



**Michael Monahan**  
Senior Director, Accounting Policy

October 25, 2013

Russ Golden, Chairman  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116

Re: Insurance Contracts Proposed Accounting Standards Update

Dear Mr. Golden,

The American Council of Life Insurers (ACLI)<sup>1</sup> welcomes the opportunity to provide comments on the FASB Insurance Contracts Proposed Accounting Standards Update (proposed ASU). We continue to support the development of a single high-quality global accounting standard for insurance contracts that improves existing U.S. guidance by eliminating product-specific accounting guidance; resolves the issue with the current mixed-attribute accounting model that results in accounting mismatches without real economic substance; improves the quality of information available to users; reduces complexity where possible, and does so at a reasonable cost. Unfortunately, the proposed ASU in its current form does not meet the Board's stated objectives described in paragraph 834-10-10-1 nor our view of a standard representing an improvement over existing U.S. generally accepted accounting principles (U.S. GAAP).

During the development of our response to the questions in the proposed ASU, we found that our deliberations focused around three overarching themes: complexity, convergence, and cost/benefit. Our comments incorporate views intended to reduce complexity, promote convergence with the International Accounting Standards Board (IASB), and reduce cost where the benefits do not justify the cost. We strongly recommend the FASB focus on these themes during the re-deliberation process.

### **Executive Summary**

We recognize the fact that existing U.S. GAAP for insurance contracts have evolved over many years as new insurance products and features have emerged. Those changes have resulted in multiple models that vary based on the nature of the insurance contract.

Having followed this project since its inception, we have offered specific and detailed comments throughout the process to assist the Board toward the development of an improved accounting standard

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<sup>1</sup> The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with more than 300 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American Families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 90 percent of industry assets and premiums. Learn more at [www.acli.com](http://www.acli.com).

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for insurance contracts. Consequently, ACLI believes that the Board needs to make significant changes and improvements in the following areas to achieve its objective. The balance of this letter details the areas requiring change along with our recommendations to improve the guidance in a way that could lead to an accounting standard supportable by the industry.

### **Accounting Mismatch**

A major concern of insurers is the accounting mismatch and reported volatility created by Statement of Financial Accounting Standards No. 115-*Accounting for Certain Investments in Debt and Equity Securities* adopted in 1993, whereby most financial assets are measured at fair value with insurance liabilities generally measured under a cost model. While the proposed ASU building block model, i.e., current fulfillment measurement approach, is a step toward reducing the accounting mismatch and related volatility, we remain concerned that the proposed ASU, in combination with the recently proposed changes to classification and measurement criteria in the financial instruments exposure draft, is not sufficient to fully eliminate accounting mismatches. Specifically, the accounting guidance for financial instruments and insurance contracts should allow reporting entities the ability to align the measurement of financial assets with the measurement of insurance liabilities to minimize the effects of any accounting mismatch.

### **Setting the Discount Rate**

The development of the yield curve and setting the discount rate for the measurement and reporting of insurance contract liabilities is critical. Our concerns are twofold. First, using discount rates that are consistent with “observable current market prices” could result in significant accounting volatility in equity and earnings when long-term interest rates change near or beyond the end of the observable yield curve. An example or explicit guidance to address credit spreads is recommended.

Second, the development and application of the discount rate to measure interest expense attributable to the insurance liability must not contribute to an accounting mismatch. We agree that an entity should segregate the effects of the underwriting performance from the effects of changes in discount rate. To accomplish that and minimize accounting mismatches, the classification and measurement of financial assets and insurance liabilities need to be aligned such that amounts reported in earnings and other amounts reported in other comprehensive income represent an understandable distinction between management performance and market influences.

### **Lock-in of the Margin**

The FASB proposed ASU states that the margin shall not be adjusted, i.e., locked in, when there are changes in estimates of cash flows. Our recommendation is that the margin should be unlocked when the change in estimates affect the future estimate of cash flows in order to be consistent with the building block model and the purpose of the margin, which is to represent the unearned profit.

### **Presentation**

We do not support the proposed ASU requirement to present insurance contract revenue in the financial statements, nor exclude any amounts received that an entity is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs and excluding from expenses the corresponding repayment of those amounts. Our view is that the proposed guidance for reporting insurance contract revenue masks important information about the source of earnings; is an artificial calculation that does not achieve the intended outcome, i.e., comparable information with other industries, and does not provide meaningful information to users. Our recommendation is to disaggregate information, which we refer to as the building block elements (BBE) presentation view that would provide a very transparent presentation of the actual fulfillment cash flows, the fulfillment cash

flows expected in the period, as well as the other changes in fulfillment cash flows in the period, along with the amount of margin recognized and the impact of the unwinding of the discount rate in the period.

We also recommend changes to the definition and application of “estimated returnable amount”, which we believe is overly complex and does not enhance the usefulness of the information resulting from its application.

### **Transition/Effective Date**

While we support the retrospective application in the proposed ASU, because of the long-term nature of many insurance products, greater flexibility and use of the practical expedient is needed. It is impracticable and costly to go back in time 30-40 years or more only to discover that the entity cannot get “objective information” to determine the margin. A zero margin on in-force business is not an acceptable outcome. Our response to the questions on transition provides our recommendation for ways to improve transition.

Because of the fundamental change in accounting for nearly every insurance product, this guidance would go well beyond mere changes in accounting and financial reporting processes of other accounting standards. The effects would be deep and far reaching within almost every area of a company’s operations. Therefore, we believe that this standard should be effective for public companies no earlier than the first fiscal quarter of the first annual period beginning four years after the issuance of a final standard – in other words, the quarter ended March 31, 2019 if a final standard is issued by December 31, 2014.

### **Convergence**

The FASB and IASB have worked together in an effort to achieve a single global standard for insurance contracts. However, there remain significant differences in many areas related to elements of measurement and presentation. In our opinion, in order to create a single high-quality insurance standard, convergence in the following areas is essential.

- **Single margin vs. dual margin** - The choice between the FASB single margin and the IASB risk adjustment/contractual service margin should be made taking into account complexity, usefulness of the information, and cost.
- **Unlocking the margin** - While unlocking the margin has the effect of increased cost and complexity, the advantage – which we believe is significant especially for users – is that the unlocked margin provides a faithful representation of the unearned profit, which furthers an understanding of the financial statements and contributes to comparability.
- **Decomposition of cash flows** - The proposed bifurcation of cash flows is overly complex, costly to implement and maintain with little, if any, benefit. The conceptual desire for precision does not ensure a better estimate. The result will remain an estimate with full knowledge that actual results will differ.
- **Discount rate used to measure interest expense in profit or loss** - The implementation guidance is overly prescriptive and does not always provide relevant information. Greater flexibility is needed in the methods and techniques available in the development of the yield curve and discount rates especially where there is limited observable information.
- **Acquisition costs** - Different definitions and the requirement to capture and amortize these costs will not only result in different earning patterns, the increased cost is not justified especially when there is an opportunity to eliminate the burden of the existing deferred acquisition cost model.

- **Investment component** - The different definitions and application for disaggregation is unworkable in its present form. A fresh start is likely needed in this case.
- **Transition** - While the retrospective approach is conceptually sound, a practical expedient is necessary to reduce the cost of implementation and produce a margin on the in-force business that has some degree of comparability to new business being written.

In addition, we are offering an alternative to the proposed presentation of amounts within the statement of comprehensive income, along with changes to the disclosure requirements and recommendations described in our response to the questions, to address industry concerns.

## Conclusion

Companies that issue insurance contracts serve as long-term stable investors in corporate debt, support the consumer financial and housing markets, and protect individuals' financial security. The impact that the proposed insurance contract accounting could have on long-duration insurance products, such as life insurance, long-term care insurance and income for life guarantees, which decrease financial burdens on the public sector, could be significant.

Failure to satisfactorily address our concerns in the areas noted above and to arrive at a standard that is substantially converged could result in final guidance that is not an improvement over existing U.S. GAAP. The costs associated with implementing the guidance would not justify the perceived benefit to financial statement preparers, users, and analysts. Not only will there be significant unnecessary costs to the industry, there would likely be an increase in the cost of capital caused by the difficulty users and analysts will have understanding the financial performance of reporting entities as they struggle to decide which reporting basis is best.

Unless substantial changes to the proposed ASU consistent with the views expressed herein are made to arrive at a final standard, some member companies would recommend that FASB take a targeted approach to improve U.S. GAAP for insurance contracts without replacing the entire model. Given this level of concern, we strongly encourage the FASB and IASB to jointly make the needed changes and resolve their differences to arrive at a single high-quality accounting standard for insurance contracts.

Finally, we encourage the Board to give serious consideration to the formation of a group consisting of FASB staff, preparers, auditors, and analysts to address issues and questions that, no doubt, will be raised as companies begin the process of implementing the new accounting standard for insurance contracts. We welcome the opportunity to continue working with the Board during the re-deliberation process on this important matter.

Sincerely,



Michael Monahan  
Senior Director, Accounting Policy

### **FASB Question 1**

#### *Questions for All Respondents*

Question 1: Do you agree with the scope and scope exceptions of this proposed guidance, including its applicability to contracts written by noninsurance entities? If not, what types of contracts or transactions also should be included or excluded from the scope and why?

#### **ACLI Response:**

Yes, we support the scope of the proposed guidance, which applies to all entities that issue insurance contracts as defined unless those contracts are specifically excluded from the scope of the proposed guidance. However, we do not believe the scope of the insurance contract standard (i.e., insurance contracts vs. insurance entities) inhibits the development of comprehensive accounting guidance (i.e., classification and measurement for financial instruments and insurance contracts) that reflects the long-term nature of the insurance business and addresses the linkage between assets and liabilities in financial reporting.

Please also see our response to Question 16 for additional discussion on this topic.

Lastly, we noted that warranties issued by a manufacturer, dealer, or retailer are scoped out of insurance and would be within the scope of the proposed *Revenue from Contracts with Customers* guidance. It is unclear how warranty contracts issued by an insurer would be accounted for under the proposed guidance. Since the coverage period for many warranty contracts is greater than one year (3 to 5 years or more), some companies and auditors may take the view that these contracts should be measured using the building block model while others may apply the PAA model in accordance with paragraph 834-10-25-18b. We recommend that the Board scope out all warranty contracts so that there is no ambiguity and there is consistency with manufacturers, dealers and retailers.

#### ***Recognition***

### **FASB Question 2**

#### *Questions for All Respondents*

Question 2: Do you agree with the requirements included in this proposed Update for when noninsurance components of an insurance contract, including embedded derivatives, distinct investment components, and distinct performance obligations to provide goods or services, should be separately accounted for under other applicable Topics? If not, why?

#### **ACLI Response:**

We support the requirements in the proposed guidance that appropriately limits the “unbundling” of embedded derivatives, distinct investment components, and distinct performance obligations to provide goods or services that would require separate accounting under other applicable Topics. We agree with the indicators in 834-10-25-3, which specifies when an investment component is not distinct.

While we support the criteria for the unbundling of embedded derivatives, we believe the proposed guidance does not adequately address the issue of inconsistency that exists today under U.S. GAAP with respect to the identification of embedded derivatives. Although the proposed guidance points to Subtopic 815-15 for the identification of embedded derivatives, there are certain ambiguities within the guidance that result in diversity in practice across industry on the treatment of certain types of options and guarantees. This is particularly true for GMXB type riders on variable annuities and Guaranteed Minimum Withdrawal Benefits for Life riders. We recommend that the Board further clarify the application of Subtopic 815-15 as it applies specifically to insurance riders such as these so as to promote comparability and consistency across reporting entities. This will enhance the understanding of financial statements by users. The proposed guidance on embedded derivatives also impacts reinsurance related to business ceded on a modified coinsurance basis. Currently, the FASB has

treated these reinsurance agreements as having an embedded derivative that should be separated from the rest of the agreement. There is also a provision that allows companies to choose to value the assets associated with the policies involved in the modified coinsurance agreement at fair value. This option has been removed in the proposed guidance. We believe that in order to match the measurement basis of two related items and have a financial statement that is more understandable to analysts, it will be necessary to restore the option to allow companies to fair value the affected assets.

While we support the criteria for unbundling distinct performance obligations to provide goods or services, there is confusion among ACLI member companies surrounding when/if “asset management services” need to be unbundled and accounted for under other Topics. We do not support the unbundling of asset management fees because they are closely related to the insurance contract and suggest that the FASB clarify that asset management fees should not be separated for contracts such as variable annuities, where fees are the principle source of cash inflows and an integral component of the insurance contract.

### *Initial and Subsequent Measurement*

#### **FASB Question 3**

##### *Questions for Users*

Question 3: Will the proposed measurement model produce relevant information that will help users of an entity’s financial statements make economic decisions? If not, what changes do you recommend and why?

#### **ACLI Response:**

Since the insurance industry, with over \$5 trillion in invested assets, is a user of financial statements as a source of information in making investment decisions, we offer the following comments. We support the principle of the building block approach for insurance contracts, i.e., fulfillment cash flows model, as well as the premium allocation approach for those contracts meeting the requirements. We believe that explicit measurement of the cash inflows and outflows along with an explicit margin should provide more relevant and useful information to all users of the financial statements since it focuses on the core elements of insurance. The nature of insurance is about the transfer of insurance risk, e.g., mortality, morbidity, and risk of loss, from the policyholder to the insurer and risk management strategies of the insurer. That is what distinguishes insurance from other financial instruments.

While we support the principles of the building block approach, we have significant concerns about the details described in the proposed ASU as well as differences in measurement and presentation between the FASB and IASB. The added complexity, e.g., the prescriptive nature of the implementation guidance, and the methodology surrounding the development and application of the discount rate (yield curve), causes us to pause and ask whether the proposed ASU is in fact an improvement. Unless significant changes are made to the proposed ASU that address the issues noted in this letter along with changes that result in a significantly converged standard with the IASB, the cost to implement the proposed ASU will outweigh any perceived benefits.

Specific areas where changes are needed to achieve the Board’s objective of a high quality standard for insurance contracts include but are not limited to the following: unlocking the margin, investment component, bifurcation of cash flows, presentation, and resolution of differences in guidance related to a single margin or two margin approach, acquisition costs, and discount rates. Our responses to the questions posed in the proposed ASU provide details about our concerns. Our comments throughout this letter reflect our views as preparers and users of financial statements.

**FASB Question 4**

Question 4: Which aspects of the proposed measurement model most significantly improve the information that will be used in making economic decisions and why?

**ACLI Response:**

As noted in our response to Question 3, explicitly measuring cash inflows, outflows, and an explicit margin, reflecting current assumptions, i.e., current fulfillment value, along with the roll forward of the beginning to ending balances for the reporting period should enhance the quality of the information available to users in making economic decisions. The presentation model proposed for the statement of comprehensive income, however, does not provide useful information and masks important activity reflected by the changes occurring in the period. Incorporating the presentation approach proposed by the ACLI (see our response to Question 34), we believe, not only will enhance the usefulness of information but it will also provide a clear linkage between amounts reported on the balance sheet and information presented in the statement of comprehensive income. If the only significant benefit in the proposed ASU is the conceptual building block model, we believe that this benefit could be achieved with targeted changes to existing U.S. GAAP by unlocking assumptions.

***Measurement Approaches*****FASB Question 5**

*Questions for All Respondents*

Question 5: Do you agree that entities should apply different approaches to contracts with different characteristics, described as the building block approach and the premium allocation approach? If not, which model do you think should apply and do you think there should be any changes made to that model?

**ACLI Response:**

We agree that entities should be allowed to apply different approaches, i.e., building block approach or the premium allocation approach, to contracts with different characteristics. However, the guidance should not mandate a certain approach as proposed. For example, a portfolio of contracts may be measured using the building block approach but a reinsurance contract associated with this portfolio may be more appropriately measured using the premium allocation approach. The proposed guidance would require that the reinsurance be measured using the building block approach, which we believe adds complexity and cost and does not reflect the economics of the reinsurance arrangement.

Please also see our responses to Questions 6 and 7.

**FASB Question 6**

Question 6: Do you agree that entities should be required to apply the premium allocation approach if the coverage period of the insurance contract, considering the contract boundary guidance, is one year or less? If not, what would you recommend and why?

**ACLI Response:**

The premium allocation approach should not be required. The reporting entity should have the flexibility to use the model that best reflects the nature of the insurance contract and the one providing information that best serves the needs of the users without the burden of extensive analysis for determination of whether the criteria for the premium allocation approach are met, or separate accounting for entities that primarily write business that is long-term in nature. It would therefore allow these companies to account similarly for contracts/products that are managed together.

The proposed guidance has a conflict between the requirement to use the same measurement approach for the underlying contract and the reinsurance ceded on that contract vs. the requirement to use the premium allocation approach if the contract coverage period is one year or less. This conflict arises, for example, when stop loss for 1 year is purchased to cover underlying contracts that are long term and therefore measured using the building block approach. Under the current guidance, a 1 Year Stop Loss reinsurance agreement covering such contracts is required to be measured using the premium allocation approach due to its duration, but also required to use the building block approach because of the measurement used for the underlying contracts. This conflict will be resolved by making the premium allocation approach optional for all contracts. There is no need to require the use of the same measurement approach for the underlying contract and the reinsurance ceded on that contract, so long as the assumptions used by the cedant are the same for valuing the underlying contract and the reinsurance ceded on that contract. The results should be similar.

**FASB Question 7**

Question 7: Do you agree that entities should be required to apply the premium allocation approach if, at contract inception, it is unlikely that during the period before a claim is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract? If not, what do you recommend and why?

