Public Roundtable Meeting to Discuss Comments Received in Response to Proposed Accounting Standards Update, *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts*

April 19, 2017
8:00 a.m.–12:30 p.m.

Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut

AGENDA

Purpose: To listen to stakeholder views and to further develop the Board's understanding of the issues raised or alternatives proposed.

Topic 1: Liability for Future Policy Benefits

A. Assumption Update Method
B. Disclosures
C. Discount Rate—Nonparticipating Contracts
D. Discount Rate—Participating Contracts
E. Change in Accounting—Initial Application

Topic 2: Market Risk Benefits

A. Single Measurement Model
B. Disclosures
C. Change in Accounting—Initial Application

Topic 3: Deferred Acquisition Costs

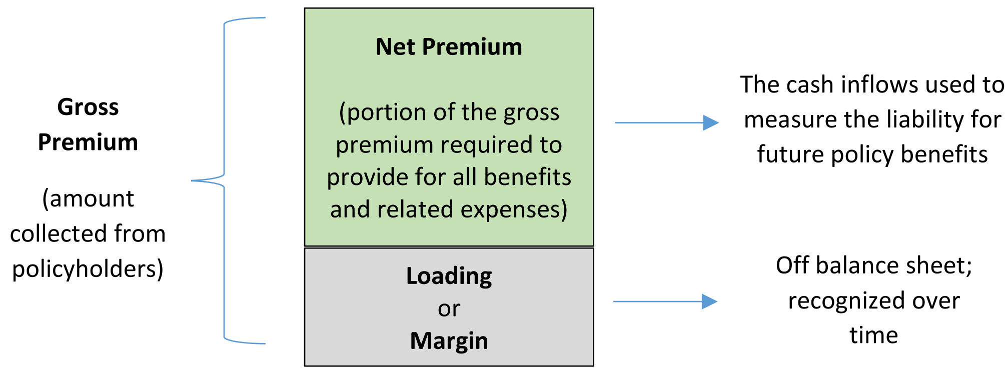
A. Investment Contracts and Other Balances
B. Impairment
C. Disclosures
D. Change in Accounting—Initial Application

Topic 1: Liability for Future Policy Benefits

TOPIC BACKGROUND

Terminology

1. Under current GAAP, a *net premium* reserving model is used to calculate the liability for future policy benefits for traditional, limited-payment, and participating insurance contracts whereby:
   (a) The *gross premium* is the premium charged to policyholders (that is, the revenue that the insurer collects).
   (b) For reserving purposes, the gross premium is divided into the following components:
      (i) *Net premium* is the portion of the gross premium required to provide for all benefits and certain related expenses.
      (ii) The difference between gross premium and net premium is generally referred to as *loading* or *margin.*



2. The *net premium ratio* refers to the ratio of total expected benefits and certain related expenses to total expected gross premiums (on a present value basis). This ratio is used to increase the liability (and recognize benefit expense) over time in proportion to premium income.

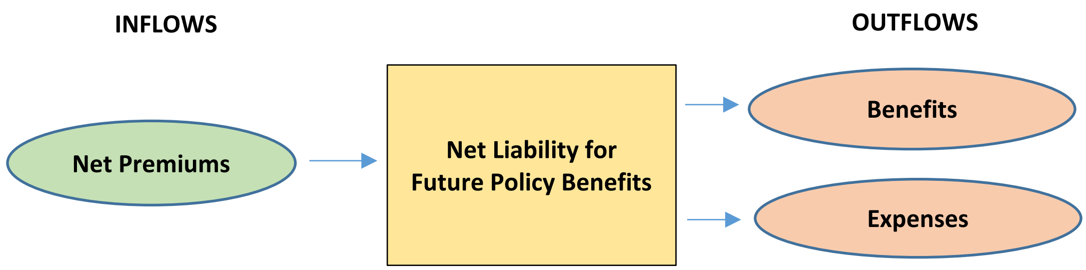
$$\frac{\textbf{Present Value of Expected Benefits \& Expenses (Outflows)}}{\textbf{Present Value of Expected Gross Premiums (Inflows)}} = \textbf{Net Premium Ratio}$$

