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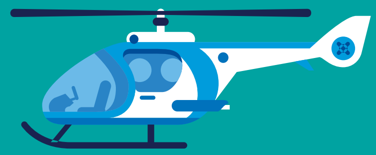


Defining Issues®

FASB changes long-duration insurance accounting model

August 17, 2018

KPMG reports on ASU 2018-12, which changes how insurance entities recognize, measure, present and disclose long-duration contracts.[1]

Applicability

Insurance entities in the scope of US GAAP guidance on accounting for long-duration contracts, excluding holders of insurance contracts and non-insurance entities.[2]

Key facts

The standard made these primary changes to the accounting for long-duration contracts.

- **Liability for future policy benefits for nonparticipating traditional long-duration and limited-payment contracts.** Review cash flow assumptions at the same time every year, and update if there is a change, unless experience suggests more frequent updates. Use an upper-medium grade (low-credit risk) fixed-income instrument yield for the discount rate and update each reporting period.
- **Market risk benefits.** Measure all market risk benefits at fair value.
- **Deferred acquisition costs.** Amortize deferred acquisition costs (DAC) on a constant level basis over the expected term of the related contracts.
- **Disclosures.** Improve the disclosures for liability for future policy benefits, policyholder account balances, market risk benefits, deferred acquisition costs, and separate account assets and liabilities.
- **Effective date.** Annual and interim periods beginning after December 15, 2020 for public business entities. For all other entities, annual periods beginning after December 15, 2021 and interim periods beginning after December 15, 2022. Early adoption is permitted.
- **Transition.** Apply the standard to contracts in force as of the beginning of the earliest period presented. Retrospective application is allowed.

The standard introduces new data requirements, and may require significant changes to systems, processes and internal controls. The pattern of earnings for long-duration contracts will change and will affect financial performance indicators and profitability analysis. Insurances entities with long-duration contracts should begin to analyze how the standard will affect them.

Liability for future policy benefits

The standard changes the accounting for nonparticipating traditional long-duration and limited-payment contracts, but did not change the accounting for the liability for participating contracts.

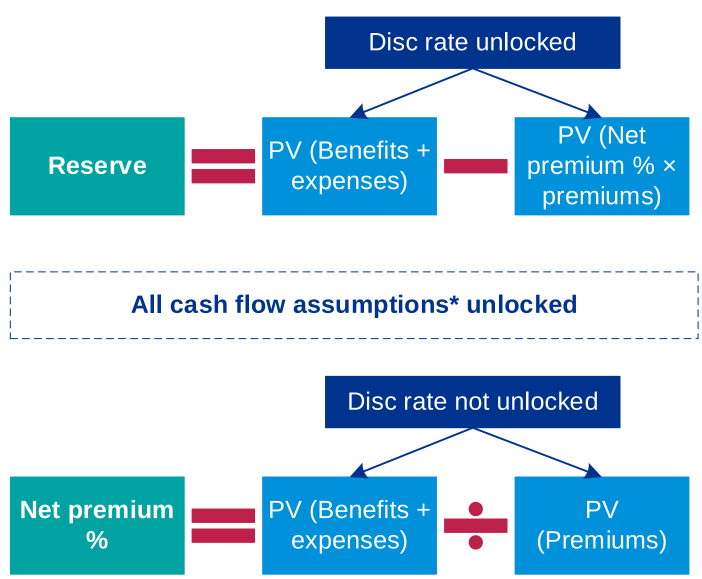
1 ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts

2 ASC 944, Financial Services – Insurance

Current US GAAP	New standard
Cash flow assumptions, including a provision for risk of adverse deviation, are locked in at contract issuance and not updated unless a premium deficiency exists.	— Cash flow assumptions are reviewed annually at the same time every year, or more frequently if suggested by experience. If assumptions are changed, updates are made using a catch-up method for the net premium ratio with changes recorded as a component within benefit expense as a separate line item or parenthetically in the statement of operations. — Assumptions should not include a provision for risk of adverse deviation.
Premium deficiency analysis required.	Premium deficiency analysis is no longer required, however the net premium ratio cannot exceed 100 percent.*
Cash flows are discounted using a locked-in expected investment yield.	Discount using a current upper-medium grade (low-credit risk) fixed-income instrument yield (updated each reporting period) with the effect of rate changes recorded in other comprehensive income.

* When the net premium ratio exceeds 100 percent, net premiums are set equal to gross premiums and the liability for future policy benefits is increased with a corresponding charge to net income in the current period.

Net premium model



*Expense assumptions should be updated consistently with the standard's new methodology used for other cash flow assumptions, unless an entity-wide election is made to not update the expense assumption.