**ACLI Response:**

No, the premium allocation approach should not be required under any circumstance. We believe an entity should have the option to apply the building block approach for those contracts where it is more appropriate given the nature of those contracts. The entity should be able to use the premium allocation approach where it is appropriate, provides useful information, and is understood by users especially for short-duration contracts, e.g., property and casualty, certain accident and health contracts, etc., but would not require extensive analysis for determination of which approach to use for entities that primarily write business that is long-term in nature. We don't believe there is room for abuse in providing this option to preparers of financial statements.

We believe the FASB should converge with the IASB and provide the option to use the premium allocation approach.

***Portfolio and Contract Boundary***

**FASB Question 8**

*Questions for Preparers and Auditors*

Question 8: Do you agree with the definition of a portfolio of insurance contracts as included in this proposed Update? If not, what do you recommend and why?

**ACLI Response:**

No. We have significant concerns with the FASB definition of a portfolio of insurance contracts and believe the concept of a portfolio should more appropriately center on contracts that are managed together as a single pool.

FASB Definition:

A group of insurance contracts that:

- (a) Are subject to similar risks and priced similarly relative to the risk assumed
- (b) Have similar duration and similar expected patterns of release from risk, that is, reduction in variability in cash flows.

Our concerns are as follows:

- “Similar risks” is not well defined and is subject to significantly different interpretation. We have noted different interpretations among companies, accounting firms, and members of the FASB/IASB staff. We suggest additional clarity by defining similar insurance risks. Additionally, the criteria of similar insurance risks may not be appropriate to all contracts, as it might require an entity to disaggregate contracts with optional riders dependent on whether the policyholder elected the optional rider, when the pricing of that group of contracts is managed together.
- “Priced similarly relative to the risk assumed” is being interpreted by some to suggest an undue level of granularity. For example, the profit margin on term life contracts for 20 year-olds and 60 year-olds are different and it has therefore been suggested that they would need to be in different portfolios. We do not believe this is appropriate, as these contracts, while priced differently, are all still managed together as a single pool by insurance companies. Further, there is no practical reason as to why they should be in different portfolios.
- “Have similar duration” also suggests a portfolio cannot include term life policies for 20 year-olds and 60 year-olds. Additionally, consider a group deferred annuity contract issued to a plan sponsor in support of a Defined Contribution benefit plan. Assuming that the contract allowed for individual participants to annuitize their accumulated account balance, the group annuity contract would be valued under the building block approach. Such a contract would cover both current and future eligible employees. Eligible participants would be allowed to make contributions into the group annuity contract on a regular periodic basis for years and potentially decades. It is unclear from the guidance whether it would be appropriate to consider all cash flows associated with such a group annuity contract as falling into one portfolio, or whether the cash flows for this one group annuity contract would need to be allocated amongst multiple portfolios.
- We also question the rationale for including the requirement that the contracts have “similar expected patterns of release from risk, that is, reduction in variability in cash flows”. Again, term life contracts for 20 year-olds and 60 year-olds will have different patterns of release of risk, and the language in the portfolio definition suggests they should not be included within the same portfolio. Because the margin will be recognized based on some measure of risk (for example, amount at risk), margin will be released appropriately regardless of the definition of portfolio and this criterion is not needed.

We propose the following definition, which would alleviate these concerns and still achieve the Board’s objective:

A group of insurance contracts managed together as a single pool. Indicators that the insurance contracts are managed together as a single pool includes insurance contracts that:

- Are subject to similar risks (e.g., mortality, morbidity, risk of loss, etc.), and
- Are priced appropriately relative to the risk undertaken.

We note that the FASB has not specified whether a portfolio is an “open” portfolio or a “closed” portfolio. We believe most companies and accounting firms are interpreting the definition to mean an “open” portfolio. This suggests that the definition of a portfolio only has an indirect impact on measurement as it is rarely, if ever, used in applying the standard. For example, because interest will be accreted on the margin at historical interest rates, insurance contracts will need to be tracked and measured on a more detailed level, such as a discrete period, or cohort level. Similarly, it is believed loss recognition testing is more appropriately performed on a closed portfolio or therefore cohort level. We believe our proposal, with this understanding, is more workable and also addresses the most significant aspects of the FASB’s concern that insurance contracts with expected losses would be offset with contracts with expected

gains and therefore companies would not recognize a day one loss. Further, the use of cohorts for loss recognition will result in a measurement of loss recognition that also prevents losses from inappropriately being offset against gains.

Adding the criteria “managed together as a single pool” (with indicators) will ensure entities do not disaggregate portfolios to a very low level that reduces the meaningfulness of the measured results. For example, a focus on pricing without consideration of how a company manages its business means the portfolios may not reflect the diversification strategies implicit in the business model of insurance. Diversification with respect to insurance obligations is typically achieved through writing a large portfolio of independent insurance contracts, across a number of different product lines, geographical areas or with varying risk characteristics (e.g., frequency/severity of claims). Accordingly, it may be appropriate and even necessary to group insurance contracts in a manner that allows some diversification to be reflected in the measurement result. Without the flexibility to group contracts according to how an entity manages its business, erroneous and misleading information may result from the application of the measurement guidance as proposed.

The law of large numbers indicates that the more voluminous the data is, the more reliable it is and the more weight can be given to it. Thus, the smaller the portfolio, the less reliable the data becomes. Further, the aggregated amount of risks within a product portfolio or at a company level may be smaller or less than the simple addition of the individual risks. If the entity cannot group contracts in a manner consistent with its business strategy, then the sum of the portfolios may not provide a meaningful result.

The Boards have indicated that they are substantially converged on the measurement of profit and that only the timing of profit recognition differs. However, we believe the FASB’s portfolio definition, as currently expressed, is more prescriptive than the IASB’s, and could lead to lower levels of disaggregation of portfolios than under the IASB model. This could lead to different amounts of profit/loss recognition. Without the modifications proposed above, the FASB’s proposed guidance may lead to:

- Greater disaggregation of insurance contracts than exists today due to singular focus on duration and pricing similarities.
- Diversity in practice due to differing judgment as to what “similarly” priced means, without the flexibility to group contracts according to how the product mix is managed.
- Added complexity and cost without a corresponding increase in benefit in terms of improved relevance and reliability of information presented.
- Arbitrary grouping of contracts that is not meaningful for measurement and presentation purposes.

We also believe it is imperative the Boards converge in this essential area to provide for comparability and eliminate needless differences for dual filers.

#### **FASB Question 9**

Question 9: Do you agree with the requirements included in this proposed Update on contract boundary (that is, the requirements that establish how to identify the future cash flows that will arise as the insurer fulfills its obligations)? If not, what do you recommend and why?

#### **ACLI Response:**

Yes, we support the proposed requirements included within the proposed ASU on contract boundary.

## ***Fulfillment Cash Flows***

### **FASB Question 10**

#### *Questions for Preparers and Auditors*

Question 10: Do you agree with the types of cash flows that would be included in the measurement of the fulfillment cash flows, including embedded options and guarantees related to the insurance coverage under existing insurance contracts that are not separated and accounted for as embedded derivatives? If not, what cash flows do you think also should be included or excluded and why?

#### **ACLI Response:**

We support including the measurement of options and guarantees under the insurance contracts that are not separated and accounted for as embedded derivatives in the measurement of fulfillment cash flows. However, we also support the principle that the measurement of the liability includes all cash flows that will arise directly from existing insurance contracts or can be attributed to them on a reasonable and consistent basis. The FASB's definition of fulfillment cash flows excludes important cash flows such as acquisition costs and premium taxes that are paid to third parties. We believe these are integral to the fulfillment of insurance contracts and should be included within the fulfillment cash flows in order to provide a faithful representation of the "margin" under the building block approach. In addition, we also recommend that the measurement model include "other assessments" as allowed in ASC 944-30-35-5 so that revenue-sharing contracts with underlying mutual funds may be considered within the fulfillment cash flows.

We do not believe trying to draw analogies to other industries or standards is appropriate when trying to justify excluding costs such as some commissions or certain acquisition costs from cash flows as no other industry or standard is required to utilize a liability driven building block approach. Such a fundamentally different approach requires fundamentally different principles.

The FASB's definition of fulfillment cash flows also seems to provide less latitude for including certain variable overhead as fulfillment cash flows, which appears in the IASB's definition. We believe a converged principle-based approach should be developed by the Boards and believe it is imperative the Boards converge on this essential building block for comparability and to eliminate needless differences for dual filers.

Please also see our responses to Questions 2, 28 and 29.

### **FASB Question 11**

Question 11: Do you agree that the assumptions used in the measurement of the fulfillment cash flows should be updated each reporting period? If not, what do you recommend and why?

#### **ACLI Response:**

Yes, we agree that the assumptions used in the measurement of the fulfillment cash flows should be updated each reporting period. We do not, however, support a lock-in of the margin as proposed by FASB because the measurement of the liability will not provide a faithful representation of the unearned profit that is expected to be recognized over the remaining coverage period.

Please also see our response to Question 13.

### **FASB Question 12**

Question 12: Do you agree that the fulfillment cash flows for contracts measured using the building block approach and the liability for incurred claims for contracts measured using the premium allocation approach should be based on an explicit, unbiased, and probability-weighted estimate (that is, the mean) of the future cash flows, as of the reporting date, expected to arise as the entity fulfills the contract, adjusted to reflect any contractual linkage between the contract and any underlying assets? If not, what do you recommend and why?

#### **ACLI Response:**

We agree with the building block measurement objective of expected value and the language that clarifies that expected value represents the “mean”. We also agree that probability-weighted estimates are an appropriate method of meeting this objective for forecasts of future cash flows on certain long-duration products. However, the language in 834-10-30-2 defines fulfillment cash flows in a manner that implies fulfillment probability-weighted cash flows are required to meet the measurement objective for all liabilities and conflicts with the application guidance, which recognizes that other methods can be used to derive the mean, or expected value. Therefore, we recommend modifying the first sentence in 834-10-30-2 as follows:

*“The fulfillment cash flows comprise the present value of the unbiased, expected value of future cash outflows less the future cash inflows that will arise as the entity fulfills the insurance contract...”*

### **FASB Question 13**

#### *Questions for All Respondents*

Question 13: Do you agree with the approach in this proposed Update to recognize changes in estimates of cash flows (other than the effect of changes in the liability arising from changes in the discount rates) in net income in the reporting period? If not, what do you recommend and why?

#### **ACLI Response:**

No, we do not agree with the approach in the proposed ASU that recognizes changes in cash flows (other than the effect of changes in the liability arising from changes in discount rates) in net income in the reporting period. Consistent with the FASB’s view expressed in BC 197, we view the margin as the expected profit of an insurance contract at its inception (i.e., with the exception of cash flows being explicitly excluded from the building block cash flows). To be consistent with this view throughout the life of the insurance contract, we believe the margin should be “unlocked” for changes in estimates of all future fulfillment cash flows. We believe determining a fully unlocked margin in this way would represent the margin that would have existed had the change in assumptions been known at inception and thus would represent the unearned profit at the end of any period. Differences in cash flows as a result of actual cash flows not equaling expected cash flows should be recognized immediately within income in the reporting period.

The measurement of the liability will not provide a faithful representation of the unearned profit that is expected to be recognized over the remaining coverage period if the margin is not adjusted to reflect changes in future fulfillment cash flows after inception. For favorable developments, unlocking the margin would also be consistent with the prohibition to recognize gains at inception. Unlocking the margin further obviates the need for loss recognition which produces counter-intuitive results (gain recognition when a portfolio becomes onerous) and increases costs with no practical benefits.

The roll forward of the insurance liability provides transparency for users of financial statements under the building block approach and should eliminate any lingering FASB concerns surrounding confusion that might be analogous to that which exists today related to “cumulative catch-up adjustments” under DAC amortization models.

In summary, the following benefits would result from recognizing changes in estimates of future cash flows as an adjustment to the margin rather than in net income currently:

- Measurement consistency between contracts issued before and after an assumption change. For example, with a locked in margin, no gains can be recorded at issue but a gain could be recorded the next reporting period when a favorable assumption change is made. This would not occur with an unlocked margin.
- Avoiding the recognition of potentially significant losses on otherwise profitable contracts in reporting periods in which a small adverse assumption change is made.
- Reducing the ability for small changes in judgmental assumptions with respect to future cash flows from having a potentially significant effect on current earnings, even if there is little or no change in the level of uncertainty in those future cash flows (the driver of day 1 profit release).
- Reducing unrepresentative volatility in net income (which users have expressed concerns about with respect to SFAS 97) while providing transparency about the degree of remaining margin in the liability (which would address user concerns about SFAS 60).
- Strengthening the justification for a simplified determination of the remaining margin at transition (See Questions 44 and 46).
- Reduces complexity by eliminating the need for special contract modification guidance, since new, in-force, and modified contracts would be treated consistently (see Question 39).
- Avoiding the consideration of writing off margins on “loss making” contracts, which would produce counter-intuitive net income in the period the loss is recognized and would require onerous record keeping and tracking of historical experience in what is intended to be a prospective model (see Question 27).
- Simplifying the process of continually unlocking the margin for changes in qualifying acquisition costs expected to be paid in future periods, if qualifying acquisition costs are treated similarly to other fulfillment cash flows in unlocking the margin each period (see Question 29).
- Improving the possibility for convergence with the IASB.

For participating contracts, if the margin is unlocked, the margin should not be adjusted for changes in estimates of cash flows that depend on investment returns if those changes arise as a result of changes in the value of the underlying items. These changes should be reflected in the statement of income (see Question 20).

With respect to reinsurance, changes at re-measurement (proposed ASU paragraph: 834-10-35-3) in the expected present value of future cash flows on reinsurance ceded should adjust the margin rather than the reinsurance asset, thus amortizing the gain or loss, to be consistent with initial measurement. At inception of such an agreement the proposed ASU currently requires both reinsurance gains and losses to be amortized into income over the period the coverage is provided because the assumptions will most often impact cash flows that occur many years in the future. We believe that this same logic should apply to changes in fulfillment values at re-measurement. When the modeling assumptions change, including changes in the credit rating of the reinsurer, the changes in fulfillment values on reinsurance ceded should adjust the margin with no limit (e.g., losses are to be amortized as well as gains, consistent with the treatment at initial measurement).

Please also see our response to Question 10 and pages 35-38 of the ACLI June 2012 Report, “*An Analysis of the Insurance Contracts Project Tentative Decisions*,” that provides additional commentary and illustrations about unlocking the margin.

### *Discount Rates and Discounting*

#### **FASB Question 14**

##### *Questions for All Respondents*

Question 14: Do you agree that the discount rates used by the entity for nonparticipating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

#### **ACLI Response:**

No, we believe the discount rates should be derived from the expected return on the actual assets backing the liabilities (or a reference portfolio of assets with similar duration as the liabilities). This is consistent with pricing practices and prevents losses (or a significantly reduced margin) at inception for contracts that are expected to be profitable overall and, therefore, reflects the most likely outcome of the insurance activity as a whole, considering the underwriting and investment function together.

This approach would also avoid noneconomic volatility that will arise as short-term fluctuations in asset spreads affect the measurement of assets but not the measurement of the liabilities. This impact can be significant. For example, a 100 basis point increase in asset spreads, as happened in 2008, could create the optical insolvency of an insurer by substantially reducing or eliminating its equity. Such a basis point change would decrease the reported fair value of a \$100 billion asset portfolio, with five-year duration, by approximately \$5 billion with no corresponding reduction for fully guaranteed insurance contract liabilities. For most contracts using the building block approach, an entity holds those assets for the long term to enable it to fulfill its obligations under the insurance contracts it issued; therefore, those temporary fluctuations which are largely due to market sentiment make it more difficult for users of the entity's financial statements to assess the entity's long-term performance.

We note the FASB has strong views against using an unadjusted asset-based discount rate and, along with the IASB, believes it has addressed the aforementioned noneconomic volatility concerns through the application of the top-down discount rate. Specifically, we note that in several staff papers, joint meetings of the Boards, and discussions with both IASB/FASB staff /Board members, it has been expressed that the top-down discount rate would counteract concerns that current period fluctuations in discount rates exaggerate the volatility of long-term insurance liabilities. As currently written, we do not believe the top-down discount rate addresses this concern as contemplated by the Board. We are also concerned that using discount rates that are consistent with observable current market prices will result in significant volatility in liability values when long-term interest rates change (near, at or beyond the end of the observable yield curve).

Please see our response to Question 18 for a more expansive view on these issues and how they should be addressed.

#### **FASB Question 15**

Question 15: For contracts measured using the premium allocation approach, do you agree that an entity should discount the liability for incurred claims? Do you agree that an entity should be allowed to elect not to discount portfolios when the incurred claims are expected to be paid within one year of the insured event? Why or why not? If not, what would you recommend and why?

#### **ACLI Response:**

Yes, we agree that an entity should discount the liability for incurred claims but be allowed to elect not to discount portfolios when the incurred claims are expected to be paid within one year of the insured event as these amounts are likely to be immaterial.

**FASB Question 16**

Question 16: Do you agree that an entity should segregate the effects of underwriting performance from the effects of changes in discount rates (which would reverse over time) by recognizing changes in the present value of the fulfillment cash flows due to changes in the discount rates in other comprehensive income? If not, do you think that the effect of changes in the discount rates should be presented in net income? Please explain your reasoning.