Existing Accounting Model

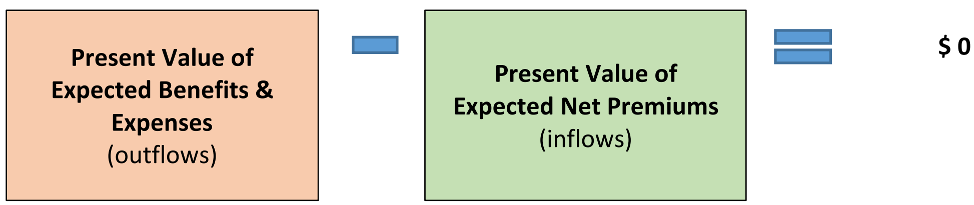
3. The liability for future policy benefits is a net liability as depicted by the following formula:

Present Value of Expected Benefits & Expenses (outflows/payable)	−	Present Value of Expected Net Premiums (inflows/receivable)	=	Net Liability for Future Policy Benefits

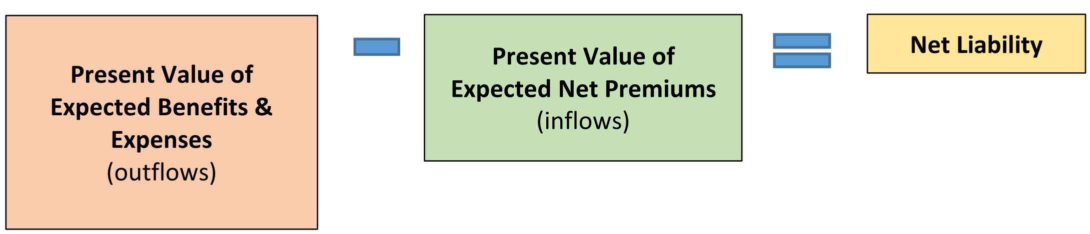
4. In the liability calculation, net premiums are the cash inflows; benefits and expenses are the cash outflows.



(a) *At contract inception*: The present value of net premiums is calibrated to fully offset the present value of benefits and expenses, resulting in a $0 liability:



(b) *In subsequent periods*: The liability is increased (and benefit expense is recognized) in proportion to premium income; this proportion is the *net premium ratio* (discussed in paragraph 2). (Note: the liability is also adjusted for benefit payments and interest accrual.)



A. ASSUMPTION UPDATE METHOD

Proposed Changes

5. Assumption changes would be calculated as follows:
   (a) *Cash Flow Assumptions—Cumulative Catch-Up Adjustment (Retrospective)*
      (i) A cumulative catch-up adjustment would be recorded to remeasure the liability to what it would have been had actual experience and updated assumptions been known at contract inception.
      (ii) Future profits would emerge on the basis of actual historical experience and updated future assumptions.
   (b) *Discount Rates—Immediate Present Value*

(i) The total present value effects of discount rate changes would be recognized immediately in other comprehensive income.

(ii) The amount included in accumulated other comprehensive income would represent the difference between the carrying amount of the liability measured using updated discount rates and rates determined at contract inception.

6. The Board considered the prospective method of updating assumptions but rejected that approach because it would have carried forward into future periods the prior-period effects of assumption changes.
7. The Board also considered that the cumulative catch-up adjustment (retrospective) update method is currently used by insurance entities for updating nontraditional contract benefits.

Feedback

Comment Letters

8. A majority of comment letter respondents agreed that cash flow assumptions should be updated and the effect of updating cash flow assumptions should be recognized in earnings. Although some respondents stated that the cumulative catch-up adjustment (retrospective) update method is more theoretically correct, a majority of respondents preferred the prospective update method.

