains are higher in an insured arrangement than a self-insured arrangement, in spite of the fact that the cash values are equal. Death creates a gain or loss to reconcile the cash surrender value recorded as an asset to the company's share of the death proceeds.

Example 17: Company records the \$576K in cash value for its 65 year-old executive who has just retired. The cash value grows to \$596K at year-end, reflecting \$31K of interest crediting and \$11K of actual COI charges. The adjusted COI charges incurred for the year are \$12K. Charging the \$12K against the benefit obligation requires a \$12K credit to insurance gain. In other words, the adjusted COI charges have already been accrued and should not be reflected in insurance expense.

Cash value at age 65	\$576K	a	
Interest crediting	\$31K	b	
Actual COI charges	(\$11K)	c	
Cash value at age 66	\$596K	d	=a+b+c
Actual cash value gain	\$20K	e	=d-a
Adjusted COI incurred	\$12K	f	
Adjusted cash value gain	\$32K	g	=e+f

TIMING OF RECOGNITION

Myth #7: Categorizing a split-dollar arrangement as an agreement to maintain a policy leads to different accounting results than categorizing a split-dollar arrangement as an agreement to pay a benefit.

Reality: Immediate recognition of gains and losses creates the smoothest pattern of net income, and results in no difference in the statement of financial position. The distinction between insurance gain/loss and benefit gain/loss on the income statement is not worth the complexity that results from precisely accounting for an agreement to maintain a policy.

During the executive's lifetime, insurance gains inflated by the adjusted COI incurred help to mitigate the effect on benefit losses from the increasing expected age at death. At death, any benefit gain from no longer incurring adjusted COI charges helps to mitigate any insurance loss from reconciling the cash value carried as an asset to the company's share of the death proceeds. These entries mitigate the effect on net income only when benefit gains and losses are recognized immediately.

Example 18: Consider the change in owner's equity in Example 14, assuming an insured arrangement. The schedule below labels the change in owner's equity as comprehensive income and shows the component detail, which comprises insurance gain, interest and service cost on the benefit, and benefit gain/loss. Consider year 20 in particular. Whereas Example 14 shows an increase in cash value of only \$22,470, an insured arrangement results in \$40,062 insurance gain, which reflects both the cash value increase and the \$17,592 of adjusted COI incurred. Whereas Example 14 shows an increase in the benefit liability of \$15,454, the detail of an insured arrangement shows \$24,244 in interest, less \$17,562 of adjusted COI incurred, plus a loss of \$8,802.

Year	Age	Insurance Gain	Interest and Service Cost on Benefit	Benefit Gain/ (Loss)	Comprehensive Income
1	50	\$-4,302	\$14,341		\$-18,642
2	51	-2,975	15,775		-18,750
3	52	-1,653	17,316		-18,969
4	53	-278	18,973		-19,251
5	54	1,090	20,751		-19,662
10	59	8,714	31,782		-23,068
15	64	17,228	47,323		-30,095
20	69	40,062	24,244	-8,802	7,017
25	74	52,291	28,187	-16,822	7,282
30	79	71,168	32,189	-32,109	6,870
35	84	101,522	35,920	-60,337	5,265
36	85	-529,930		732,249	202,319
	Sum	\$731,856	\$997,942	\$266,086	0

Because life insurance asset accounting is ineligible for delayed recognition of gains, immediate recognition of the benefit losses creates the smoothest pattern of net income.

Example 19: This example contrasts the results of an insured arrangement with delayed recognition, a self-insured arrangement with delayed recognition, and either arrangement with immediate recognition. Results at retirement are identical and no amortization of gains and losses is assumed. The insured arrangement with delayed recognition of actuarial losses results in the highest postretirement net income. The self-insured arrangement with delayed recognition of actuarial gains results in the lowest postretirement net income. Immediate recognition under either approach results in the smoothest effect on net income. The ultimate effect on owners' equity is zero, which is consistent with the company's recovery of its premium outlays (without interest) through death proceeds.

Year	Age	Insured Arrangement with Delayed Recognition	Self-Insured Arrangement with Delayed Recognition	Immediate Recognition	
15	64	\$(337,642)	\$(337,642)	\$(337,642)	Cumulative Net Income
16	65	11,856	(520)	6,407	Net Income
21	70	17,093	(2,187)	7,144	Net Income
26	75	26,367	(5,657)	7,287	Net Income
31	80	43,263	(11,033)	6,631	Net Income
35	84	65,602	(16,798)	5,265	Net Income
		\$263,844	\$(468,012)	\$(202,319)	Cumulative Net Income
		(466,163)	265,693	0	Accumulated OCI
		\$(202,319)	\$(202,319)	\$(202,319)	Cumulative Effect on Owners Equity
36	85	(529,930)	470,070	202,319	Effect of Death on Net Income
		\$(266,086)	\$2,058	\$0	Cumulative Net Income
		266,086	(2,058)	\$0	Accumulated OCI
		\$0	\$0	\$0	Cumulative Effect on Owners Equity

To summarize, insured arrangements and self-insured arrangements have the same assets, liabilities, and comprehensive income. Without delayed recognition of benefit gains and losses, all comprehensive income is reflected in net income. When insured arrangements and self-insured arrangements recognize benefit gains and losses immediately, net income is the same. Only the insurance gain and benefit expense elements of net income differ. The obvious complexity of accounting for an insured agreement to maintain a policy combined with the lack of any clear difference in accounting result raises doubts about the wisdom of using such methodology. The simplicity of using the methodology for agreements to pay a benefit is far simpler, at least for actuaries who are already familiar with postretirement benefit accounting.