**ACLI Response:**

Yes, we agree that an entity should segregate the effects of underwriting performance from the effects of changes in discount rates (which would reverse over time) by recognizing changes in the present value of the fulfillment cash flows due to changes in the discount rates in other comprehensive income. We are extremely concerned, however, that the FASB's proposal, in combination with the classification and measurement criteria proposed in the financial instruments exposure draft, is not helpful in eliminating materially significant accounting mismatches. We believe that accounting for insurance entities should reflect the long-term nature of insurance and the accounting should recognize the linkage between assets and liabilities. When an insurer's assets and liabilities are economically matched, no accounting volatility should be reported in either net income or other comprehensive income. We believe this is rather easy to accomplish if the focus is on the broader principle of eliminating material accounting mismatches and what is meaningful to users of financial statements and not objections to creating accounting options or industry specific guidance.

We urge the Board to reconsider providing specific guidance for assets within the financial instruments classification and measurement standard when those assets are economically financed by insurance contract liabilities measured at FV-OCI. Specifically, we believe the Board should include a FV-OCI option when measuring financial assets at FV-OCI (fixed income securities and equity securities) that would reduce or mitigate an accounting mismatch related to an insurance contract liability measured at FV-OCI, regardless of the cash flow characteristics or business model tests. Without such an option, there will be instances where assets supporting insurance contract liabilities will be measured at amortized cost or FV-NI, thus creating an avoidable material accounting mismatch.

We believe such a FV-OCI option should be limited to assets backing liabilities in the scope of the insurance contracts standard and where changes in the discount rate are recorded in OCI. Thus, the FV-OCI option would better align the measurement of assets and liabilities for insurance contracts and provide more relevant and useful information to users of financial statements. The hedging programs of insurers also need to be specifically addressed within either the insurance contracts standard itself or when the Board completes its work on macro-hedging in order to ensure insurers' hedges are also appropriately aligned with the accounting for their hedged items (i.e., the insurance contract liabilities at FV-OCI).

We understand the FASB rejected the approach contemplated above because, in part, it did not want to create industry specific carve-outs. We believe it is appropriate to reconsider that policy. The financial instruments classification and measurement proposal was developed, at least in significant part, to obtain an accounting match of a bank's core assets and liabilities. The criterion for amortized cost treatment is tailor-made for banking loans and core-deposit liabilities. Likewise, broker-dealers have a special carve-out in the proposed standard that specifically addresses their unique business model. Investment companies also have special accounting that addresses their unique circumstances. We believe special consideration should also be made for the insurance industry business model to eliminate needless accounting mismatches.

Another alternative is to allow preparers of financial statements with insurance contract liabilities to select the appropriate accounting principle (e.g., Current fulfillment value-OCI or Current fulfillment value-NI) for measuring insurance contract liabilities not unlike preparers select the appropriate accounting principle for depreciation of fixed assets (e.g., straight-line or double declining balance, etc.). Preparers often choose depreciation that best reflects the appropriate asset usage pattern and, similarly, preparers would be allowed to select the appropriate measurement principle for insurance liabilities that best reflects the measurement basis of the associated assets. Such an election would be made on a portfolio (or percentage of a portfolio) basis that is best expected to match the accounting of the underlying assets. An insurer would not be allowed to change the accounting principle unless circumstances indicate it is appropriate to change under ASC 250 or IAS 8.

We encourage the FASB to coordinate with the IASB in this fundamental area where significant changes are required to eliminate avoidable and material accounting mismatches.

**FASB Question 17**

Question 17: Because the proposed guidance includes the approach under which changes in the insurance liability arising from changes in the discount rates should be recorded in other comprehensive income, do you think that a test should be required to trigger recognition in net income of some or all of the amounts in accumulated other comprehensive income (that is, a loss recognition test based on asset-liability mismatches)? Why or why not?

**ACLI Response:**

No, we do not think that a test should be required to trigger recognition in net income of some or all of the amounts in accumulated other comprehensive income (that is, a loss recognition test based on asset-liability mismatches). We believe such a test would over complicate the calculation of OCI for changes that automatically reverse over time while providing no additional benefit to users of financial statements.

**FASB Question 18**

*Questions for Preparers and Auditors*

Question 18: Do you agree that the method for calculating the discount rates should not be prescribed? Is the proposed guidance on determining the discount rates understandable and operable? If not, what do you recommend?

**ACLI Response:**

Yes, we agree that the method for calculating the discount rates should not be prescribed. There are too many unique situations (countries, products, risk-sharing mechanisms, etc.) such that any prescribed methodology would be inappropriate in many, if not most, circumstances. The proposed guidance on determining the discount rates is understandable and operable. However, it is not always appropriate to require market consistent information when determining discount rates in a fulfillment cash flow model. Fulfillment value is not an exit value. Disclosure of methodologies and significant assumptions would provide the information relevant to financial statement users, while maintaining the relevance and usefulness of information reported. We have two concerns with the proposed guidance.

First, throughout the deliberations of the insurance contract project (jointly deliberated Board meeting, staff papers, staff and Board member comments), the top down discount rate methodology was identified as the solution to mitigating balance sheet volatility created by the effects of changes in credit spreads. The basis for this assertion was that the adjustment for unexpected defaults was not observable. Therefore, it was assumed an entity would use estimates consistent with existing U.S. GAAP guidance on fair value measurement, particularly for Level 3 fair value measurement. Because

forecasts of unobservable inputs tend to put more weight on longer-term trends than on short-term fluctuations, that interpretation would alleviate concerns regarding volatility created by changes in credit spreads. This concept has not been explicitly acknowledged in the FASB proposed guidance. We are concerned the FASB's objective will not be met and insurers' balance sheets will reflect significant volatility (as illustrated in our response to Question 14) because the accounting firms will be precluded from allowing such an interpretation if not explicitly allowed in the final standard. Our discussions to date with accounting firms confirm this concern. We request that this concept be acknowledged in the final standard, either through a simple example or explicit reference in the description of the top-down discount rate methodology.

Second, we are also concerned that using discount rates that are consistent with "observable current market prices" could result in significant volatility in liability values when long-term interest rates change (near, at or beyond the end of the observable yield curve). We believe that it is the Board's intention to allow for the use of level 3 estimates for points on the yield curve where there is no observable market data, especially for liabilities that are expected to be settled many years from the reporting date (BC 151). However, the proposed standard does not explicitly address this and raises the same concern with accounting firm interpretation. Long-term liabilities are extremely sensitive to small movements on the long end of the yield curve and we therefore request that this concept be explicitly acknowledged in the final standard, either through a simple example or explicit reference in the determination of the discount rate methodology.

Such a principle should be based on the understanding that the observable points on the yield curve are a continuum that is less reliable the farther out one goes. For example:

Deep and Liquid Markets - Cash flows within durations at which there is a deep and liquid market for fixed income securities. For these cash flows, liabilities can be measured on the basis of fixed income financial instruments whose prices and yields can be reliably determined. In the U.S. and Canada, this will typically represent cash flows out to about 15 years.

Not Deep or Liquid Markets - Cash flows within durations for which there is a market for fixed income securities, but not deep or liquid. For these cash flows, assets can be obtained to measure the liability cash flows, but the prices and yields on those assets are less reliable. In the U.S. and Canada, this will typically represent cash flows out from about 15 years to about 30 years.

No Market - Cash flows within durations for which there is little or no market for fixed income securities. For these cash flows, there are limited or no assets available off which to measure the liabilities. In the U.S. and Canada, this will typically represent cash flows beyond about 30 years.

We propose building on the principle of using observable data, when it is available, but augmenting that with long-term averages when it is not available. Our proposed approach is to incorporate a principle that uses the observable discount rate for points on the yield curve when there is a deep and liquid market for fixed income securities. For points on the yield curve where there is little or no market for fixed income securities, a long-term expected average discount rate should be used. This rate will not be expected to reflect short term changes in market interest rates, although it may change occasionally if changes in interest rates over a longer time horizon cause a change to long-term expectations. Finally, points on the yield curve representing the period between liquid and illiquid points should be interpolated.

We acknowledge that an appropriate OCI calculation will avoid the impact of such volatility in net income. However, we believe the impact of changes in interest rates beyond the point where there are observable prices in deep liquid markets could be significant and care must be taken so as not to misrepresent the economics of the business.

**FASB Question 19**

Question 19: Do you agree that interest expense generally should be based on the discount rates determined at the date the portfolio of contracts was initially recognized? Why or why not? If not, what do you recommend?

**ACLI Response:**

Yes, we agree that for fully guaranteed contracts interest expense should be based on the discount rates determined at the date the portfolio of contracts was initially recognized. Conceptually, fluctuations in interest rates create fluctuations in liability values that reverse over time and should be separated from the current period measurement of net income. This will also provide better matching with the assets of life insurers which will primarily be reported at fair value through other comprehensive income.

While we agree with the concept that interest expense should generally be based on the discount rates determined at the date the portfolio of contracts was originally recognized, similar to our concern expressed in the response to Question 8, it is unclear as to how this guidance would apply to a product such as a group deferred annuity contract issued to a plan sponsor in support of a defined contribution benefit plan. Specifically, it is unclear from the proposed guidance whether interest expense should be based on the discount rate at the date the group annuity contract was issued, or whether it would be necessary to allocate cash flows for this one group annuity contract over multiple portfolios, each with a separate set of discount rates. In this instance, we believe it is appropriate to base the accretion rate on the date the group annuity contract was issued but request the FASB clarify to eliminate ambiguity.

See also our response to Question 16 for the ACLI's recommendation to further eliminate accounting mismatches.

**FASB Question 20**

Question 20: Do you agree that upon any change in expectations of the crediting rates used to measure the insurance contract liability for insurance contracts with discretionary participation features, the interest accretion rates should be reset in a manner that recognizes any changes in estimated interest crediting and related expected cash flows on a level-yield basis over the remaining life of the contracts? If not, what do you recommend?

**ACLI Response:**

Although we believe the "level yield approach" is on the right track, we recommend the following enhancements.

First, although we agree that changes in expectations of future crediting rates should be reflected prospectively in the income statement, we recommend the Board avoid prescribing a specific method for updating the interest accretion rate. While the method proposed in the exposure draft may be appropriate for some products with an explicit account balance and an explicit crediting rate, it is operationally very difficult for others. For example, modeling techniques for deferred annuities that project cash flows based on dynamic and interdependent interest and lapse assumptions make it difficult to separate the change in cash flows attributable to crediting rates from the impact of lapses. For discretionary participating contracts such as some long-term care insurance, there is no explicit account balance or crediting rate and the level yield approach can't be applied. The Board prescribed a general principle for setting the initial discount rate for participating contracts and we believe the guidance should be non-prescriptive for the income statement guidance as well. We do not object to leaving the level yield concept in the application guidance as an example but we believe the guidance needs to be more principle-based to ensure it can be appropriately applied in all circumstances.

Second, and more importantly, we believe an extremely critical modification needs to be made to the proposed guidance to achieve the Board's objective of presenting interest expense consistent with the variable rate nature of the amounts "borrowed" by the insurer under the contract (BC255).

The FASB proposed guidance requires that the discount rate should be reset in a manner that recognizes any changes in estimated interest crediting and related expected cash flows on a level-yield basis over the remaining life of the contracts.

Our proposal is based on the view that since the discount rate is used as the interest accretion rate, it should reflect the rate of interest expected to be credited to the contract in cases where the credited rate is known. The credited rate is commonly known for universal life contracts and for many participating life insurance contracts. When the cash flows are based on an expected crediting rate, the discount rate can be set equal to a constant spread over or under the expected crediting rate. In this method, resetting the discount rate means resetting the spread. The discount rate for any valuation follows the expected path of the credited rate over time, plus or minus a constant spread.

The FASB method requires two projections at the valuation date:

- One under prior period interest rate assumptions (present value of cash flows taken using prior period accretion rate).
- One under current period interest rate assumptions (new accretion rate is set to level rate that makes the present value of these cash flows the same as that in the other valuation.)

Our proposal also requires two projections at the valuation date:

- One under prior period interest rate assumptions (present value of cash flows taken using prior period accretion rate).
- One under current period interest rate assumptions (new accretion rate is set to the path of interest rates equal to expected crediting rates plus a level spread. Spread is set so that the present value of these cash flows is the same as that in the valuation using prior period assumptions.)

Our proposal differs from the FASB method as it does not determine the discount rate on a level-yield basis. Under our proposal, if the expected credited rate varies, the discount rate follows a path up or down in parallel with the expected crediting rate.

Why does this matter? In most cases the credited rate on these contracts is determined, in part, based on asset returns measured at amortized cost. When interest rates change, returns on a portfolio measured at amortized cost do not change right away. They gradually change over time as current investments mature and funds are re-invested at the new level of market interest rates. This path of gradual change over time can be leveled, but doing so does not reflect the actual pattern of interest accretion on these contracts.

The difference between the two approaches can be substantial, easily reaching 200 basis points or more over the life of a portfolio. That kind of difference in interest expense can easily equal or exceed the total expected net income for a year. Appendix A to this letter contains a more detailed explanation of our proposal and the inappropriate impact the level yield approach can have.

If the margin is unlocked the margin should not be adjusted for changes in estimates of cash flows that depend on investment returns if those changes arise as a result of changes in the value of the underlying items. These changes should be reflected immediately within the income statement. Our

interest accretion proposal (or the FASB interest accretion proposal) would not work without such an adjustment if the margin is unlocked.

Please also see our response to Question 13.

***Margin for Contracts Measured Using the Building Block Approach***

**FASB Question 21**

*Questions for All Respondents*

Question 21: Do you agree that an insurer should not recognize a gain at initial recognition of an insurance contract (such a gain would arise when the expected present value of the cash outflows is less than the expected present value of the cash inflows) but, rather, should defer that amount as profit to be recognized in the future? Why or why not?

**ACLI Response:**

Yes, we agree that an insurer should not recognize a gain at initial recognition of an insurance contract (such a gain would arise when the expected present value of the cash outflows is less than the expected present value of the cash inflows). We believe such an amount should be deferred, re-estimated periodically and recognized in the future as the insurer fulfills the contract.

To be consistent with this view throughout the life of the insurance contract, we believe the margin should be “unlocked” for changes in estimates of cash flows (other than the effect of changes in the liability arising from changes in discount rates). Specifically, the measurement of the liability would not provide a faithful representation of the unearned profit related to the estimate of future cash flows if the margin is not adjusted to reflect changes made after inception. For favorable developments, unlocking the margin would be consistent with the prohibition to recognize gains at inception.

Please also see our response to Question 13.

**FASB Question 22**

Question 22: Do you support using a one-margin approach, as is included in this proposed guidance, or an explicit risk adjustment and a contractual service margin (as the IASB proposes)? Please explain the reason(s) for your view.

**ACLI Response:**

In our October 26, 2010 letter to the Boards documenting our views on the explicit margin, we stated that the majority of ACLI members support the use of a one-margin approach proposed by the FASB for the measurement of insurance contract liabilities. There is a significant minority view that supports the risk adjustment and contractual service margin approach. Those supporting the one margin believe it reflects the unearned profit that is priced in the contract, is less complicated, and more easily understood than the two margin approach. They further noted that the risk adjustment would overlay a regulatory requirement within U.S. GAAP that is inconsistent with the Conceptual Framework and that there is no single method that can be applied consistently across all portfolios. Those supporting the two-margin approach believe that it better reflects the economic risk aversion, represents the compensation for bearing risk and better aligns with market consistent valuation theory.

We believe it is imperative that the Boards converge in this fundamental area to provide for comparability and eliminate needless differences for dual filers. To truly make the standard cost beneficial, we believe convergence is more important than any perceived benefits of one approach over the other.

**FASB Question 23**

Question 23: If you support a risk adjustment and a contractual service margin, do you agree with the IASB's approach to adjust the contractual service margin for changes in estimates of cash flows? Why or why not? Do you agree with the IASB's approach to not specify acceptable approaches to determine the risk adjustment? Why or why not?

**ACLI Response:**

While we conceptually agree that the contractual service margin should be unlocked for changes in estimates of future cash flows, the specific guidance in paragraphs B68 (c) – (e) needs to be clarified for the proposal to be workable. Please also see our response to Question 13.

We agree that the IASB's approach should not specify approaches to determine the risk adjustment. Currently, no prescribed methodology works well for all portfolios of insurance contracts. Determination of risk is also an area that continues to evolve and companies should use the method most appropriate for the portfolio of contracts being measured. If the Boards were to converge and choose the risk adjustment and contractual service margin, the guidance would need to be enhanced to clarify the level at which the risk adjustment should be measured since the current IASB guidance does not specify the level.

To be consistent with the decision to unlock the margin, we recommend that the IASB approach be modified such that 1) for participating contracts, changes in reinvestment risk not passed on to policyholders should also offset the contractual service margin, and 2) changes in the risk adjustment for changes related to future expectations should offset the contractual service margin.

For disclosure purposes, the IASB has decided to require insurers to translate the result of using risk adjustment techniques other than the confidence level into a confidence level. For example, an insurer using the cost of capital technique would need to describe the effects of the risk adjustment in confidence level (or percentile or value-at-risk) terms. This disclosure would require insurers to (a) determine fairly granular risk distributions for all material assumptions (e.g., mortality, policyholder behavior, expenses, etc.) and, (b) solve, perhaps through multiple iterations, for the percentile stress that would result in a confidence level that equates to the risk adjustment produced by the cost of capital technique. This is likely to be an extremely challenging and resource-intensive exercise, and most likely could not be done on a routine basis. We do not believe this disclosure is appropriate and should be eliminated.

**FASB Question 24**

Question 24: Do you agree that a loss at initial recognition of a portfolio of insurance contracts should be recognized immediately in net income (such a loss would arise when the expected present value of the cash outflows exceeds the expected present value of cash inflows)? Why or why not?

