Interagency Accounting Conference

Accounting Update: Bank Owned Life Insurance (BOLI) and Deferred Compensation Arrangements

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Presenters

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Topics

► Bank owned life insurance (BOLI) contracts
  ► Overview and common types to life insurance contracts
  ► Understanding the risks
  ► Recognition, initial and subsequent measurement, de-recognition, and presentation matters
  ► Illustrative examples

► Deferred compensation
  ► Overview and common deferred compensation arrangements
  ► Recognition and measurement
  ► Illustrative examples

Bank owned life insurance (BOLI) contracts
An introduction: Life insurance contracts

Entities purchase life insurance policies for a variety of purposes:

- Funding the cost of providing employee benefits (tax-free distributions and investment income)
- Protecting against the loss of key persons
- Receiving death benefits tax-free

Common types of life insurance contracts

- **Universal Life**
  - A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a very high cash surrender value. Alternatively, the policyholder can make minimal payments in an amount just large enough to cover mortality and other insurance charges.

- **Whole Life**
  - A traditional form of permanent insurance designed so that fixed premiums are paid for the entire life of the insured. Death benefit protection is provided for the entire life of the insured, assuming all premiums are paid.

- **“Term” Insurance**
  - Provides life insurance protection for a specified time period. Death benefits are payable only if the insured dies during the specified period. If a loss does not occur during the specified term, the policy lapses and provides no further protection.
Understanding the risks

- Board Oversight
- Pre-purchase review
- Policies and procedures
- Ongoing monitoring

Accounting for BOLI: Recognition and initial measurement

- An investment in a life insurance contract shall be reported as an asset. [ASC 325-30-25-1]
  - Election to account using either the investment method or the fair value method is irrevocable and made on an instrument basis

- Initial recognition

<table>
<thead>
<tr>
<th>Investment method</th>
<th>Fair value method</th>
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</thead>
<tbody>
<tr>
<td>Transaction price + initial direct external cost (e.g., legal costs)</td>
<td>Transaction Price</td>
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**Illustrative Example**: Assume Bank A purchase a group life policy on 20 executives on January 1, 2017. The entire policy was funded with an initial single premium of $10,000,000. Bank A incurred direct external costs of $45,000.

Dr. BOLI $10,045,000  
Cr. Cash $10,045,000

Dr. BOLI $10,000,000*  
Cr. Cash $10,000,000*

* Assumes premium approximates fair value
Accounting for BOLI: Subsequent measurement

An asset representing an investment in a life insurance contract shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position... [Excerpt from ASC 325-30-35-1]

► Subsequent measurement

<table>
<thead>
<tr>
<th>Investment Method</th>
<th>Fair Value Method</th>
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<tbody>
<tr>
<td>Determine the amount that could be realized under the insurance contract by evaluating the change in cash surrender value</td>
<td>Re-measure the investment at fair value</td>
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<tr>
<td>Recognize the change in cash surrender value in the period in which the changes occur</td>
<td>Recognize changes in fair value in earnings in the period in which the changes occur</td>
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<tr>
<td>Capitalize continuing costs (policy premiums and direct external costs, if any) to keep the policy in force</td>
<td>Expense continuing costs as incurred</td>
</tr>
<tr>
<td>Evaluate the asset for impairment</td>
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Illustrative example: Investment method (cont.)

At the end of the year, on December 31, 2x17 Bank A receives a statement from the insurance carrier indicating that the cash surrender value of the contract is $9,700,000. The statement also indicates that there are no claims stabilization reserves or surrender charges in the policy, but deferred acquisition costs that will be recouped from the insurance company are $25,000. The premium Bank A paid for the year was $1,000,000. Bank A liquidated a marketable security to pay for the premium.