This remeasurement calculates a revised net premium ratio as of contract inception using actual historical experience and updated future cash flow assumptions. To calculate reserves, an insurance entity cannot group contracts together from different issue years but can group into quarterly or annual groups. The liability should never be less than zero for the level of aggregation used to calculate reserves.

For the discount rate, an upper-medium grade (low-credit) fixed-income instrument yield is generally considered an A rating, and an insurance entity is required to:

- maximize the use of relevant observable inputs and minimize the use of unobservable inputs;
- use reliable information that reflects duration characteristics of the liability for future policy benefits; and
- use the original discount rate as the interest accretion rate.

KPMG observation

Data requirements will increase as actual historical financial data are needed to calculate the net premium ratio using the catch-up method.

The contract grouping decision will be a key decision when implementing this standard. Therefore, insurance entities should begin analyzing how these changes will affect their actuarial models.

With the discount rates on investments and reserves no longer connected, the asset liability management discount rate may not be consistent with the discount rate used in the reserve calculation.

Income statement volatility is expected to increase due to the use of updated assumptions.

Market risk benefits

The standard creates a new term for certain contracts or contract features that provide for potential benefits in addition to the account balance. A contract or contract feature in a long-duration contract that protects the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk is a market risk benefit.

Current US GAAP	New standard
Some benefits are recorded at fair value as an embedded derivative and others follow the insurance benefit model.	— All market risk benefits associated with deposit (or account balance) contracts are measured at fair value. — Separately present changes in fair value on the statement of operations. However, changes in fair value attributable to a change in the instrument-specific credit risk of market risk benefits in a liability position are recorded separately in other comprehensive income.

In evaluating whether a contract or contract feature is a market risk benefit, the following items should be considered.

- Protection refers to the transfer of a loss in, or shortfall (i.e. the difference between the account balance and the benefit amount) of, the contract holder's account balance from the contract holder to the insurance entity, with the transfer exposing the insurance entity to capital market risk that would otherwise have been borne by the contract holder (or beneficiary).

- Protection does not include the death benefit component of a life insurance contract (i.e. the difference between the account balance and the death benefit amount). This condition does not apply to an investment contract or an annuity contract (including an annuity contract classified as an insurance contract).
- A nominal risk is a risk of insignificant amount or a risk that has a remote probability of occurring. A market risk benefit is presumed to expose the insurance entity to other-than-nominal capital market risk if the benefit would vary more than an insignificant amount in response to capital market volatility.

Determining whether a contract or contract feature meets the definition of a market risk benefit requires judgment. If a contract includes multiple market risk benefits, those benefits should be aggregated as a single compound market risk benefit.

When a contract includes benefits in addition to the account balance, an insurance entity needs to assess what the appropriate accounting treatment should be using the guidance in the standard at contract inception. The insurance entity should determine, in the following order, what features should be accounted for as:

- market risk benefits;
- derivatives; or
- death, annuitization or other insurance benefits.

KPMG observation

Market risk benefits include all types of guaranteed minimum benefits in variable annuity separate accounts and general account annuities (e.g. guaranteed minimum death, withdrawal, withdrawal-for-life, accumulation and income benefits).

Some of these features are not currently recorded at fair value (e.g. guaranteed minimum death benefits). Insurance entities should begin to assess whether contract features meet the definition of a market risk benefit.

DAC amortization

The standard simplifies the amortization of DAC for long-duration contracts, except certain investment contracts. The amortization method should be applied consistently over the expected term of the related contracts, and should not be a function of revenue or profit emergence.

Current US GAAP	New standard
Various amortization models are used and linked to revenue or profit of the related insurance contracts (e.g. premiums, gross profits or gross margins).	Amortized on a constant level basis, either on an individual contract basis or on a grouped contract basis, over the expected term of the related contracts.
Interest accrues to the unamortized balance of DAC at the rate used to discount expected gross profits.	No accrual of interest on the unamortized balance of DAC.
Adjustments are made for the effect of investment performance or changes in expected future liability cash flows (shadow adjustments).	No shadow adjustments.
Evaluated for impairment.	Written off for unexpected contract terminations but are not subject to an impairment test.

The balance of DAC should be reduced for actual experience in excess of expected experience. The effect of changes in future estimates, such as revisions of mortality or lapse assumptions, should be recognized over the remaining expected contract term as a revision of the future amortization amounts.

Assumptions used to amortize DAC should be consistent with those used to estimate the liability for future policy benefits.

Amortization of DAC can be performed on an individual contract or group contract basis.

- Individual contracts are amortized on a straight-line basis.
- Group contracts are amortized on a constant level basis that approximates straight-line amortization on an individual contract basis.