**ACLI Response:**

Yes, we agree that a loss at initial recognition of a portfolio of insurance contracts on direct business should be recognized immediately in net income as this is consistent with the general loss recognition criteria in U.S. GAAP. We do, however, believe three modifications are required.

First, we believe additional guidance is necessary to clarify how this calculation is performed at initial recognition for an "open portfolio." In other words, when newly issued contracts are added to an existing portfolio, it is not clear whether this "test" is to be performed before, or after, the newly issued contracts are added to the portfolio. Also, it is not clear how this calculation interacts with the ongoing "test" for an existing portfolio.

Second, we believe losses should not be recognized if certain cash flows are excluded from the fulfillment cash flows solely under the proposed standard (e.g., asset management fees).

Third, for reinsurance contracts, we agree with the exception to the general rule of recognizing losses at initial recognition provided in 834-10-30-31 for prospective reinsurance contracts measured using the building block approach. The loss should be recognized over the coverage and settlement period as provided in 834-10-35-41. We also recommend a change in the proposed ASU to give the same treatment on re-measurement.

Please also see our responses to Question 8, 10, 13 and 27.

#### **FASB Question 25**

##### *Questions for Preparers and Auditors*

Question 25: Do you agree with the proposed method(s) of recognizing the margin (that is, as the entity is released from risk under the insurance contracts as evidenced by a reduction in the variability of cash outflows)? If not, what do you suggest and why?

#### **ACLI Response:**

Yes, we agree with the proposed method(s) of recognizing the margin under a single margin approach. This approach, however, is not appropriate under a dual margin approach where the release of risk concept is more appropriately aligned with the risk adjustment.

However, the paragraph 834-10-35-12 requirement that “an entity’s methodology used to determine the value of coverage for each portfolio shall be applied consistently throughout the life cycle of the portfolio” and the paragraph 834-10-55-141 requirement that “an entity’s methodology used to determine release from risk for each portfolio should be applied consistently throughout the lifecycle of the portfolio” may be problematic. The methodologies used for portfolios of contracts at transition will have an impact on the emergence of earnings from insurance contracts for years/decades into the future. Some have suggested that the methodologies will become consistent among companies over time. While we agree that consensus on accepted methodologies will likely emerge over time, the lack of flexibility in the paragraphs cited above could be a significant issue for any company whose methodology selected at transition proves to be an outlier when such consensus emerges.

We agree with the flexibility afforded by the guidance allowing issuers of insurance contracts to choose the appropriate methodology for recognizing the margin; however we also believe that there should be a provision allowing for a change in the locked in methodology in certain limited circumstances. We refer to the guidance of ASC 820 *Fair Value Measurement* that permits changes in a valuation technique or its application if the change results in a measurement that is equally or more representative of fair value in the circumstances. Examples of applicable circumstances include: new markets develop, new information becomes available, information previously used is no longer available, valuation techniques improve, or market conditions change. We believe that similar guidance should be included in the proposed ASU related to the methodology chosen for recognizing the margin and such changes should be classified as changes in accounting estimate. Without this flexibility, any lack of consistency among companies at transition would result in a lack of comparability of results well into the future. We further suggest that the “applied consistently” wording in paragraph 834-10-55-141 appears to contradict the guidance in paragraph 834-10-55-137 which states, “Different entities may measure a reduction in variability of cash flows in different ways as further information is obtained about the expected cash flows during the life cycle of an insurance portfolio.” Further, while we have no objection with the method utilizing standard deviation within example 16 of the proposed ASU, we believe the proposed guidance should be further clarified that it is not the only way of determining the reduction in the variability of cash flows.

Please see also our response to Question 22.

**FASB Question 26**

Question 26: Do you agree that interest should be accreted on the margin and therefore affect insurance contract revenue? If not, why?

**ACLI Response:**

Yes, the margin represents the present value of expected profits at the inception of the contract. Without the accretion of interest on the margin, it would be understated in future periods.

We believe the accretion rate(s) for the margin, for both participating and non-participating contracts, should be the same as the accretion rate(s) used for recognition in the income statement on the unwind of the discounted cash flows. Please also see our responses to Questions 19 and 20.

We are troubled by the language in paragraph 834-10-35-16 (and supported by BC 304) as follows:

“Revenue for the fulfillment of cash flows shall include interest accretion on the premiums received for the insurance component and other services related to the fulfillment of cash flows to reflect the time value of money for the period of time between when the entity receives premiums and its provision of the corresponding coverage, using the interest accretion rates specified in paragraphs 834-10-35-24 through 35-25.”

The language needs to be clarified because it could be interpreted to mean interest should be accreted on premiums subsequent to receipt. If this is the intent, we believe the calculation is theoretically unsound and will result in double counting.

**FASB Question 27**

Question 27: Do you agree that if the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance contracts will exceed the expected cash inflows, an entity should recognize the remaining margin immediately in net income? Why or why not?

**ACLI Response:**

No, we do not agree that if the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance contracts will exceed the expected cash inflows, an entity should recognize the remaining margin immediately in net income. First and foremost, we support the unlocking of the margin which makes such a loss recognition test unnecessary.

Notwithstanding our view on the unlocking of the margin, we do not support such a loss recognition test. This is unnecessary for contracts with the unlocking of assumptions and best estimates of cash flows. It is counter-intuitive to recognize a gain (by way of releasing the margin) upon failing this test. This counter-intuitive gain recognition will be exacerbated by the “cliff effect” when a portfolio turns into a loss position over an extended period of time, as such gain will only be recognized in the period when cumulative expected outflows exceed cumulative expected inflows.

In addition to the conceptual reasons supporting an unlocked margin, the cost and efforts to monitor for loss recognition are significant and produce counter-intuitive results that we do not believe will be useful to users of financial statements. The costs will be significant because such a test would require the retention of all historical information for contracts, often decades, for what is supposed to be a prospective calculation and then having to test the combined historical and future projected cash flows every period to determine whether the contract has met the loss making threshold.

We suspect the FASB was unaware of the cost and complexity in calculating such an ongoing loss recognition test because the guidance in 834-10-35-22 is vague and does not prescribe cumulative cash flows (or historical discount rates) which are both required for any such loss recognition test to be theoretically well grounded. For example, if all premiums were received in advance, one cannot just take the present value of the future cash flows at current discount rates for purposes of determining loss recognition.

Please see also our response to Question 13.

### ***Acquisition Costs***

#### **FASB Question 28**

*Questions for Preparers and Auditors*

Question 28: Do you agree that the direct acquisition costs presented with the margin should include only the costs directly related to the entity's selling efforts that result in obtaining the contracts in the portfolio and that all other acquisition costs should be recognized as expenses when incurred? If not, what do you recommend and why?

#### **ACLI Response:**

No, all direct acquisition costs should be treated as fulfillment cash flows. At a minimum, we believe the FASB should not be more limiting than ASU 2010-26. While currently unclear, some are interpreting the proposed guidance as more limiting.

We believe that changing the unit of account to the portfolio and removing "incremental" from the definition of deferrable costs in ASU 2010-26 warrants reconsideration by the Board because acquisition costs associated with unsuccessful efforts are costs incurred to acquire successful efforts and are factored into expected profits by the insurer. Therefore, in order for the margin to reflect expected profits, acquisition costs associated with unsuccessful efforts need to be included as cash outflows.

While we supported the changes made in ASU 2010-26, new definitions and scenarios within the proposed insurance contract standard have contributed to our amended view. We do not believe trying to draw analogies to other industries or standards is appropriate when trying to justify excluding such costs as no other industry or standard is required to utilize a liability-driven building block approach. Such a fundamentally different approach requires fundamentally different principles. Furthermore, we see no need to amortize acquisition costs as proposed in the ASU since to do so would be inconsistent with a fulfillment cash flows model, adds complexity, and most importantly, does not provide useful information to users of the financial statements.

We believe it is imperative the Boards converge in this area to provide for comparability and eliminate needless differences for dual filers.

Please see also our responses to Questions 10, 29 and 31.

#### **FASB Question 29**

Question 29: Do you agree that the measurement of the margin for contracts measured using the building block approach and the liability for remaining coverage for contracts measured using the premium allocation approach should be reduced for direct acquisition costs incurred? If not, what do you recommend?

**ACLI Response:**

No, the measurement of the margin for contracts using the building block approach should not be directly reduced for direct acquisition costs incurred. We believe acquisition costs (both successful and unsuccessful) should be treated like any other cash outflow in determining the margin(s). The separate aggregation of acquisition costs as a debit balance reducing the margin adds complexity, which is unnecessary to both measurement and presentation and will only increase confusion for users of financial statements.

Further, if the acquisition costs are netted against the margin, it is unclear what happens when the actual acquisition costs (particularly renewal commissions) do not equal expected. It is unclear if the difference goes to earnings or if the “net margin” gets adjusted contrary to the “locked-in” margin concept.

We believe it is imperative the Boards converge in this area to provide for comparability and eliminate needless differences for dual filers. Converging to our proposed approach, which is described in more detail in our response to Question 34, will reduce needless complexity and avoid confusion for users of financial statements.

For contracts measured under the premium allocation approach, which is fundamentally different than the building block approach, the accounting and presentation of acquisition costs should be consistent with that measurement attribute, i.e., separately measured and presented in the financial statements consistent with the Revenue Recognition model.

Please also see our responses to Questions 10, 28 and 34.

**FASB Question 30**

Question 30: Do you agree that an entity should recognize acquisition costs as an expense in net income in the same pattern that it recognizes the margin for contracts measured using the building block approach or in the same pattern that it reduces the liability for remaining coverage under the premium allocation approach? If not, why not?

**ACLI Response:**

No, we do not agree that an entity should recognize acquisition costs as an expense in net income in the same pattern that it recognizes the margin for contracts measured using the building block approach. We believe acquisition costs are cash outflows fundamental to fulfilling an insurance contract and should be treated similarly as any other cash outflows when determining the margin(s). Please also see our responses to Questions 10 and 29.

We also believe acquisition costs should be reported in the income statement as incurred, similar to all other cash out flows, with a corresponding release of the estimate of acquisition costs included in the measurement of the liability. This approach provides complete transparency of the treatment of acquisition costs, is consistent with the overall building block approach and provides the most meaningful information for users of financial statements as its interaction with the movement of the liability is understandable and complete. The income effect of the FASB approach is to have acquisition costs emerge in proportion to the release of the margin, which is artificial, does not provide useful information to users, and adds unnecessary complexity. The effect of the FASB proposal is to move, what is currently referred to as the deferred acquisition cost asset, to the liability side of the balance sheet and offsets it against the insurance liability

Please see our responses to Questions 31, 32 and 34 for a more complete view of the ACLI’s position on presentation.

**FASB Question 31**  
**Insurance Contract Revenue**

*Questions for All Respondents*

Question 31: Do you agree that users of financial statements would obtain relevant information that faithfully represents the entity's financial position and performance if, in net income, for all insurance contracts, an entity presents insurance contract revenue and incurred expenses, rather than only information about changes in margins (that is, the net profit)? If not, why not?

**ACLI Response:**

No, while we agree that financial statement users should be provided with more details on the face of the statement of comprehensive income than only information about changes in margins, we do not agree with the proposed insurance contract revenue presentation approach (formerly referred to as the earned premium approach) for insurance contracts measured under the building block approach.

Please also see our responses to Questions 32 and 34 for a more complete view of the ACLI's position on presentation.

**FASB Question 32**  
**Insurance Contract Revenue**

*Questions for All Respondents*

Question 32: Do you agree that, for all contracts, revenue should exclude any amounts received that an entity is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs and that expenses should exclude the corresponding repayment of those amounts? If not, what do you recommend? Please specify whether your view depends on the type of contract.

**ACLI Response:**

No, we do not support excluding any amounts received that an entity is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs and excluding from expenses the corresponding repayment of those amounts. We share the concerns expressed by some respondents to the IASB 2010 ED that it would be too complex to separate interrelated cash flows.

In addition, to exclude the estimated returnable amount from amounts reported in the statement of comprehensive income further minimizes the value of information contained therein. Measurement of insurance liabilities is based on a cash flow model. Understanding the changes in cash flows is critical to analysts and financial statement users in order to understand the nature and economics of the business.

Further, we do not agree with the current definition of "estimated returnable amount", or its application. The cash value/surrender value of a traditional life insurance contract should not fall under the definition of an amount to be excluded from amounts presented in the statement of comprehensive income since surrender of the contract results in eliminating the insurance risk transferred to the insurer. The recently adopted Affordable Health Care Act requires 80% of the premium to be applied to claims. This mandate should not result in 80% of the premium being excluded. Whereas, an account balance in a UL contract that is returned in addition to the death benefit may meet the definition of an amount to be excluded.

The effect of the current definition is that significant elements of life insurance contracts will be characterized and treated as if they were a bank account. To suggest that a life income annuity contract containing a period certain, e.g., 10 years, contains an amount to be excluded from incurred claims equal to the first 10 years of payments ignores the essence of the contract since the contract contains

neither an account value nor surrender value. The Appendix B Example 2 illustrates the effect of characterizing the first 10 years of a life income annuity as an amount to be excluded from incurred claims and provides additional commentary.

ACLI proposes that the definition of “estimated returnable amount” be modified to read as follows:

“The amounts available to the policyholder of an insurance contract that, if withdrawn, would not affect the insurance risk covered by the contract”.

We note that Implementation Guidance and Illustrations on estimating the returnable amounts found in Examples 18 and 19 (paragraphs 834-10-55-154 through 55-161) are complicated and introduce yet another variable to be considered in the future pattern of recognizing insurance contract revenue (see paragraphs 834-10-55-157 through 55-159). Further, it is unclear from the examples how this guidance would be applied to products with recurring periodic contributions such as group deferred annuity contracts commonly issued to support defined contribution benefit plans.

Given that eligible participants would be allowed to make contributions into the group annuity contract on a regular periodic basis for years and potentially decades, and given that the assumptions of future cash flows would be updated each period, the Guidance and Illustration examples in paragraphs 834-10-55-157 through 55-159 including the calculation and recognition of the revised expectation of the amount of insurance contract revenue to be presented in net income over the life of the contract plus accretion of interest thereon would be unworkable. Further, the results of the very complex measurement would be of little if any use to financial statement users.

Our proposed presentation view as set out in the response to Question 34 would make the requirement to exclude estimated returnable amounts from amounts disclosed in the statement of comprehensive income less difficult to apply in practice.

### **FASB Question 33**

#### **Insurance Contract Revenue**

##### *Questions for All Respondents*

Question 33: For contracts measured using the premium allocation approach, do you agree that if the contract has a financing component that is significant to the contract, an entity should adjust the liability for remaining coverage to reflect the time value of money and recognize the accretion of interest with insurance revenue? Do you agree with the practical expedient that an entity should not be required to reflect the time value of money in measuring the liability for remaining coverage (that is, if the entity expects, at contract inception, that the time period between when the policyholder pays all or substantially all of the premium and when the entity provides the corresponding part of the coverage is one year or less)? If not, what do you recommend and why?

#### **ACLI Response:**

Yes, we support reflecting the time value of money in the liability for remaining coverage for contracts measured using the premium allocation approach if the contract has a financing component that is significant to the contract. We also support the practical expedient that an entity should not be required to reflect the time value of money in measuring the liability for remaining coverage if the entity expects, at contract inception, that the time period between when the policyholder pays all or substantially all of the premium and when the entity provides the corresponding part of the coverage is one year or less.

**FASB Question 34**  
**Insurance Contract Revenue**

*Questions for Preparers and Auditors*

Question 34: For contracts measured using the building block approach, does this proposed Update contain sufficient guidance on how to determine insurance contract revenue in accordance with the principle that it should be allocated between reporting periods as performance obligations are satisfied over time (that is, to allocate consideration between periods by reference to the relative value of the services provided in each period)? If not, explain what additional guidance is necessary.

**ACLI Response:**

As stated in the response to Question 31 above, we do not agree with the insurance contract revenue presentation approach for contracts measured using the building block approach. We believe it to be a mechanical exercise with little relevance for financial statement users and conflicts with the stated objective described in paragraph 834-10-10-1a that the guidance is meant to provide decision-useful information about an entity's insurance contracts in its financial statements, including the nature, amount, timing, and **uncertainty of cash flows** (highlighted for emphasis) related to those contracts. In our opinion, the development and reporting of insurance contract revenue is an artificial calculation that does not directly take into account the contractual premiums required under the contract, unlike the *Revenue from Contracts with Customers* (Revenue model) tentative guidance. Consequently, the reported insurance contract revenue will not equal the premiums plus accrued interest as contemplated, i.e., to make insurance mirror the Revenue model. While the insurance contract revenue approach meets the narrow objective of aligning presentation with the revenue recognition principles, it is neither prospective in nature nor the focus of analysts as a key metric in forecasting future earnings. Furthermore, the insurance contract revenue approach is complex, will be extremely expensive and difficult to implement, and does not provide a meaningful measure of the value of the services provided in the period nor the sales activity of the reporting entity.

The fact that this proposed ASU exists is an acknowledgment that the economics of insurance contract transactions are fundamentally different from other types of contracts and therefore makes the case that an appropriately tailored presentation of the results of these contracts is also warranted.

The Revenue model used for non-insurance contracts is a cost model where assumptions are not unlocked and an explicit margin is not calibrated. Whereas the insurance contract fulfillment cash flows measurement approach under the building block approach uses current assumptions, which are unlocked. Further, contracts subject to the Revenue model tend to be short-duration with revenue representing sales activity without disaggregating components into the cash flows inherent in the contract, i.e., that portion of the revenue expected to cover the cost of the product or service and the explicit margin representing the profit the entity expects to earn from the sale. That is why the Revenue model is often characterized as an approach that follows the matching principle since the revenue attributable to the reporting period would align with the costs incurred to provide those goods or services with the difference representing the net income, i.e., profit margin.