Bank A records the following journal entry to record payment of the premium during the year:

Dr. BOLI 1,000,000
Cr. Marketable security 1,000,000

On December 31, 2x17, Bank A records the following journal entry to account for the change in cash surrender value since purchase of BOLI:

Dr. Non-interest expense (BOLI) 320,000*
Cr. BOLI 320,000*

Bank A's BOLI amount as of December 31, 2x17 would be $9,725,000, calculated as:

Cash surrender value 9,700,000**
Deferred acquisition costs 25,000

$9,725,000

* Calculated as $10,045,000 - $9,725,000
** Assumes the premium paid for the year is included in the cash surrender value as of year-end.
Accounting for BOLI: De-recognition

...It is not appropriate for the purchaser of life insurance to recognize income from death benefits on an actuarially expected basis. The death benefit shall not be realized before the actual death of the insured, and recognizing death benefits on a projected basis is not an appropriate measure of the asset. [Excerpt from ASC 325-30-35-1]

Illustrative Example: Investment method

Assume that Bank A was made aware of a policyholder’s death on January 1, 2x18. At the time, the policy for this employee had a carrying value of $486,250*. The insurance proceeds were $600,000**.

Bank A records the following journal entry to record the proceeds as of January 1, 2x18:

- Dr. Cash 600,000
- Cr. BOLI 486,250
- Cr. Non-interest income 113,750

* Calculated as 1/20 (1 of the employee) of BOLI’s carrying amount on 12/31/2x17
** Payout based on the insurance contract (face value)

Accounting for BOLI: Presentation matters

► Balance Sheet
  ▶ Investments measured at fair value should be disclosed separately from those accounted for under the investment method
  ▶ Typically disclosed in other assets

► Income Statement
  ▶ Investment method: Death benefits reported as non-interest income
  ▶ Fair value method: Both changes in fair value and premiums paid in the same line item of the income statement
  ▶ Typically disclosed as non-interest income/expense

► Cash Flow Statement
  ▶ Classify based on the nature and purpose for which the insurance contract was acquired (i.e., investing or financing)
Deferred Compensation Arrangements: Overview

Entities enter into various forms of deferred compensation arrangements:

- Individual deferred compensation
- Deferred compensation contracts with individual employees if those contracts, taken together, are equivalent to a plan that provides pension or other postretirement benefits
- Termination indemnities (Postemployment benefits)
Deferred Compensation Arrangements:
Scoping and Accounting Framework

- **Retirement Plan**
  - Follow the accounting guidance in ASC 715-30 (defined benefit pension) or ASC 715-60 (defined benefit other postretirement) plans—Example SERP

- **Postemployment Plan**
  - Most likely a contractual termination benefit pursuant to a plan
  - Follow ASC 712-10-25 by reference to ASC 710-10-25-1

- **Individual Arrangement**
  - Follow ASC 710-10-25-9

Deferred Compensation Arrangements:
Compensation General

- In general, ASC 715-10-25-1 requires that an employer recognize a cost and a liability for employee's compensation, if it meets all the following conditions:
  - The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered.
  - The obligation relates to rights that vest or accumulate.
  - Payment of the compensation is probable.
  - The amount can be reasonably estimated

Note: Vested rights are those for which the employer has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee's future service. Accumulate means that earned but unused rights to compensated absences may be carried forward to one or more periods subsequent to that in which they are earned, even though there may be a limit to the amount that can be carried forward.
Individual Deferred Compensation Arrangements: Recognition

► ASC 715-10-25-9 requires that to the extent the terms of the contract attribute all or a portion of the expected future benefits to a period of service greater than one year, the cost of those benefits shall be accrued over that period of the employee's service in a systematic and rational manner.

Individual Deferred Compensation Arrangements: Measurement and Attribution

► ASC 715-10-30-1 requires that the amounts to be accrued periodically under paragraph 710-10-25-9 shall result in an accrued amount at the full eligibility date equal to the then present value of all of the future benefits expected to be paid.

► For payments over the life of individuals, the estimates shall be based on the life expectancy of each individual concerned (based on the most recent mortality tables available) or on the estimated cost of an annuity contract rather than on the minimum payable in the event of early death.
Individual Deferred Compensation Arrangements: Attribution Examples

Example 1: Nonvesting Deferred Compensation Contract

Facts: An employer's deferred compensation contract does not provide a vested benefit for employees' prior service at the date the contract is entered into. Employees must render 30 years of service to receive benefits under a deferred compensation contract. An employee has rendered 16 years of service at the date of entering into the contract. Credit is granted for that prior service in determining eligibility for the benefit to be provided.

Response: The employer should accrue the total obligation under the deferred compensation contract in a systematic and rational manner over the employee's future service period to the date full eligibility for the benefits is attained, that is, over the next 14 years. If the employee is eligible to receive a portion of the benefits without regard to future service, that is, the credit for prior service results in a vested benefit, the obligation for that benefit should be fully accrued at the time the contract is entered into.