Investors

9. Substantially all investors supported the notion to unlock the liability measurement assumptions to reflect a more current view of an insurance entity's obligations. Investors also stated that periodically updating assumptions would help reduce or eliminate "cliff effect" losses.
10. Most investors favored the cumulative catch-up adjustment update method over the prospective update method because the liability would be adjusted when a change in future cash flows is identified, and it would allow investors to more clearly see when an insurer has revised its estimates and the effect those revised estimates would have on future profitability. Investors noted that liability adjustments would likely not be backed out of their analyses because those adjustments would relate to the core of the insurance business (that is, viewed as operating).
11. Investors did not favor a prospective method because the liability would not be adjusted when an expected change in future cash flows is identified and it would provide less transparency into the effect of assumption changes. If a prospective update method is used, investors would need robust disclosures to provide transparency into what or why assumptions were updated, and the effects of those assumption changes on future profit emergence.

Questions for Participants

1. What aspects of the cumulative catch-up adjustment (retrospective) update method would make it costly or complex? Please distinguish between one-time initial costs and ongoing costs.
2. Would a prospective update method provide decision-useful information for investors and, if so, how?

B. DISCLOSURES

Proposed Changes

12. The proposed disclosures were developed in response to investor feedback. Investors noted that current financial statement disclosures provide limited decision-useful information and that additional

disclosures would greatly improve the decision usefulness of the financial statements. Investors stated they currently rely on information obtained from various sources other than the GAAP financial statements; however, quality varies and investors spend time and incur costs when searching for information.

Liability—Insurance Reserving Model

13. The following disclosure requirements were proposed for the liability for future policy benefits and the additional liability for annuitization, death, or other insurance benefits:
    (a) Disaggregated tabular rollforward; separate presentation of expected future net premiums and expected future benefits and expenses for the liability for future policy benefits and the related present value discount—for example:

		December 31, 20X1	
		Term Life	Whole Life
Present Value of Expected Net Premiums	Balance, beginning of year	$ XXX	$ XXX
	Beginning balance at original discount rate	XXX	XXX
	Change in cash flow assumptions	XXX	XXX
	Effect of variances from cash flow assumptions	XXX	XXX
	Adjusted beginning of year balance	XXX	XXX
	Issuances	XXX	XXX
	Interest accrual	XXX	XXX
	Net premiums collected	(XXX)	(XXX)
	Derecognition (lapses)	(XXX)	(XXX)
	Experience adjustments	XXX	XXX
	Ending balance at original discount rate	XXX	XXX
	Effect of new discount rate assumption	XXX	XXX
	Balance, end of year	$ XXX	$ XXX

		Term Life	Whole Life
Present Value of Expected Future Policy Benefits	Balance, beginning of year	$ XXX	$ XXX
	Beginning balance at original discount rate	XXX	XXX
	Change in cash flows assumptions	XXX	XXX
	Effect of variances from cash flow assumptions	XXX	XXX
	Adjusted beginning of year balance	XXX	XXX
	Issuances	XXX	XXX
	Interest accrual	XXX	XXX
	Benefit payments	(XXX)	(XXX)
	Derecognition (lapses)	(XXX)	(XXX)
	Experience adjustments	XXX	XXX
	Ending balance at original discount rate	XXX	XXX
	Effect of new discount rate assumption	XXX	XXX
	Balance, end of year	$ XXX	$ XXX

    (b) Weighted-average duration
    (c) The amount of gross premiums recognized in earnings
    (d) Qualitative and quantitative information about significant measurement assumptions (including ranges, weighted averages, and comparison to actual experience)
    (e) Qualitative and quantitative information about contracts with adverse development or contracts for which no reserve is established because no future losses are expected.