In contrast with the Revenue model, the building block approach is a cash flow model with the components separately identifiable and explicitly measured and presented. While the balance sheet reports the net insurance liability, the reconciliation between years, we believe, would provide the detail allowing users to understand how the components of the measurement unfold over time. This model is fundamentally different from the Revenue model. One thing is certain about insurance contracts, that is, over time actual experience will always differ from expected. Therefore the most important information about insurance contracts measured under the building block model is the understanding of the difference between actual and expected cash flows as they emerge over the life of the contract. That is why we offer as an alternative an approach based on the elements of the building block model for the

purpose of presenting information in the statement of comprehensive income that addresses users' requests for information that would help them understand the nature of insurance.

In the process of developing our response to this question, we went back and reviewed paragraphs 112 – 126 of the FASB's 2010 Discussion Paper (DP), *Preliminary Views on Insurance Contracts*. In the ACLI November 30, 2010 letter to the Board in response to the DP, we expressed our objection to the presentation proposal described in these paragraphs stating:

“We do not support the proposed margin presentation approach. The insurance business fundamentally involves the collection of premiums and the payment of claims and associated expenses. While we agree that the presentation should flow from the measurement of insurance contracts, we believe that the cash flow components of the building block, premiums, benefits, and expenses, are as essential to the measurement as the margin component and therefore merit equally prominent presentation on the face of the financial statements. In addition, we believe that the recognition of premiums as deposits, with expenses, claims and benefit payments as withdrawals would be a fundamental change to current practice, which may misrepresent the nature of the business and result in a loss of essential information for users of financial statements. We will provide a separate letter detailing our recommended alternative.<sup>2</sup>”

We continue to believe that information presented in the statement of comprehensive income should flow from the measurement of the insurance contracts. We further continue to agree with paragraph 72d of the IASB *July 2010 Insurance Contracts Exposure Draft* (2010 ED), which states that the statement of comprehensive income should include experience adjustments and changes in estimates, disaggregated either in the statement of comprehensive income or in the notes. Since the experience adjustment is a function of the differences between actual and expected of the premiums, benefits, and expenses attributable to the reporting period, disaggregating the experience adjustment requires reporting of information related to premiums, benefits, and expenses. The Appendix B Example 1 compares and contrasts the proposed insurance contracts revenue approach with our proposed building block elements model (BBE) and explains why we believe our proposal is a faithful representation of the nature of insurance and provides more meaningful information to users and analysts that helps them understand the performance of the reporting entity.

Our proposed BBE presentation view includes a very transparent presentation of the actual fulfillment cash flows, the fulfillment cash flows expected in the period, as well as the other changes in fulfillment cash flows in the period, along with the amount of margin recognized and the impact of the unwinding of the discount rate in the period. We believe the proposed presentation view, along with the proposed insurance contract liability roll forward disclosures, will provide information useful to analysts and users of the financial statements in understanding the period to period change in the amount presented as the insurance contract liability on the Statement of Financial Position within the context of the actual measurement model.

The BBE presentation view builds on the Summarized Margin view contained in the 2010 DP. This view proposes to retain the explicit presentation of the margin released in the period. Explicitly presenting the margin released in the period clearly depicts the insurance performance. The insurance contract revenue approach masks this information making it less transparent. The Board has noted on many occasions that the objective of a single standard for insurance is to increase transparency and understandability. In addition, our proposal would disaggregate the amounts making up the reported experience adjustment, i.e., actual premium payments, benefits and expenses incurred, and the release of the expected portion of the insurance liability for the reporting period. (See the Appendix B Example 1). We note that this presentation model is similar to the alternative presentation Example 1 included in

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<sup>2</sup> The separate letter to the Board detailing our recommended alternative was dated February 11, 2011.

Appendix A to the Agenda Paper 4D/74D discussed at the IASB/FASB joint meeting held during the week commencing October 17, 2011.

The BBE presentation view has the advantage of negating the need for the construct of an artificial insurance contract revenue amount, which will then require explanation and the need to monitor and explain the concept of acquisition costs incurred but not yet recognized in the statement of comprehensive income.

We further note that the insurance contract revenue presentation proposal would result in information that is very different from that currently used in the insurance industry and provided to the users of financial statements. While the proposal results in the presentation of information that is similar to revenue and expenses for other long-term contracts, such information is currently not used as key information by management of entities with insurance activities.

Revenue should not be confused with earnings. Revenue for non-insurance contracts is an indicator of sales activity. Where the contract with the customer spans multiple years, it is understandable for revenue to reflect the performance to date and any unearned amount reported as a liability since cancellation of the contract before completion typically results in a refund of the unearned amount. For insurance contracts, the sales activity is the contractual premium payable by the customer. To suggest that the policyholder, who pays a level premium, e.g., \$500 annually for a \$500,000 ten year term insurance contract, prepays a portion of the insurance cost misrepresents the nature of the contract. Such a view implies that if the policyholder stopped paying the annual premium, e.g., after the 4th year, they would be entitled to a refund, which is not the case.

We also disagree with the proposed ASU's presentation of acquisition costs. The proposal is unnecessarily complex and inconsistent with the building block model, which is based upon the present value of expected cash flows. Amortizing acquisition costs over the life of the contract not only creates administrative burden to keep track of those costs and amortization schedule, in our view, it adds little value to analysts in understanding the entity's performance.

### ***Participating Contracts***

#### **FASB Question 35**

##### *Questions for Preparers and Auditors*

Question 35: Do you agree that participation features that are contractually dependent on the performance of other assets or liabilities of the insurer or the performance of the entity itself should be measured on the same basis used to measure the underlying items and changes in the measurement should be presented in the same statements (that is, net income or other comprehensive income)? Do you agree that this approach should be limited to only participating features for which the amount of the performance of the underlying items passed through to policyholders is contractually determined and not extended to participating features that allow an entity discretion about the amount of the performance of the underlying item to pass through to the policyholders? If not, what do you recommend and why?

#### **ACLI Response:**

Yes, we support the concept of mirroring and agree that participation features that are contractually dependent on the performance of other assets or liabilities of the insurer or the performance of the entity itself should be measured on the same basis used to measure the underlying items and changes in the measurement should be presented in the same statements (that is, net income or other comprehensive income).

While we support the mirroring concept for contractually linked contracts, it will only appropriately minimize accounting mismatches if the impact of embedded derivatives, that are not unbundled, is addressed when the Board completes its work on macro-hedging. Specifically, an insurers' hedge accounting needs to be appropriately aligned with the accounting for the hedged items. The building block for the non-mirrored cash flows will generally include cash flows where other comprehensive income is appropriate in accordance with the general criteria of the proposed standard (e.g., changes in death benefit cash flows for a variable universal life contract or changes in cash flows related to any general account funds related to any variable contract, etc.). The building block will also include cash flows related to embedded derivatives, that are not unbundled, where such other comprehensive income treatment is questionable if hedging derivatives are required to be marked to market through income. In particular, these hedges need to be afforded accounting treatment that matches the hedged derivatives embedded within the liability because these embedded derivatives are a big source of volatility for many products, such as variable annuities, that will qualify for mirroring under the proposed guidance.

We also agree with the FASB conclusion that the mirroring approach should not be extended to participating features that allow entity discretion about the amount of the performance of the underlying item to pass through to the policyholders. Requiring mirroring for such contracts would be unworkable.

Lastly, the FASB's mirroring approach would apply only to the level of returns contractually linked, and not to any additional discretionary amount of returns that the entity expects to pass on to policyholders. For example, if a contract specifies that at least 80 percent of return must be passed on to policyholders, as the entity expects to pass to the policyholder 90 percent of the returns, the IASB would measure the cash flows related to 90 percent of the returns on the same basis as the underlying items. Under the FASB's approach, 80 percent of the return would be measured on that basis. We are concerned that the IASB approach can result in a trivial feature being added to the contract that will cause significantly different valuations for otherwise similar products.

As separate account assets comprise approximately 35 percent of U.S. life insurer assets, the importance of a workable mirroring proposal (including hedging) is critical. We encourage the FASB and IASB to work together and develop guidance that is not overly complex and is converged. The FASB's proposed model could serve as a starting point.

With respect to reinsurance, we believe it would be helpful to clarify that the guidance for participation features that are contractually dependent on the performance of other assets or liabilities of the insurer would not apply to modified coinsurance reinsurance contracts with embedded derivatives. We believe the language is intended to apply to insurance contracts that would otherwise have embedded derivatives, such as separate account products. Although the language can easily be read to apply to modified coinsurance, we believe it cannot apply, since the embedded derivative would have been separated from the host contract before applying the guidance on contractually dependent participation features.

### ***Reinsurance***

#### **FASB Question 36**

##### *Questions for All Respondents*

Question 36: Do you agree that a cedant should record a margin if the expected present value of the cedant's future cash inflows exceed the expected present value of the cedant's future cash outflows (thus prohibiting the recognition of a gain at inception upon entering into a reinsurance arrangement) for (a) retrospective reinsurance contracts accounted for using either the building block approach or the premium allocation approach and (b) prospective reinsurance contracts accounted for using the building block approach? If not, what do you recommend and why?

**ACLI Response:**

Yes, we agree with the proposed guidance.

**FASB Question 37**

*Questions for Preparers and Auditors*

Question 37: Do you agree that a cedant should estimate the fulfillment cash flows (including the ceded premium) for a reinsurance contract using assumptions consistent with those used to measure the corresponding fulfillment cash flows for the underlying insurance contract or contracts, without reference to the margin on the underlying contracts? If not, what would you recommend and why?

**ACLI Response:**

Yes, we agree with the proposed guidance. For entities that either dispose of a business through sale or 100% reinsurance prior to the effective date of a new insurance accounting standard, we believe that the proposed ASU should allow a practical expedient, which we describe in greater detail in our response to Question 45.

**FASB Question 38**

**Insurance Contracts Acquired in a Business Combination**

*Questions for All Respondents*

Question 38: Do you agree that entities should record a loss at the acquisition date in the amount by which any excess of the asset and liability balances related to insurance contracts measured in accordance with the guidance in this proposed Update exceeds the fair value of those assets and liabilities? Do you agree that entities should record a margin (not an immediate gain) for the amount that the fair value of the asset and liability balances exceeds those assets and liabilities measured in accordance with the guidance in this proposed Update? If not, do you think an entity should instead increase or decrease goodwill for the differences between the fair value and the measurement in accordance with the guidance in this proposed Update on those assets and liabilities? Why or why not?

**ACLI Response:**

We agree with the Board's decision to measure the initial margin for a portfolio of insurance contracts acquired as part of business combination as the excess of the fair value of the portfolio of insurance contracts over the asset or liability as measured under the BBA with the resulting margin floored at zero. We disagree, however, with the requirement in the proposed ASU to record a loss at the acquisition date on individual portfolios for which the fair value is above (below) the insurance asset (liability) as measured under the BBA, and we support the IASB approach to effectively capture that difference in goodwill.

Flooring the margin at zero when the fair value of the insurance portfolio is above (below) the insurance asset (liability) measured under the BBA, effectively results in an exception to the fair value measurement principle for initial recognition in a business combination. A day 1 loss in this situation would constitute a significant change to business combination accounting guidance, as it would be inconsistent with the treatment of other assets and liabilities that are deemed as exceptions to the day 1 fair value recognition principle in a business combination (e.g. employee benefit plan liabilities initially measured under ASC 715, formerly FAS 87). Therefore, we support the IASB's decision that effectively incorporates this difference into goodwill, consistent with the resulting treatment currently for assets or liabilities in a business combination initially measured at an amount that is not equivalent to fair value.

## ***Contract Modifications***

### **FASB Question 39**

#### *Questions for Preparers and Auditors*

Question 39: Do you agree that for a substantial modification (a) an entity should recognize a gain or loss as the difference between the measurement of the modified contract using the current entity-specific price that the entity would hypothetically charge the policyholder for a contract equivalent to the new contract and the carrying amount of the existing contract and (b) that the carrying amount of the existing contract should be derecognized? If not, what do you recommend?

#### **ACLI Response:**

No, we believe the FASB, in using existing guidance in ASC 944, formerly contained in AICPA Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts* ("SOP 05-1"), has inadvertently made the contract modification guidance overly complex and not useful. The FASB has only carried over parts of the guidance from SOP 05-1, while neglecting other critical parts (i.e., guidance related to integrated and non-integrated features and valuable application guidance).

First, as we understand the proposed guidance, a contract modification occurs only when it is agreed upon by both the policyholder and insurer and the modification is outside the terms of the original contract. This concept needs to be further clarified in paragraph 834-10-40-4.

Said another way, a contract modification is not the result of an election by the contract holder of a benefit, feature, right or coverage that was within the original contract such as a term to whole life conversion (with no underwriting required), a premium deposit for a universal life contract or a premium rate increase for a portfolio of long-term care contracts. We believe these are modifications due to contractual rights (e.g., not subject to re-underwriting, etc.) of a policyholder that are already contemplated and accounted for at inception via paragraph 834-10-30-7:

“The measurement of the fulfillment cash flows shall include embedded options and guarantees that are not accounted for as embedded derivatives under Topic 815. Those embedded options and guarantees are a result of features in an insurance contract that enable policyholders or the entity to take actions that change or otherwise affect the amount, timing, nature, or uncertainty of the benefits the policyholders will receive. Examples of those features include surrender options, conversion options, and options to cease paying premiums but still receive some benefits. Those features also may include interest rate guarantees and minimum benefit guarantees.”

With that background, it is important to note that there are several notable differences between the proposed guidance and SOP 05-1.

- SOP 05-1 requires special treatment for changes that are both within, and outside, the terms of the original contract depending upon the terms of the contract and the conditions of paragraph 9,
- Unlike SOP 05-1, the proposed guidance is dynamic with the unlocking of assumptions each reporting period,
- Unlike SOP 05-01, there is an explicit margin, which is run-off as risk diminishes,
- Unlike current U.S. GAAP, there are not multiple accounting models applied to a contract modification.

Because of these differences, the contract modification guidance can be simplified under the new regime. For modifications outside the terms of the original contract, the measurement of the modified (new) contract (and margin) should be determined using the current entity-specific price (as contemplated in the proposed guidance) that the entity would hypothetically charge the policyholder for a contract equivalent to the new contract and assign it to a new portfolio. Any margin attributable to the old contract will automatically be eliminated upon re-measurement of the exited portfolio. This obviates the need to determine whether a contract modification was substantial or not substantial and to track the margin at a unit of account that is less than the portfolio (or cohort) level. It also eliminates complicated “modification” accounting while largely (if not exactly) achieving the same result.

As we have indicated in our response to Question 13 and elsewhere, we strongly encourage the FASB to reconsider the benefits of an unlocked margin. One of the benefits of moving to a margin that is unlocked each period for changes in expected future cash flows is that the contract modification guidance can be simplified, as all modifications would be accounted for as changes in fulfillment cash flows that adjust the margin, except when a contract was modified such that it no longer qualified to be in the same portfolio or was no longer within the scope of the insurance standard. It would reduce complexity and significantly simplify retrospective application at transition, and lead to a converged outcome with the IASB in this regard.

### *Presentation*

#### **FASB Question 40**

##### **Presentation**

*Questions for all Respondents*

Question 40: Do you agree with the presentation requirements included in this proposed Update? If not, what would you recommend and why?

#### **ACLI Response:**

Our comments on the insurance contract revenue presentation proposal are included in the response to Questions 31 and 34 above. In addition we have the following comments and recommendations:

- We note that the presentation requirements set out in the proposed ASU, examples of which are found at paragraphs 834-10-55-171 through 55-173 are in conflict with current presentation requirements for financial statements filed with the Securities and Exchange Commission (SEC) as set out in SEC Regulation S-X *Form and Content of and Requirements for Financial Statements* (Regulation S-X). Regulation S-X provides specific guidance on line items required for presentation, delineated based upon the type of entity filing the financial statements as follows:
  - Article 5 – Commercial and Industrial Companies
  - Article 6 – Registered Investment Companies
  - Article 7 – Insurance Companies
  - Article 9 – Bank Holding Companies

As an example of this conflict, §210.7-04 (“Article 7”) indicates that premiums; net investment income; benefits, claims, losses, and settlement expenses; and underwriting, acquisition, and insurance expenses should appear on the face of the statement of comprehensive income of an insurer. Conglomerates and other organizations which are not principally insurance companies, may issue insurance contracts. As Article 7 is intended for insurance companies only, these organizations would not likely be subject to those requirements. Some entities that are not primarily insurance entities but have a substantial insurance business include all insurance

business in a single “other income” line item, while others separate premiums from other non-insurance revenue amounts, with disclosure of the policy and additional information about insurance activities in the notes to the financial statements.

We believe that it is imperative that the Board coordinate with the SEC to assure that the presentation requirements in the proposed ASU are in line with the presentation requirements specified in Regulation S-X prior to the effective date of the proposed ASU.