JOURNAL ENTRIES

For companies that insist on using the methodology for insured arrangements, the following examples illustrate journal entries during lifetime and at death.

Example 20: Policy year 16 of example 14 reflects a cash value increase from \$575,763 to \$596,539 with no premium. The APBO increases from \$425,905 to \$440,273, reflecting 5% interest and adjusted COI incurred of \$12,376.

CSV	\$20,776	
Insurance gain		\$20,776
<i>Adjust CSV to actual</i>		
APBO	\$12,376	
Insurance gain		\$12,376
<i>Adjust benefit liability and insurance gain to reflect adjusted COI</i>		
Interest on APBO	\$21,295	
APBO		\$21,295
<i>Record interest on APBO at 5%</i>		
Actuarial loss	\$5,449	
APBO		\$5,449
<i>Adjust APBO to reflect incurring adjusted COI for an increased expected age at death</i>		

Example 21: Policy year 36 of Example 14 assumes death. Company A recovers its premiums of \$487,500 and loses its

cash value asset of \$1,017,430. The APBO at death is \$732,249. The benefit paid to the executive's beneficiary is \$1,000,000.

APBO	\$732,249	
Actuarial gain		\$732,249

Record actuarial gain when death eliminates expectation of future adjusted COI charges.

Cash	\$487,500	
Cash value loss	\$529,930	
CSV		\$1,017,430

Record receipt of the company's share of the split-dollar death proceeds

Note that the net effect of the \$732,249 actuarial gain and the \$529,930 cash value loss is a gain of \$202,319. This is the same amount as the gain assuming immediate recognition in Example 19.

SUMMARY

Agreements to maintain a policy are the most common type of postretirement split-dollar arrangement and require companies to accrue the "cost of the insurance policy." Applying the EITF's intended meaning of this term presumes an unusually high level of understanding of life insurance. The EITF's intended methodology is needlessly complex, which leads to differences in accounting policy and misunderstandings or "myths" about the appropriate accounting methodology. This article dispels the seven most common myths and supports the contention that accounting for an agreement to maintain a policy is substantially similar to the accounting for an agreement to pay a benefit. Therefore, we recommend that companies with agreements to maintain a policy follow the methodology for an agreement to maintain a benefit because of its relative simplicity for accountants and actuaries.

NOTES

1. Section 402 of the Sarbanes-Oxley Act of 2002 prohibits publicly-traded companies from providing personal loans to directors and executive officers. Certain types of split-dollar arrangements can be considered personal loans.

2. IRS Notice 2002-8 requires split-dollar arrangements that were not terminated before January 1, 2004, to be taxed either as loans or economic benefits. Earlier arrangements created the opportunity for income tax-free transfers of life insurance cash values to executives. Arrangements entered into or modified after September 17, 2003, are taxed under the less favorable Treasury Regulation §§ 1.61-22 and 1.7872-15.
3. Accounting changes are the focus of this article.
4. Some tax-exempt employers have begun to offer collateral assignment split-dollar arrangements as an alternative to IRC § 457(f) arrangements.
5. Paragraph 715-60-35-178.
6. EITF Issue No. 06-4, Issue Summary No. 1, Supplement No. 2, paragraph 7.
7. EITF Issue No. 06-4, Issue Summary No. 1, Supplement No. 2, paragraph 3.
8. EITF Abstracts, Issue No. 06-4, paragraph 5.
9. September 7, 2006, EITF Meeting Minutes, page 35, paragraph 11.
10. EITF Issue No. 06-4, Issue Summary No. 1, Supplement No. 2, Revised, uses the term “cost of insurance” no less than 18 times. *See* paragraphs 2, 16, 17, 18, 20, 31, and 32. *Also see* the description of View A’ just before paragraph 31. *Also see* the facts of Exhibit 06-4B and the sample journal entries for View A’.
11. EITF Issue No. 06-4, Issue Summary No. 1, paragraph 4, includes the following statement: “Appendix A includes an example of the terms of a typical endorsement type of policy.” The description of the life insurance policy in Appendix A includes the statement: “A single premium payment is made by the employer.”
12. Issue No. 06-4, Issue Summary No. 1, Supplement No. 2, Revised, paragraph 2.
13. EITF Issue No. 06-4, Issue Summary No. 1, Supplement No. 2, Revised, Exhibit 06-4B.
14. September 7, 2006, EITF Meeting Minutes, page 36, paragraph 13.
15. EITF Issue No. 06-4, Issue Summary No. 1, Supplement No. 2, Revised, paragraph 31.
16. Table 2001 is based on mortality experience for individuals covered by group term-life insurance during the 1985 to 1989 period, as reflected in a Society of Actuaries report. The rates were updated to reflect improvements in mortality through 2000, a 10% load factor, and a 50/50 blend of male and female rates.
17. IRS Notice 2002-8, section III, paragraph 3.
18. Paragraph 715-60-35-2.
19. Paragraphs 715-60-35-79 through 35-83.
20. No. 06-4, Issue Summary No. 1, Supplement No. 2, Revised, paragraph 32.
21. *Ibid.*
22. Section 715-60-20 (glossary).
23. *Ibid.*
24. Paragraph 715-60-35-68.
25. *Ibid.*
26. Paragraph 715-60-35-9.
27. Paragraph 715-60-55-27.
28. Paragraph 715-60-35-10.
29. Paragraph 715-60-35-11.
30. Paragraph 715-60-35-23.

31. Paragraph 325-30-35-2.
32. EITF Issue No. 06-4, Issue Summary No. 1, Supplement No. 2, Revised, Exhibit 06-4B.