Liability—Deposit Model (Account Balance Products)

14. The following disclosure requirements were proposed for the liability for policyholders' account balances and separate account liabilities:
    (a) Disaggregated tabular rollforward
    (b) Weighted-average earned rates and crediting rates
    (c) Guaranteed benefit amounts in excess of current account balances (commonly referred to as the net amount at risk)
    (d) Cash surrender values
    (e) Tabular presentation of account balances by range of guaranteed minimum crediting rates, and the related range of the difference between rates being credited to policyholders and the respective guaranteed minimums
    (f) Qualitative and quantitative information about hedging activity.

15. Following is an example of a disaggregated tabular rollforward disclosure, with accompanying information about weighted-average earned rates and crediting rates, net amount at risk, and cash surrender values:

	December 31, 20X1	
	Universal Life	**Fixed Annuity**
Balance, beginning of year	$ XXX	$ XXX
Premiums	XXX	XXX
Policy charges	(XXX)	(XXX)
Surrenders and withdrawals	(XXX)	(XXX)
Benefit payments	(XXX)	(XXX)
Net transfers from (to) separate account	XXX	XXX
Interest credited	XXX	XXX
Other	XXX	XXX
Balance, end of year	$ XXX	$ XXX
Weighted-average earned rate	X.XX%	X.XX%
Weighted-average crediting rate	X.XX%	X.XX%
Net amount at risk	$ XXX	$ XXX
Cash surrender value	$ XXX	$ XXX

Disaggregation and Disclosure Frequency

16. Disclosures would be disaggregated in a manner that allows investors to understand the amount, timing, and uncertainty of future cash flows arising from the liabilities. Disclosures would be aggregated or disaggregated such that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have significantly different characteristics.
17. Disclosures would be provided for annual and interim reporting periods.

Feedback

Comment Letters

18. While many comment letter respondents stated that disclosing rollforwards for material balances provides decision-useful information, many of those respondents disagreed with certain aspects of the

proposal. Respondents generally noted that the proposal would result in disclosures that are too granular, not decision useful, or costly to prepare. Several respondents provided suggestions for alternative disclosure requirements.

19. Many respondents suggested that disclosures should be required annually rather than quarterly. Those respondents cited existing requirements to provide disclosures on an interim basis when warranted.

Investors

20. Substantially all investors supported enhancing the current disclosure requirements. Some stated that current disclosure requirements are limited and there is diversity in practice with varying quality, making comparability across companies challenging. Although some of the proposed disclosures may be provided outside the financial statements today, some investors stated that having these disclosures in the financial statements for all companies will reduce the time and costs they incur when searching for similar types of information.

21. Investors favored disaggregated disclosures; some suggested that the disaggregation criteria should be more prescriptive to further increase comparability. Investors noted that the rollforward disclosures would provide insights into the drivers of liability changes, including the identification of which product lines are growing because of new sales or shrinking because of surrenders. Investors also supported the comparison between actual and expected experience for certain assumptions (for example, lapse rates). Some investors noted that rollforwards further disaggregated by contract issue year (or groups of years) would be especially useful for certain types of products. Investors also noted that distinguishing between the effect of changing cash flow assumptions versus changes in discount rate assumptions is important. Investors stated that disclosures should include information about how discount rates are determined, particularly when market observable inputs are not available or are limited.

Questions for Participants

3. Do you support the proposed disclosure requirements? If not, what changes do you recommend and why?
4. Since there would be no cumulative catch-up adjustment to the liability for future policy benefits under a prospective update method, what specific disclosures do you recommend that would provide investors with visibility into the nature, timing, and amount of assumption changes, and the effects of those assumption changes on future profit emergence (including the period over which those changes would be reflected)?

C. DISCOUNT RATE—NONPARTICIPATING CONTRACTS

Proposed Changes

22. The proposal would require that future cash flows be discounted using a current high-quality fixed-income instrument yield. This change maximizes the use of market-observable inputs, independent of the return that an insurance entity expects to earn on its investment portfolio.