- We do not support the presentation requirement in paragraph 834-10-45-2 to separately present portfolios of insurance contracts in an asset position from portfolios in a liability position. We note that it would be common to have portfolios of contracts move from an asset position to a liability position over time. We would support a net presentation in the face of the statement of financial position with disclosure of portfolios in an asset position and those in a liability position in the notes to the financial statements. Separate presentation may lead to unnecessary complexity in the required reconciliations of opening balances to closing balances for the period.
- We do not support the paragraph 834-10-45-7 requirement to present investment income generated from the assets in the qualifying segregated fund arrangements and the interest credited to policyholders as a pass through of that investment income as part of investment income and interest expense, respectively, in net income. Segregated fund returns can vary significantly from period to period and actually be negative in a given period. Therefore, significant fluctuations can and will likely occur in both investment income and interest expense. This proposed presentation could lead to confusion for financial statement users.

This presentation approach is a departure from current U.S. GAAP under which such amounts associated with separate accounts (as that term is currently defined in U.S. GAAP) are netted. Current guidance is found at 944-80-45 Financial Services – Insurance, Separate Accounts, and Other Presentation Matters. Paragraph 944-80-45-3 states, “For the portion of separate account arrangements meeting those criteria, the related investment performance (including interest, dividends, realized gains and losses, and changes in unrealized gains and losses) and the corresponding amounts credited to the contract holder shall be offset within the same statement of operations line item netting to zero.”

We concur with the rationale for the current guidance found in Appendix A *Basis for Conclusions* to the American Institute of Certified Public Accountants Statement of Position 03-1 *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*, paragraph A7 which states “Collectively, the unique features of separate account arrangements warrant presentation distinct from an insurance enterprise’s other assets and liabilities. AcSEC concluded that summary account totals in the statement of financial condition and the offsetting of investment performance and corresponding amounts credited to the contract holder provide the most meaningful presentation to the users of the financial statements for contracts meeting the four criteria specified in paragraph .11 of this SOP. In addition, that presentation allows financial statement users to more readily analyze investment returns of insurance enterprises by excluding amounts that are legally insulated from the general account and not available to shareholders.”

Rather than include these amounts within amounts presented on the face of the statement of comprehensive income, we support disclosure of such information in the notes to the financial statements as provided for in paragraph 834-10-50-16.

- The proposed ASU (paragraph 834-10-30-33) would require that a cedant recognize ceding commissions and other fees that are expected to be received from the reinsurer that are not contingent on claims and benefits experience as a reduction of premium ceded to the reinsurer. Proposed paragraph 834-10-35-46 would require the cedant to consider cash flows (including

premiums and ceding commissions) that are contingent on claims and benefits experience to be netted against claims. Reinsurance ceding commissions should be shown separately and not netted against reinsurance premiums or claim reimbursements in the statement of profit or loss for both the cedant and the reinsurer. The proposed guidance effectively creates a different presentation model for reinsurance contracts than for direct contracts. Netting will cause the results of preparers with different mixes of direct and assumed business versus ceded business to lack comparability. One of the express purposes of the Project is to make the financial statements more transparent to analysts and others trying to understand the results. Currently a significant way for analysts to compare companies against each other and against the industry aggregate is to look at premiums and claims before and after reinsurance. The amount of the ceding commissions is one “tile in the mosaic” of information that will be helpful to financial statement readers. We strongly oppose netting of ceding commissions because it reduces the information available to readers from that currently available.

**FASB Question 41**

**Disclosure**

*Questions for All Respondents*

Question 41: Do you agree with the disclosure requirements included in this proposed Update? If not, which disclosure requirement(s) would you change and why? Are there any additional disclosures that would provide decision-useful information and why? Do you think that any of the disclosure requirements included in this proposed Update would not provide decision-useful information and should not be required? If so, which ones and why?

**ACLI Response:**

We do not agree with the disclosure requirements included in this proposed ASU as we believe that the level of disclosure is overly burdensome. We understand the need for relevant disclosures that assist users in understanding the amounts reported in the financial statements. However, the volume and depth of the proposed disclosures are so overwhelming that their usefulness will be severely compromised as financial statement users struggle to understand what is important.

We believe the proposed disclosures go beyond usefulness. Also, the level of detail required as to the inputs, judgments and assumptions used and changes therein, and the nature and extent of risks will pose challenges for both preparers and their auditors. Although similar types of disclosures are required under U.S. GAAP and SEC reporting rules, in many cases such information is found outside of the base financial statements; appearing in the Risk Factors, Management’s Discussion and Analysis, and Quantitative and Qualitative Disclosures about Market Risk sections of the Annual Report on Form 10-K. Currently, forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 are subject to the so called safe-harbor rules thereunder. Moving these types of disclosures to the body of the financial statements will not only remove this safe harbor, but would also require that such data be covered by the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. We suggest that the Board coordinate with the SEC and other regulators to establish appropriate principles for disclosure requirements.

We also have the following significant operational concerns surrounding the proposed disclosures: 1) the amount of time and effort required to develop processes and systems to produce this information as currently proposed, 2) the development of controls for these processes which previously were not required for financial statement footnote disclosures, and 3) the auditability of the information necessary to complete the proposed disclosures. New processes and controls would be instituted in order to ensure that the data inputs and information from the systems is accurate. These processes

would include developing, testing and implementing internal control over financial reporting. The time and expense involved in implementing these system changes, as well as the additional documentation and maintenance requirements, would be considerable. If the standard were adopted in its current form, we would require at least 4 years to prepare systems, create and test new controls, etc., in order to enable adoption.

In addition to the preceding general comments, we provide the following comments for specific proposed disclosures for your consideration:

- **Estimated Returnable Amounts**

As stated in our response to Question 32 above, we do not support excluding amounts received that an entity is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs and excluding from expenses the corresponding repayment of those amounts. Eliminating this requirement would eliminate the need for the related disclosures required by paragraph 834-10-50-12.

- **Acquisition Costs**

As stated in our response to Question 34 above, our proposed BBE presentation view has the advantage of negating the need to monitor and explain the concept of acquisition costs incurred but not yet recognized in the statement of comprehensive income. Such presentation would eliminate the need for the disclosure required by paragraph 834-10-50-14.

- **Participating Contracts**

Discretionary dividends are projected many years or decades into the future and depend upon numerous contingencies, such as general economic conditions, investment returns and mortality and expense experience, etc. The amount of these projected aggregate dividends that will be paid in any given year or range of years could fluctuate significantly from period to period and will not crystallize until approved by the Board of directors. The focus on these non-guaranteed cash flows in isolation, and not others, will at a minimum be unhelpful and at worst could give rise to inappropriate expectations by policyowners or others, especially when similar, equally discretionary credits and charges for universal life are not required to be disclosed.

- **Risks**

We believe that the requirements in paragraph 834-10-50-28 to 50-32 to disclose information about the sensitivity to insurance risk before and after risk mitigation by reinsurance are too technical and detailed to be useful to users of financial statements. We are also concerned that the guidance may require disclosing proprietary information. For example, the disclosures include qualitative information about risk exposures and risk management techniques and methodologies based on information provided internally to key management personnel. These requirements may be crossing the line between useful information and confidential information. We suggest that instead of being prescriptive, the disclosure requirements regarding risk mitigation be more general and be principle based.

In addition, we suggest that the requirement in paragraph 834-10-50-33 to disclose information about the credit quality of reinsurance assets is problematic. Valuation of reinsurer credit risk is complex; reinsurer credit risk is neither reasonably certain nor reasonably estimable; and the expected value is close to zero in any event. Aside from publicly available information, a cedant has very little ability to make such an assessment unless a reinsurer is in default.

From a drafting perspective, it is unclear from the lead in sentence to paragraph 834-10-50-34 whether the guidance in this paragraph is intended to apply specifically to market risk arising from insurance contracts or whether the intent is for this guidance to apply to assets supporting insurance contract obligations as well. The intent of the Board should be made clear. We believe that the requirements in

this paragraph to disclose information with regard to market risk, including sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period (for example, interest rates, equity prices, and foreign currency exchange rates, among others) will be unduly burdensome.

See also our response to Question 23.

#### **FASB Question 42**

##### **Effective Date and Transition**

###### *Questions for Preparers and Auditors*

Question 42: The Board will establish the effective date of the requirements when it issues the final amendments. However, the Board is interested in determining the key drivers affecting the timing of implementation. What are those key drivers? How do those drivers affect the time it will take to implement this proposed guidance?

#### **ACLI Response:**

This proposed ASU, if implemented, would represent a fundamental change in accounting for nearly every product that a life insurance company sells. Never before, to our knowledge, has a standard that requires retrospective application been so far reaching in scope, making it especially challenging for an industry where it is not uncommon to have policies still in force that were issued decades ago. Like no other accounting standard in recent history, the implementation of this guidance would go well beyond mere changes in accounting and financial reporting processes. The effects would be deep and far reaching within almost every area of a life insurance company's operations, requiring a significant amount of time for both internal and external stakeholders to understand as well. Summarized below are the key drivers affecting the timing of implementation for this proposed standard:

- Requirement of new systems and updated software and hardware to perform discount cash flow calculations.
- Analysis of data requirements to apply the proposed measurement guidance, in particular, accumulation of the necessary data for all in-force contracts (if there was no perceived need to store the data historically or if the systems used to store the data have since been retired).
- Development, testing and implementation of new processes, procedures and controls to address the additional accounting and reporting requirements each reporting period to ensure timely filing of financial reports with external stakeholders.
- Upstream and downstream system enhancements to accommodate new financial statement and disclosure requirements.
- Company-wide education of the new standards to support reengineering of business processes outside of accounting and financial statement reporting such as: product development and design, asset/liability management, internal controls, risk management, planning and forecasting, investor relations, portfolio management, etc.
- Extensive education of senior management, analysts, rating agencies, regulators and other users of our financial statements in order for them to fully understand the results of our business each period.
- Development of a revised definition of "operating earnings" and a related processes, procedures and controls around it, to be used for management/segment reporting, MD&A, analyst presentations, etc. The extent of this work will directly depend on the extent to which the final

accounting model appropriately captures the economics of the business and minimizes unwarranted accounting mismatches.

- Implementation of other major new accounting standards at the same time, including, but not limited to, Revenue Recognition, Leases, Financial Instruments - Classification and Measurement and Financial Instrument – Credit Losses.
- Internal and external resource constraints, given the finite supply of qualified technical accountants and actuaries in the world that can assure the most efficient and effective implementation process. The extent of this driver having a significant effect on implementation time will be heavily impacted by the nature of the practical expedients for transition included in the final standard, as well as the reduction in the level of complexity in the final standard.

We believe that this standard should be effective for public companies no earlier than the first fiscal quarter of the first annual period beginning four years after the issuance of a final standard. In other words, the quarter ended March 31, 2019, for calendar year companies, if the standard is finalized before the end of 2014. In addition, we believe that early adoption should not be allowed due to the complexity of the new proposals and concerns regarding comparability.

Further, given the significant interrelationship between assets and liabilities for insurance companies, we recommend that insurance companies be allowed to adopt the new financial instrument classification and measurement guidance at the same time as this proposed ASU. Otherwise, we would question the usefulness of financial statements that reflect only the changes to financial assets during the interim period before the adoption of new guidance on insurance contracts.

**FASB Question 43**

Question 43: Do you think the effective date should be the same for both public and nonpublic entities? Do you think the effective date should be the same for regulated insurance entities and other entities that issue insurance contracts within the scope of this proposed guidance? Why or why not?

**ACLI Response:**

Many smaller companies have limited personnel responsible for the accounting and financial reporting function and may not have the financial or human resources to manage a change of this magnitude. Wholesale changes in accounting require a significant investment in time, systems and personnel. Therefore, we believe that the effective date should be at least one year later for non-public companies, including both regulated insurance entities and other entities that issue insurance contracts within the scope of this proposed guidance.

**FASB Question 44**

Question 44: Do you agree that the practical expedients relating to transition included in this proposed guidance are sufficient for retrospective application (that is, are the transition provisions in this proposed guidance operable)? If not, what would you recommend and why?

**ACLI Response:**

We appreciate that the proposed transition approach provides several practical expedients to determine the margin and AOCI component of the insurance contract liability at transition when full retrospective application is deemed impracticable.

However, we have identified the following significant operational challenges in determining the margin at transition, even when applying the practical expedients provided in the proposed standard:

- It may be a challenge to obtain objective information necessary to support what the projected fulfillment cash flows may have been for long-dated contracts.
- The farther back in time, the more difficult it is to objectively determine what historical fulfillment cash flows “would have been” at inception without the benefit of hindsight.
- It would be operationally challenging to retroactively perform the following from inception to the transition date for every portfolio, or portion of a portfolio (i.e., cohort) for which a margin has been separately determined:
  - an onerous contract test each period to ensure that the margin at inception should not have been released at any point in the life of the contracts;
  - an assessment and accounting for all substantial and non-substantial contract modifications each period to ensure modified contracts are in the appropriate portfolio and margins have been adjusted appropriately since inception;
  - amortizing the margin each period by truing up for actual experience and prospectively adjusting the earnings pattern for the remainder of the life of the portfolio based on a new expectation of future claims and expenses every period determined without the benefit of hindsight; and
  - accreting the margin for participating contracts where the interest accretion rate would have been reset to a new effective level yield every time expectations (of future crediting rate changes occurred during this period of time) determined at transition without the benefit of hindsight.

Given all of these operational challenges in determining the margin at transition, even utilizing the practical expedients provided, we strongly encourage the Board to consider allowing preparers the option to use the practical expedient to determine the margin at the transition date. The use of this approach would not only alleviate significant operational burdens for preparers, but it would vastly improve both verifiability and comparability, while still providing a margin at transition that faithfully represents the profit remaining for those contracts in force at that date. The cost of precision cannot be justified.

While we understand there may be conceptual concerns with using 20/20 hindsight for determining the margin at transition, as it is tantamount to having “unlocked” the margin between inception and the transition date, we believe that such treatment is warranted in these circumstances. Given cost/benefit considerations, we believe a margin calculated in this way provides a more relevant measure to financial statement users than defaulting to a zero margin, as the proposed standard may otherwise require.

We also encourage the Board to consider additional practical expedients as it continues its outreach process, especially for smaller companies. One suggestion – to alleviate the cost of full retrospective adoption for smaller companies or less material lines of business – could be for the guidance to include a practical expedient specifically allow a reasonable proxy for determining the margin at transition on certain simple lines of business.

#### **FASB Question 45**

Question 45: For business combinations that occurred before the transition date, is the requirement included in this proposed Update on reallocating the fair value of the asset and liability balances related to insurance contracts between the expected fulfillment cash flows and the margin operable? Why or why not? If not, what would you recommend and why?

**ACLI Response:**

As long as a company has maintained access to the information related to the fair value of each major portfolio of insurance contracts used to originally apply business combination accounting or can use objective available information to re-determine such amounts, application of these transition provisions should be operable. Other practical expedients that may be made available to assist in determining the margin at inception for contracts previously acquired outside of a business combination could also be applied to contracts acquired in a previous business combination to make these transition provisions more operable.

In addition, we believe that the proposed ASU should allow practical expedients for entities that either disposed of a business through sale or 100% reinsurance prior to the effective date of a new insurance accounting standard.

- For businesses disposed through sale or by 100% reinsurance before the effective date of a new insurance accounting standard, we see no benefit to users of restating prior period information using the proposed ASU's measurement models. (Businesses disposed of before the transition date would naturally be disregarded in the adoption.) For businesses reported as discontinued operations, we do not believe that the application of the proposed ASU to discontinued operations prior to the effective date of a new standard provides useful information, as the discontinued operations of a prior period are not relevant in assessing the ongoing operations of an entity.
- We also believe that the costs of restating prior period information will outweigh any perceived benefits. The entity that sells the business (the "reporting entity") will most likely not have the personnel or records of the sold business necessary to meet the retrospective restatement requirements of the proposed ASU. For the reporting entity, determining fulfillment cash flows and the appropriate discounting will be cost prohibitive and impracticable because the reporting entity will not own the intellectual property and systems necessary to perform the retrospective measurements. This problem will exist for the reporting entity even if it has access to the books and records of the acquirer because the current state of books and records may not allow for the data necessary to perform the retrospective measurements of the proposed ASU. However, the larger issue is that the business experts, including actuaries familiar with the sold business, who have the expertise to perform the proposed ASU's measurement, will likely no longer be employed or controlled by the reporting entity.
- We also believe that it will be cost prohibitive and impractical for the reporting entity to depend on the acquirer to provide information necessary for the reporting entity to restate prior period information and the gain or loss on the disposition. In order to retrospectively restate prior periods for its own financial statements as well as provide prior period restated information to the reporting entity, an acquirer would have to perform two different measurements. The proposed ASU requires the acquirer to use assumptions as of the acquisition date in accordance with the acquiring entity's accounting policies; however, for the reporting entity the assumptions would need to reflect fulfillment cash flows and discount rates that would have been established at the inception of the insurance contracts. We believe full resources will be utilized by all entities that are implementing a new insurance standard, and do not believe that an acquirer will have the resources to also re-measure businesses acquired for prior periods using the reporting entity's assumptions and accounting policies.
- We recommend that any business disposed of through sale or by 100% reinsurance prior to the effective date be allowed a practical expedient to be exempt from retrospective restatement.

We also believe that the proposed ASU should allow practical expedients for certain 100% indemnity coinsurance agreements:

- For certain 100% indemnity coinsurance agreements entered into before the effective date of a new insurance accounting standard, we believe the proposed ASU should allow a practical expedient for a ceding company, in situations in which the assuming reinsurer administers the business.
- In some indemnity reinsurance agreements, the contract calls for the assuming reinsurer to administer the business for the ceding entity, including the financial administration pertaining to the ceding entity's U.S. GAAP and statutory reporting requirements. For such 100% indemnity reinsurance transactions prior to the effective date of a new insurance accounting standard, we believe it will be impractical and cost-prohibitive to require a ceding company to apply the building block or premium allocation measurement model to a business it has effectively sold through reinsurance and no longer has the intellectual property, personnel, data or underlying systems necessary to effect such measurement.
- We recommend that the ceding insurer be allowed a practical expedient to measure its direct and ceded insurance based on the acquirer's/reinsurer's accounting policies and measurements as of the effective date of the ceded reinsurance, and that the ceding insurer's direct and ceded accounts be exempted from the retroactive transition application rules for periods prior to the effective date of the ceded reinsurance.