Example 2: Contract Provides Retroactive Benefits

Facts: An entity enters into a contract with a 55-year-old employee who has worked 5 years for the entity. The contract states that in exchange for past and future services and for serving as a consultant for 2 years after the employee retires, the entity will pay an annual pension of $20,000 to the employee, commencing immediately upon the employee's retirement. It is expected that the future benefits to the employer from the consulting services will be minimal.

Response: The actuarial present value of a lifetime annuity of $20,000 that begins at the employee's expected retirement date is accrued at the date the contract is entered into because the employee is fully eligible for the pension benefit at that date.
Individual Deferred Compensation Arrangements: Attribution Examples

► Example 3: Contract Provides Retroactive Benefits

► Facts: Assume the same terms as in Example 2, but the contract states that the employee is entitled to the pension benefit only if the sum of the employee's age and years of service equal 70 or more at the date of retirement. Consequently, the employee would be fully eligible for the pension benefit at age 60, after rendering 5 more years of service.

► Response: The actuarial present value of a lifetime annuity of $20,000 that begins at the expected retirement date would be accrued in a systematic and rational manner over the 5-year period from the date the contract is entered into to the date the employee is fully eligible for the pension benefit.
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Tai is a partner in EY’s National Professional Practice group. He consults with clients and engagement teams on accounting matters relating to several topics, including share based payments, pension and other post retirement and post-employment benefits. He is also the Global Firm leader on matters relating to first-time adoption of IFRS and a member of the Firm’s subject matter groups dealing with matters relating to accounting for compensation arrangements.

Tai also serves in quality assurance roles on many of EY’s foreign private issuer clients that are registered with the U.S. Securities & Exchange Commission, by providing support on a variety of registration related topics, including matters related to USGAAP, IFRS and PCAOB standards.

Prior to joining EY in June 2002, Tai was an assurance partner in the New York office of Arthur Andersen LLP, where he worked on audits of clients in several industries, including oil & gas, telecommunications, pharmaceuticals and media & entertainment.

Tai graduated from St. John’s University, Jamaica, New York with a B.S. in Accounting (Magna Cum Laude) and is a New York State licensed CPA. He is a member of the AICPA and the NYSSCPA. He served on the Advisory Board of the NYSSCPA Career Opportunities and Advancement Program and on the AICPA Diversity and Inclusiveness Committee.

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Vangjola is a senior manager in EY’s Professional Practice group in New York. Vangjola provides technical assistance on accounting issues, with a particular focus on banking and financial instruments. She supports bank audit teams across the country in the application of accounting and auditing matters.

Prior to joining professional practice, Vangjola was a Professional Accounting Fellow at the Office of the Comptroller of the Currency (OCC). In her role she led OCC’s efforts on interpreting the new credit impairment standard and developing supervisory expectations regarding its implementation. Vangjola represented the OCC on various Basel Committee on Banking Supervision subgroups.

Vangjola started her career in the Cleveland office of EY’s Banking and Capital Markets practice providing assurance and related services to banks, asset management funds, and not-for-profit organizations. She later transferred to the Chicago office to focus on community bank audits.

Vangjola is a graduate of Baldwin-Wallace University, a Certified Public Accountant in the State of Ohio and Illinois, and a member of the American Institute of Certified Public Accountants.
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Dom is a partner in EY’s National Professional Practice group with approximately 25 years of experience serving financial services clients. His responsibilities focus on the banking industry and include providing accounting, auditing and reporting guidance to EY’s financial services engagement teams and clients. Prior to joining professional practice, Dom spent most of his time with EY delivering assurance and advisory services to financial services clients, including leading companies in the banking, asset and wealth management, broker/dealer and asset servicing industries. Dom is a member of the AICPA’s Depository Institution Expert Panel.

Dom’s career took him to Zurich, Switzerland from 2004 through 2011. While in Europe, Dom provided assurance and advisory services to some of EY’s largest global financial services and industrial clients and was a director in the EY Capital Markets group with responsibility for cross-border debt and equity transactions.

Dom holds a MBA in Finance from the Stern School of Business at New York University and a Bachelor of Science in Accountancy from the State University of New York at Albany. He is a Certified Public Accountant in the State of New York.