23. The Board recognized that in some instances there may be points on the yield curve in which there are limited or no observable market data, especially for liabilities that are expected to be settled many decades from the reporting date. Additionally, there may be periods of market dislocation. For points on the yield curve in which there are limited or no observable market prices, or during periods of market dislocation, an insurance entity should use an estimate that is consistent with current GAAP guidance on fair value measurement, particularly for Level 3 fair value measurement. In applying that guidance,

an insurance entity would adjust an observable input that relates to a liability with characteristics that are different from the characteristics being measured.

24. In reaching its decision, the Board placed an emphasis on ease of operability while acknowledging that there is no perfect discount rate. The Board concluded that the discount rate should be a liability rate rather than a rate linked to the insurance entity's investment experience. An insurance entity's economic success is influenced by its ability to invest its assets and earn a rate that exceeds the time value of money on its liabilities. If an insurance entity's investment yield is used to discount the liability, the liability accretion expense would approximate the insurance entity's investment returns, which would not provide information about duration risk and the spread between the return on investment and time value of the liability.

25. The Board also considered that an insurance entity is obligated to perform on its guaranteed benefit obligations irrespective of its investment strategy. Also, the Board noted that an independent market observable rate allows for better comparability across insurance entities. An insurance entity with a lower quality investment portfolio should not report a lower liability than an insurance entity with a higher quality investment portfolio simply because the lower quality investment portfolio has a higher estimated rate of return because of increased risk.

Feedback

Comment Letters

26. Many respondents generally agreed that the discount rate assumption should reflect the characteristics of the insurance liability while maximizing the use of observable inputs. A small portion of respondents agreed with the Board's decision to use a high-quality fixed-income instrument yield when measuring the liability for future policy benefits. Those respondents noted that they supported the Board's decision because the discount rate would maximize the use of current observable market prices of fixed-income instrument yields with durations similar to the liability for future policy benefits in determining the discount rate.

27. However, most respondents disagreed with the requirement that expected future cash flows should be discounted on the basis of a high-quality fixed-income instrument yield. A majority of those respondents suggested that the Board should permit entities to discount expected cash flows using a single A-rated instrument yield. Other suggestions included:
    (a) Retaining existing GAAP guidance (that is, expected investment yield)
    (b) Referencing a "diversified representative high-quality fixed-income yield" (for example, a proposed regulatory standard under which liabilities would be discounted at a rate based on an average of Treasury, AA, A, and BBB instruments)
    (c) Providing a more principles-based approach.

Investors

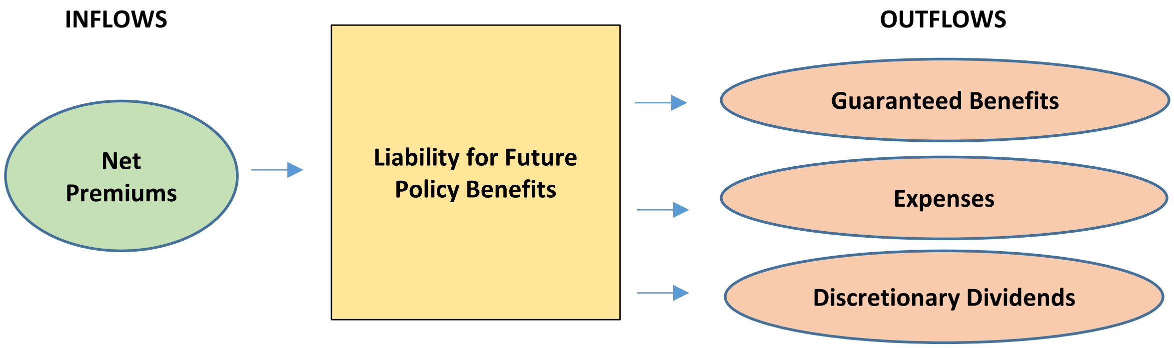
28. Investors had mixed views about the use of a high-quality fixed-income instrument yield to discount cash flows while acknowledging that there is no perfect solution. While some investors said that differing investment strategies and product mixes across companies may justify the use of a discount rate that is tied to an asset yield, more investors favored a more observable and uniform rate that improves comparability and reduces the incentive for insurers to invest in riskier (higher-yielding) assets. Other investors favored using a consistent discount rate, but recommended using a rate that more closely aligns with an insurance entity's investment portfolio and pricing strategy. Investors stressed the importance of useful disclosures, particularly for instances in which observable rates are adjusted and for periods in which observable rates are not available and an insurance entity exercises judgment.