**FASB Question 46**

*Questions for Users and Auditors*

Question 46: Do you agree that the proposed approach to transition would provide users of financial statements with relevant information that faithfully represents the entity's financial position and performance in a way that appropriately balances comparability with verifiability? Why or why not?

**ACLI Response:**

We appreciate the Board's decision to require retrospective application of the proposed guidance to ensure that the unearned profit associated with contracts in-force at the transition date is faithfully represented in the statement of financial position, to be released into income in future periods. We further appreciate that the proposed approach provides several practical expedients to assist in determining the margin and accumulated OCI component of the insurance contract liability at transition when full retrospective application is deemed impracticable. This guidance improves comparability by allowing more companies the flexibility to go back farther in time to capture additional margin at transition. However, the farther back in time the existing practical expedients are invoked, the less verifiable (i.e., less objective) the determined amounts become.

We believe that verifiability and comparability can be increased significantly, while at the same time alleviating a significant operational burden for preparers through the introduction of an additional practical expedient, as discussed in more detail in our response to Question 44.

**FASB Question 47**

**Costs and Complexities**

*Questions for Preparers*

Question 47: Describe the nature of the incremental costs of adopting the guidance in this proposed Update, distinguishing between one-time costs and ongoing costs. Explain which aspects of the guidance in this proposed Update are driving those costs and include ideas to make the proposal more cost effective.

**ACLI Response:**

ACLI members are extremely concerned about the cost to implement a new insurance accounting standard both one-time and ongoing. While only a few member companies have prepared rough estimates of the cost to implement, the estimated amount per company ranges from \$20-\$30 million on the low end up to several hundred million dollars on the high end, depending on such factors as geographical footprint, depth and breadth of product offerings, and the age of legacy administration systems, all of which have a direct effect on the extent of changes needed to systems, processes and controls. Another factor that will no doubt influence implementation costs will be the availability of resources, e.g., actuaries, accountants, and systems professionals. As companies compete for those resources, the effect will be to drive up the total cost. It is difficult to estimate whether those costs are incremental or opportunity costs. Whether the costs are incremental or not, the result is the same, i.e., significant cost to the industry.

Ongoing costs are difficult to estimate at this point in time. Most assuredly, there will be ongoing costs consisting of increased professional staff and audit fees. The degree of complexity of the standard will not only drive the costs, added complexity could have the effect of making it more difficult for users to understand the financial statements potentially leading to an increase in the cost of capital.

Implementation costs will certainly be less burdensome if the FASB and IASB resolve their differences especially with regard to measurement and presentation. This is not to say that we endorse convergence for convergence sake if the converged view increases complexity or is not a faithful representation of the insurance business causing greater use of non-GAAP measures. Every effort should be made to minimize complexity and significantly reduce or eliminate differences with the IASB proposed standard. Since there are no free resources, the cost will ultimately get reflected in the price of insurance products.

## Appendix A

### **Adjusting the Discount Rate when Measuring OCI for Insurance Contracts: An Alternate Method**

The current exposure drafts from both the FASB and IASB propose that the effect of fluctuations in interest rates on valuation should run through OCI rather than through net income. Conceptually, fluctuations in interest rates create fluctuations in value of assets and liabilities that reverse over time and therefore can be separated from the current period measurement of net income.

While the concept is laudable, the means used to implement it have not clearly achieved their purpose. The means used to implement it involve carrying out two different valuations at the end of each reporting period, one valuation for the balance sheet and a different valuation for purposes of determining net income. The change in the difference between those valuations is classified as OCI.

The valuation for the balance sheet uses a discount rate based on current market interest rates. The valuation for net income uses a discount rate that is locked in at issue for contracts with cash flows that do not depend on asset returns. However, for contracts with cash flows that depend on asset returns, that discount rate is reset whenever it is expected that a change in asset returns will affect the cash flows.

This discussion focuses on the valuation for net income in the case of contracts with cash flows that depend on asset returns. The central question is the reset of the discount rate. The method used to reset the discount rate will drive the amounts to be recognized in OCI, as well as the amount of net income. The effect on net income arises because the discount rate is also used as the interest accretion rate on the liability, and interest accreted on the liability is treated as an expense in net income.

#### **Resetting the Discount Rate: IASB, FASB, and Alternate Methods**

The IASB draft says only that the discount rate should be reset whenever expected cash flows change as a result of a change in interest rates. For these contracts, such a change in expected cash flows normally occurs in every reporting period, so the discount rate would be reset every reporting period. Assuming the discount rate is reset to current market rates, the discount rate for measurement of net income would always be the same as that for the balance sheet. Since the discount rate used for both valuations would be the same, there would be no OCI. All of the variability in valuation due to changes in interest rates would remain in net income for these contracts. This defeats the purpose of OCI, and we will not discuss it further here.

The FASB draft says that the discount rate should be reset in a manner that recognizes any changes in estimated interest crediting and related expected cash flows on a level-yield basis over the remaining life of the contracts.

An Alternate method is based on the idea that since the discount rate is used as the interest accretion rate, it should reflect the rate of interest expected to be credited to the contract in cases where the credited rate is known. The credited rate is commonly known for Universal Life contracts and for many participating life insurance contracts. When the cash flows are based on an expected crediting rate, the discount rate can be set equal to a constant spread over or under the expected crediting rate. In this method, resetting the discount rate means resetting the spread. The discount rate for any valuation follows the expected path of the credited rate over time, plus or minus a constant spread.

The Alternate method differs from the FASB method by not determining the discount rate on a level-yield basis. Under the alternate method, if the expected credited rate is not constant, the discount rate is not level but follows a path up or down in parallel with the expected crediting rate.

Why does this matter? In most cases the credited rate on these contracts is determined based on asset returns measured at amortized cost. When interest rates change, returns on a portfolio measured at amortized cost do not change right away. They gradually change over time as current investments mature and funds are re-invested at the new level of market interest rates. This path of gradual change over time can be leveled, but doing so does not reflect the actual pattern of interest accretion on these contracts.

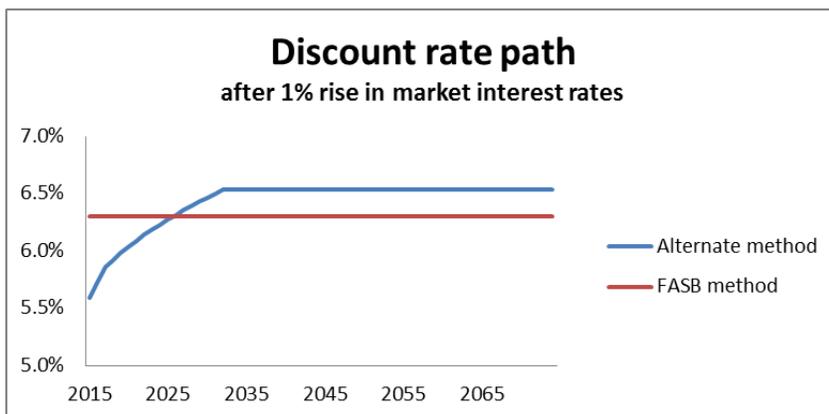
### An Example for a Closed Cohort

A model was prepared to illustrate the difference between the FASB method and the Alternate method in a hypothetical case. In this case, interest rates are assumed to have been level for a long period of time, and then suddenly rise by 1.0% at the end of the year 2014 and remain level thereafter.

The block of business in the example includes 60 years of issue of Universal Life insurance contracts<sup>3</sup>. No new business is included – this is a closed cohort. From issue until the end of 2014, the interest crediting rate has been 5.5%. Assets are invested in bonds earning 5.75% with maturities from 1 to 20 years (all bonds were originally purchased with 20 years to maturity).

We assume that just before the end of 2014, interest rates increase by 1.0%. This means that future investments will be made at 6.75% instead of 5.75%, and it means that the credited rate is expected to rise over time from 5.5% to 6.5%.

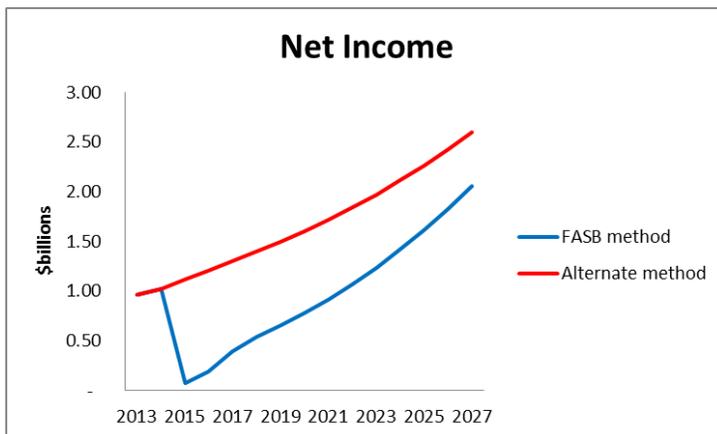
How should the discount rate be reset at the end of 2014? The chart below shows the path of the reset discount rate under the FASB method and the Alternate method at the end of 2014.



As shown in the chart, the discount rate under the FASB method is leveled at 6.30%. Under the alternate method the discount rate follows the expected credited rate on a path that rises from 5.59% in 2015 to 6.5% after 2034.

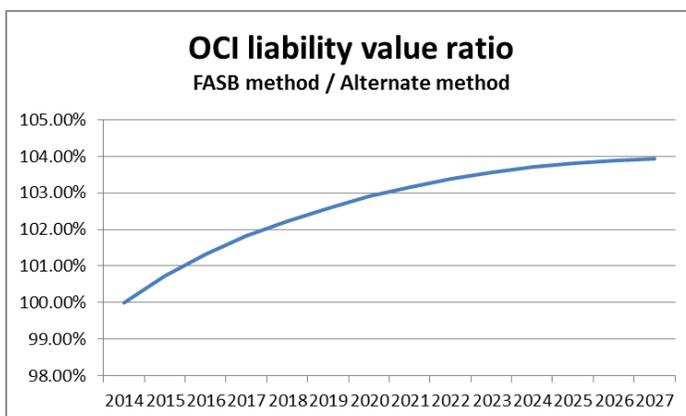
<sup>3</sup> These are simple accumulation-style UL contracts with no secondary guarantees.

This difference affects the measurement of net income. Net income is not affected much in the period that interest rates changed, because the interest accretion rate does not change in that period – it changes for future periods. In this example the interest accretion rate for 2015 changes to either 6.30% under the FASB method or to 5.59% under the Alternate method. This 0.71% difference in interest accretion rate has a very substantial effect on reported net income. The chart below shows the pattern of net income in the model used for this example, for the year before and just a dozen years after the interest rate change.



The FASB method results in a substantial reduction in net income in the first few years after the rise in interest rates, as a result of the higher accretion rate used for interest expense. This would reverse after many years, after the point where the interest accretion rate under the alternate method rose above the 6.30% leveled interest accretion rate under the FASB method.

The accretion of interest at a higher rate means that the liability grows faster. The liability as measured for accretion of interest expense can grow to be substantially different depending on the interest accretion rate that is used. In this example, the liability for measurement of interest expense grows to be 4% higher by 2027 under the FASB method compared to the Alternate method. Of course the two measures of the liability both get closer together and converge to zero over time as the contracts expire.



## An Historical Illustration: 1970 – 2011

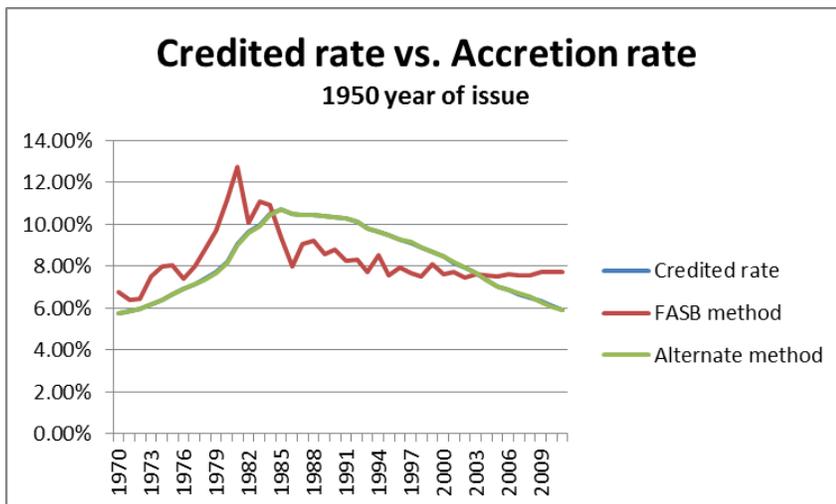
A more sophisticated model was prepared to illustrate reporting under the exposure draft as it might have played out under fluctuating economic conditions like those actually experienced from 1970 – 2011. The insurance contracts in the model are the same kind of UL contracts used for the simple example described above, and have a credited rate that is based on the portfolio earned rate as measured under amortized cost<sup>4</sup>. The model started with 60 years of business in force, with a credited rate of 5.5%. A growing amount of new business is added each year, and investments are managed with a fixed strategy<sup>5</sup>.

In this model, each year of issue was treated as a closed cohort for purposes of calculating OCI. This differs from the model used in the previous example where all of the business was treated as a single cohort and there was no new business.

The economic conditions from 1970–2011 involved a long period of generally rising interest rates followed by a long period of generally falling rates, with some bumps along the way. The differences between the two methods for adjusting the discount rate are significant in this environment. We will review comparative results for the FASB and Alternate methodology first for a single year of issue and then in the aggregate for the entire model company.

### Observations for the Cohort of Business Issued in 1950

The chart below illustrates the interest accretion rates over the years 1970–2011 for the block of business issued in 1950. Note that the credited rate and the interest accretion rate under the Alternate method are virtually identical so only one line is visible on the graph.

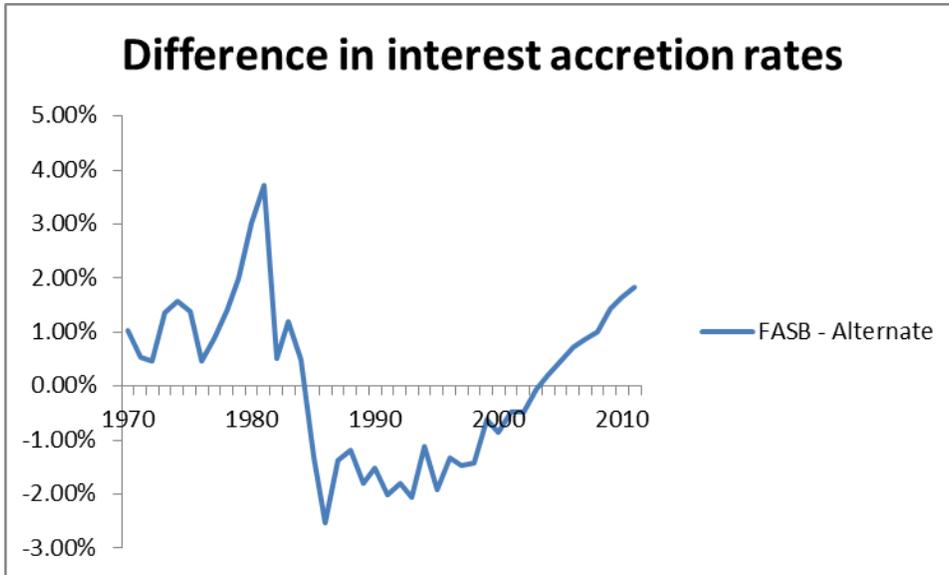


The chart above illustrates that the interest accretion rate under the FASB approach would have been higher than under the alternate approach during the entire decade of the 1970s while interest rates were rising. From then on it would have been generally lower. This makes sense because the total interest accreted over time should be about the same under both methods.

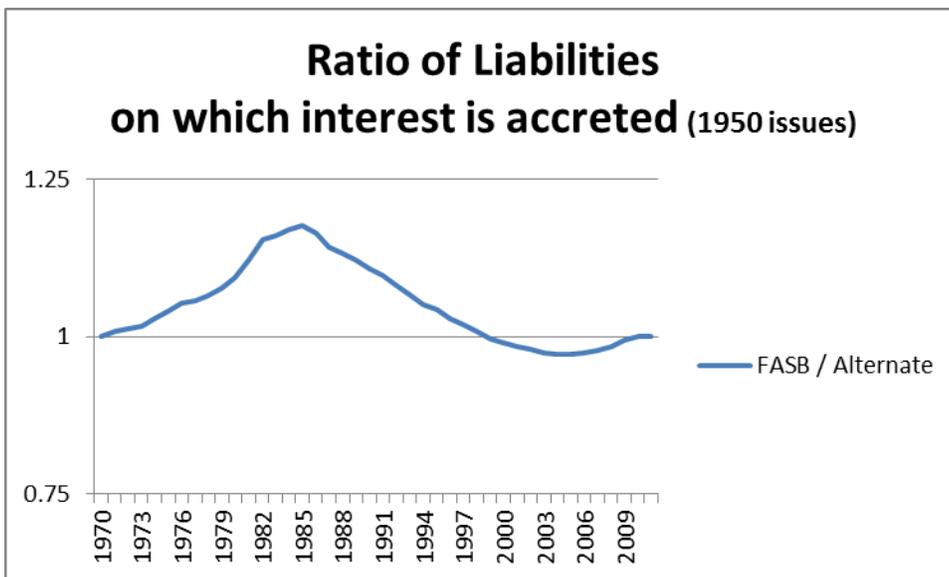
<sup>4</sup> In this historical model, some of the assets were simulated as invested in common stock. The portfolio earned rate used as a basis for the credited rate was measured only on the fixed income portion of the portfolio.