The grouping of contracts should be consistent with the grouping used to calculate the liability for future policy benefits for the corresponding contracts.

KPMG observation

The new standard does not define constant level basis. Therefore, insurance entities will need to develop processes and measures to amortize DAC.

Insurance entities that amortize balances such as the value of business acquired, present value of future profits and costs of reinsurance consistent with DAC will need to assess whether amortizing these balances consistent with DAC remains appropriate.

Enhanced disclosure requirements

Insurance entities will need to disclose quantitative information in rollforwards for balance sheet accounts as well as information about significant inputs, judgments, assumptions and methods used in measurement. The table describes the new disclosures.

Disclosure	Description
Balance rollforwards for the liability for future policy benefits, policyholder account balances, market risk benefits, separate account liabilities and deferred acquisition costs.	Disaggregated tabular rollforwards reconciled to the balance sheet.
Measurement assumptions or inputs.	Information about significant inputs, judgments, assumptions and methods used in measurement, including the technique used to determine unobservable discount rates.
Other items.	Information about gross premiums, gross benefits, actual deviations from expected experience, crediting rates and the methodology and results of premium deficiency testing for universal life-type and participating insurance contracts.

The disclosure changes introduce a principle for determining how to disaggregate the new disclosures. The intention is to provide meaningful information without including a large amount of insignificant detail or aggregating items with significantly different characteristics. An insurance entity cannot aggregate amounts from different reportable segments.

KPMG observation
The new standard will require insurance entities to determine whether they need new financial data, and whether they should update their processes and internal controls to manage the expanded disclosures. They will also need to determine what level of disaggregation should be used for the disclosures. The added work required for the expanded disclosures will need to be considered in planning the financial reporting timeline.

Effective dates and transition

	Public business entities	All other entities
Annual periods – Fiscal years beginning after	December 15, 2020	December 15, 2021
Interim periods – In fiscal years beginning after	December 15, 2020	December 15, 2022
Early adoption allowed?	Yes.	
Transition method		
Liability for future policy benefits*	Apply to contracts in force as of the beginning of the earliest period presented. May elect to apply retrospectively.	
Market risk benefits	Retrospective at the beginning of the earliest period presented.	
Deferred acquisition costs*	Apply to contracts in force as of the beginning of the earliest period presented. May elect to apply retrospectively.	
*The transition method used for the liability for future policy benefits and deferred acquisition costs should be the same.		

Liability for future policy benefits

Insurance entities will apply the standard to all nonparticipating long-duration and limited-payment contracts in force using existing carrying amounts at the transition date. They will adjust the contracts to remove related amounts in accumulated other comprehensive income. The standard defines the transition date as the beginning of the earliest period presented.

The standard requires the discount rate assumption that was used to calculate the liability immediately before the application of the standard to be used to calculate the ratio of net premiums to gross premiums at transition and interest accretion in future periods.

The liability for future policy benefits on the balance sheet is remeasured using the current upper-medium grade (low-credit risk) fixed-income instrument yield to determine the adjustment to opening accumulated other comprehensive income at the transition date.

The standard provides an option to apply the guidance retrospectively, with a cumulative adjustment to opening retained earnings. However, limited availability of historical information may limit when retrospective application can be used.

If the guidance is applied retrospectively, insurance entities are required to use the:

- same contract issue-year level on an entity-wide basis for that issue year and all subsequent issue years; and
- actual historical experience information (cannot use estimates of historical experience).

The grouping of contract issue years is based on the original policy issue date and cannot be in a combined grouping that includes all contracts issued before the effective date. For acquired contracts, the acquisition date should be considered the original contract issue date.

Market risk benefits

The accounting for market risk benefits should be applied on a retrospective basis at the beginning of the earliest period presented. The difference between fair value and carrying amount at the transition date is recorded as an adjustment to beginning retained earnings.

However, the cumulative effect of changes in the instrument-specific credit risk between contract issue date and transition date is recorded in accumulated other comprehensive income.

Insurance entities should maximize the use of relevant observable information as of contract inception and minimize the use of unobservable information. If assumptions are unobservable or unavailable and cannot be independently substantiated, entities may use hindsight to determine these assumptions.

Deferred acquisition costs

Insurance entities will apply the standard to deferred acquisition costs using the existing carrying amounts at the transition date. The carrying amount will be adjusted to remove related amounts in accumulated other comprehensive income.

Similar to the liability for future policy benefits, an option exists to apply the guidance retrospectively, with a cumulative adjustment to opening retained earnings.

The availability of historical information may limit the use of retrospective application for all issue years. The transition method and issue-year level used for deferred acquisition costs should be consistent with what was used for the liability for future policy benefits.

Contributing authors

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