<sup>5</sup> The fixed strategy is to invest available cash in 20 year AA bonds and hold them to maturity. Available cash is determined after maintaining a portfolio position in equities between 8% and 12% of total assets.

The chart below shows the difference between the interest accretion rates under the two methods. Note that the difference would often have been more than 100 basis points, and sometimes over 200 basis points. That kind of difference in interest expense can easily equal or exceed the total expected net income for a year. That makes this difference in methodology very important.



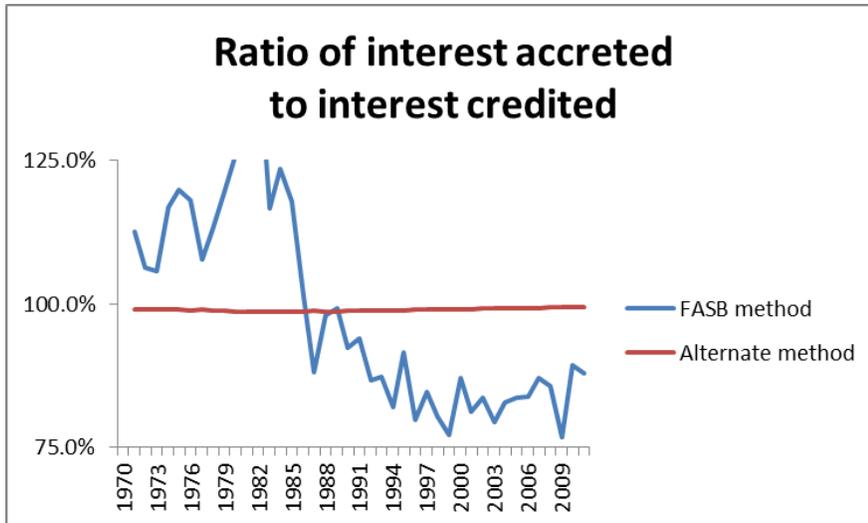
Not only are the interest accretion rates different under the two methods, but the liability value upon which interest is being accreted differs. During the decade of the 1970s, the extra interest accreted under the FASB method would have accumulated to over 10% of the entire contract liability.



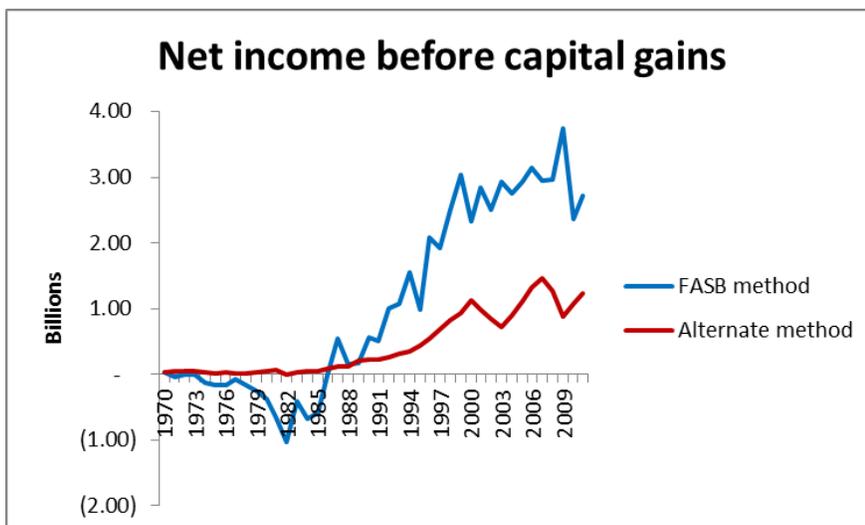
**Observations for the Entire Company**

When viewing all of the cohorts in the model company, results for the total echo those seen for the single cohort.

A major observation is that the interest accreted to the liability under the FASB approach can differ substantially from the interest actually credited to the contract values of the underlying UL contracts. However, under the alternate approach the interest accreted and the interest credited are virtually the same. The chart below illustrates this, using the ratio between interest expense (interest accreted) and the interest actually credited by the company to account balances.



The model company included equity investments in its strategy, and that creates some volatility in net income. However, we can view net income excluding capital gains in order to see whether volatility is coming from another source. The chart below shows net income before capital gains under the two methods for interest expense.



The chart makes clear that the Alternate method leads to substantially less volatility in net income (before capital gains) than the FASB method. Within this model, the volatility in net income shown for the Alternate method arises mainly due to changes in the level of accumulated assets and surplus in a company that invests partially in common stock.

**Appendix B**

**Example 1-Presentation Based on Proposed ASU vs. Alternative**

For purposes of this example, a portfolio of 10-year level premium term contracts was modeled. The following assumptions were used: males age 45 with a level of premium of \$415 payable annually. Since actual results will always differ from expected, the model assumed the following:

**Assumptions vs. Actual for the Portfolio of 100,000 Contracts**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Expected death claims	48.00	61.12	69.47
Actual death claims	48.00	61.00	69.00
Expected lapse rate	9.0%	9.0%	8.0%
Actual lapse rate	9.1%	9.1%	8.1%

**Measurement at Inception:**

PV of future benefits	1,384.3
PV of expenses	1,026.3
PV of future gross premiums	2,484.3
Single margin	73.7
Net insurance liability	(0.0)

**Financial Statement Presentation Based upon Proposed ASU**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
<b><u>Statement of Financial Position</u></b>			
Total insurance liability	(476.0)	(280.7)	(125.7)
<b><u>Statement of Comprehensive Income</u></b>			
Insurance contract revenue	217.1	248.7	266.7
Benefits incurred	96.0	122.0	138.0
Expenses incurred	50.8	46.2	41.9
Amortized Acq. Costs	<u>63.8</u>	<u>73.0</u>	<u>78.2</u>
Underwriting margin	6.5	7.6	8.6
Change in estimate	(0.9)	(0.6)	(0.2)
Net underwriting margin	5.6	6.9	8.3
Investment income	xxx	xxx	xxx
Interest on insurance contracts	(16.1)	(6.5)	0.9

## Reconciliation Between Years (Notes to Financial Statements)

			Premiums	Benefits	Expenses	Margins	Acquisition costs	Net Change in Asset/ (Liability)
<b>Reconciliation between years</b>								
<b>Year 1:</b>								
Beginning of the period			-	-	-	-	-	-
New business			2,484.3	1,384.3	303.8	796.2	-	(0.0)
New acquisition costs							722.5	
Interest			93.1	62.3	11.4	35.8	32.5	(16.1)
Receipt of premium			415.0				-	
Amount released into P&L-premium			-	96.0	50.8	70.3	-	217.1
Amount released into P&L-expense							63.8	
Change due to change in estimate			2.4	1.5	-	-	-	(0.9)
End of period			2,160.0	1,349.1	264.4	761.7	691.2	(476.0)
<b>Year 2:</b>								
Beginning of the period			2,160.0	1,349.1	264.4	761.7	691.2	(476.0)
New business			-	-	-	-	-	-
New acquisition costs							-	
Interest			80.2	60.7	9.8	34.3	31.1	(6.5)
Receipt of premium			377.0				-	
Amount released into P&L-premium			-	122.1	46.2	80.4	-	248.7
Amount released into P&L-expense							73.0	
Change due to change in estimate			2.8	1.9	0.3			(0.6)
End of period			1,860.5	1,285.8	227.8	715.6	649.3	(280.6)
<b>Year 3:</b>								
Beginning of the period			1,860.5	1,285.8	227.8	715.6	649.3	(280.6)
New business							-	
New acquisition costs							-	
Interest			68.3	57.9	8.4	32.2	29.2	0.9
Receipt of premium			342.3				-	
Amount released into P&L-premium				138.6	41.9	86.2		266.7
Amount released into P&L-expense							78.2	
Change due to change in estimate			2.1	1.6	0.3			(0.2)
End of period			1,584.4	1,203.5	194.0	661.6	600.3	(125.6)

### Observations

- The insurance contract revenue is a calculated amount derived by using the sum of the expected benefits, expenses, amortization of acquisition costs and the release of the margin rather than the customer consideration. The row labeled “Amount released into P&L-premium” show the respective amounts. Because of timing differences when premiums are received and benefits paid, the interest accretion on the cash flows will result in an insurance contract revenue amount that is not comparable to the amounts produced under the revenue model.
- Because the proposed ASU requires acquisition costs to be amortized over the 10 years, the effect is that it becomes necessary to capture separately the expected acquisition costs and those acquisition costs incurred and amortized in the same way with the expected acquisition costs amortized becoming part of the insurance contract revenue and the incurred acquisition costs becoming the amount reported as an expense.

The experience adjustment and the release of the risk adjustment and service margin are not transparent and become a result, which is reported as the net underwriting margin.

### Financial Statement Presentation Alternative-BBE Model

The alternative approach recommended by us would disaggregate information about the experience adjustment within the financial statements or alternatively present the detail in the notes.

#### View #1-Presentation within the Financial Statements

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
<b>Statement of Financial Position</b>			
Net insurance liability	(476.0)	(280.7)	(125.7)
<b>Statement of Comprehensive Income</b>			
Premiums	415.0	377.0	342.3
Benefits incurred	96.0	122.0	138.0
Acquisition costs incurred	722.5	-	-
Expenses incurred	50.8	46.2	41.9
Change in liability (unwind estimate)	(454.3)	208.8	161.8
Experience adjustment	-	0.1	0.6
Change in estimate	(0.9)	(0.5)	(0.2)
Release of margin	6.5	7.4	8.0
Underwriting margin	5.6	7.0	8.3
Investment income	xxx	xxx	xxx
interest expense on insurance liability	(16.1)	(6.5)	0.9

#### View #2-Summarized Approach Presented in the Financial Statements

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
<b>Statement of Financial Position</b>			
Net insurance liability	(476.0)	(280.7)	(125.7)
<b>Statement of Comprehensive Income</b>			
Experience adjustment	-	0.1	0.6
Change in estimate	(0.9)	(0.5)	(0.2)
Release of margin	6.5	7.4	8.0
Underwriting margin	5.6	7.0	8.3
Investment income	xxx	xxx	xxx
interest expense on insurance liability	(16.1)	(6.5)	0.9

**Reconciliation Between Years (Notes to Financial Statements)**

	Premiums	Benefits	Acquisition costs	Expenses	Change in Liability to P/L	Margins	Net Change in Asset/ (Liability)
<b>Reconciliation between years</b>							
<b>Year 1:</b>							
Beginning of the period	-	-	-	-	-	-	-
New business	2,484.3	1,384.3	722.5	303.8	-	73.7	-
Interest	93.1	62.3	-	11.4	(19.4)	3.3	(16.1)
Amount released into P&L *	415.0	96.0	722.5	50.8	454.3	6.5	460.8
Change due to change in estimate	2.4	1.5	-	(0.0)	(0.9)	-	(0.9)
End of period	2,160.0	1,349.1	-	264.4	434.9	70.5	(476.0)
<b>Year 2:</b>							
Beginning of the period	2,160.0	1,349.1	-	264.4	434.9	70.5	(476.0)
New business	-	-	-	-	-	-	-
Interest	80.2	60.7	-	9.8	(9.7)	3.2	(6.5)
Amount released into P&L *	377.0	122.1	-	46.2	(208.8)	7.4	(201.3)
Change due to change in estimate	2.8	1.9	-	0.3	(0.5)	-	(0.5)
End of period	1,860.4	1,285.8	-	227.7	(218.5)	66.3	(280.7)
<b>Year 3:</b>							
Beginning of the period	1,860.4	1,285.8	-	227.7	(218.5)	66.3	(280.7)
New business	-	-	-	-	-	-	-
Interest	68.3	57.9	-	8.4	(2.1)	3.0	0.9
Amount released into P&L *	342.3	138.6	-	41.9	(161.8)	8.0	(153.9)
Change due to change in estimate	2.1	1.6	-	0.3	(0.2)	-	(0.2)
End of period	1,584.3	1,203.4	-	193.9	(163.9)	61.3	(125.7)

\*The row titled “Amount released into P&L” represents the expected amounts of premiums, benefits, acquisition costs, and expenses released in the period with the sum of the amounts reflected in the column titled, “Change in Liability to P/L”, e.g., in year 1, expected benefits of 96 + expected acquisition costs of 722.5 + expected expenses of 50.8 – expected premiums of 415 = 454.3.

**Observations**

- Premiums would be reported as the actual premiums from the policyholders in accordance with the contractual terms of the contract, e.g., in year 1- \$415 with the amount released from the liability representing the expected amount. In a similar way benefits and expenses incurred represent the actual benefits and expenses payable with the amounts released from the liability representing the expected amount. In view #1 the release of the expected amounts for premiums, benefits, and expenses are summed and reported as a single amount labeled “change in estimate”. The reconciliation between years shows the amounts released for each component that directly ties to the amount reported in the statement of comprehensive income. Alternatively the reporting entity may choose to further disaggregate the information in a way that would show the experience adjustment for each cash flow, e.g., benefits incurred less expected benefits released equals the experience adjustments related to the payment of benefits.
- Acquisition costs would be reported as incurred with the release of the expected acquisition costs such that any difference would be the experience adjustment for acquisition costs. There would be no need to keep track of these costs over time and the need to amortize those costs would be eliminated, which would greatly simplify the approach, reduce system costs and most importantly provide more meaningful information to users. We believe this presentation is a more faithful representation of the performance of the contract.

### **Benefits of the BBE Model**

- Provides more transparent and useful information to users that better links the measurement of the insurance contract liability and the presentation of the changes in those amounts within the statement of comprehensive income.
- Negates the need to perform in artificial computation of insurance contract revenue.
- Does not require tracking of acquisition costs and maintaining the system to amortize those costs
- Eliminates the need to reconcile insurance contract revenue to actual premiums.

## Example 2- Amount to be Excluded from Incurred Claims Based on Proposed ASU vs. Alternative

The scenario for this example is based upon a portfolio of single premium life income annuities with a 10 year period certain. The policyholders pay a single premium of \$96,952 that pays \$10,000 annually as long as the policyholder lives. In the event the policyholder dies within the first 10 years the beneficiaries receive an annual payment of \$10,000 for the remaining years of the period certain e.g., if the policyholder dies in the fifth year after receiving the fifth-year payment, the beneficiary receives \$10,000 for five years.

### Financial Statements Based upon Proposed ASU

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 10</u>	<u>Year 11</u>	<u>Year 12</u>
<b>Statement of Financial Position</b>						
Invested assets	89,545	86,265	82,731	49,098	45,331	41,604
Net insurance liability	89,545	86,265	82,731	49,098	45,331	41,604
<b>Statement of Comprehensive Income</b>						
Insurance contract revenue	974	956	936	742	8,087	7,728
Benefit Payments	-	-	-	-	7,384	7,056
Acq. Costs	522	512	502	409	392	375
Expenses	7	7	7	5	5	5
Underwriting margin	445	437	428	328	306	293
Interest income	8,108	7,839	7,550	4,827	4,315	3,983
Interest on liability	7,756	7,499	7,222	4,618	4,128	3,811
Net investment income	352	340	328	209	187	172
Net income	797	777	756	537	493	465

### Financial Statements Alternative-BBE Model

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 10</u>	<u>Year 11</u>	<u>Year 12</u>
<b>Statement of Financial Position</b>						
Invested assets	89,545	86,265	82,731	49,098	45,331	41,604
Net insurance liability	89,545	86,265	82,731	49,098	45,331	41,604
<b>Statement of Comprehensive Income</b>						
Premiums	96,952	-	-	-	-	-
Benefit Payments	10,000	10,000	10,000	10,000	7,384	7,056
Acq. Costs	4,363	-	-	-	-	-
Expenses	7	7	7	5	5	5
Change in liability	82,583	(10,007)	(10,007)	(10,005)	(7,389)	(7,061)
Experience adjustment	(0)	-	-	-	-	-
Release of risk adjustment	333	327	320	240	222	212
Release of margin	112	110	108	88	85	81
Underwriting margin	445	437	428	328	306	293
Interest income	7,759	7,504	7,229	4,611	4,114	3,799
Interest on liability	7,407	7,164	6,901	4,402	3,928	3,626
Net investment income	352	340	328	209	187	172

## Observations

- The insurance contract revenue is a calculated amount derived by using the sum of the expected benefits, expenses, amortization of acquisition costs and the release of the margin rather than the customer consideration. Because the first 10 years of payments would meet the definition of amounts to be excluded from insurance contract revenue and benefit payments the amounts reported as insurance contract revenue and benefit payments during the first 10 years are notably reducing.
- Acquisition costs in this proposed ASU example are amortized in a pattern similar to Example 1.
- In a similar way to Example 1, the experience adjustment and the release of the risk adjustment and service margin are not transparent and become a result, which is reported as the net underwriting margin.
- In the BBE model, the amount reported as premiums represents the actual premium under the contractual terms of the contract with benefit payments reported in accordance with the contract for every year.
- In this example, acquisition costs are reported when incurred similar to the approach described in Example 1.