Question for Participants
5. What rate should be used to discount the liability for future policy benefits for nonparticipating traditional contracts and limited-payment contracts and why?

D. DISCOUNT RATE—PARTICIPATING CONTRACTS

Background

29. Under the proposal, participating contracts would follow the same net premium reserving model applicable to nonparticipating contracts, except for the addition of discretionary dividends as expected outflows. As premium income is recognized, the liability is increased (and benefit expense is recognized) by a proportionate amount; this proportion is the *net premium ratio* (discussed in paragraph 2).



Feedback

Comment Letters

30. Respondents disagreed with the proposed amendments on participating insurance contracts and recommended that the Board scope out participating insurance contracts from the proposal unless recommended changes were made.

31. Respondents disagreed with using a high-quality fixed-income instrument yield to discount future cash flows and recommended that the discount rate should be consistent with the dividend crediting rate. Respondents also recommended that the interest accretion rate be unlocked and adjusted to be consistent with the dividend crediting rate.

32. Respondents generally stated that the proposed amendments would be too costly for closed block participating contracts because those contracts are in run off and closed block assets are segregated for the benefit of participating contract holders. As an alternative, respondents recommended that the liability be set equal to the value of the segregated assets, and if those assets are expected to be inadequate relative to the contract guarantees an additional liability would be recognized.

Investors

33. Investors were generally supportive of including participating contracts within the scope of the proposal. Most investors noted that closed block participating books are often small or not a focal point in their analyses, but agreed on including those contracts within the scope of the proposed amendments because closed block shortfalls adversely affect the resources available to shareholders.

Questions for Participants
6. What rate should be used to discount the liability for future policy benefits for participating contracts and why? 7. Should a separate measurement model be introduced for closed block participating contracts held by demutualized insurance entities? If so, what new measurement model would you recommend and why?

E. CHANGE IN ACCOUNTING—INITIAL APPLICATION

34. An insurance entity would apply the proposed amendments on the liability for future policy benefits retrospectively (with a cumulative catch-up adjustment to the opening balance of retained earnings) as of the beginning of the earliest period presented. If it is impracticable to apply the proposed amendments retrospectively, an insurance entity would apply the proposed amendments to in-force contracts on the basis of their existing carrying amounts at the transition date, adjusted for the removal of any related amounts in accumulated other comprehensive income. The existing guidance on determining impracticability is as follows:

> **250-10-45-9** It shall be deemed impracticable to apply the effects of a change in accounting principle retrospectively only if any of the following conditions exist:
>
> a. After making every reasonable effort to do so, the entity is unable to apply the requirement.
> b. Retrospective application requires assumptions about management's intent in a prior period that cannot be independently substantiated.
> c. Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that both:
>   1. Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application
>   2. Would have been available when the financial statements for that prior period were issued.

Feedback

Comment Letters

35. Respondents expressed concern with the practical expedient included in the proposed transition guidance. Some respondents stated that the perceived impracticability threshold would be difficult to overcome because it does not take into consideration the level and extent of time, effort, and resources needed to obtain historical information. Those respondents recommended permitting the practical expedient if the transition cannot be performed without undue cost and effort, even if the impracticability threshold is not met. Other respondents favored applying the proposed guidance for all cohorts prospectively as of the transition date.

Question for Participants
8. What are the challenges with the existing impracticability threshold, and what are your recommendations for improving the operability of the transition requirements?

A. SINGLE MEASUREMENT MODEL

Proposed Changes

36. All market risk benefits would be measured at fair value. The portion of any change in fair value attributable to a change in the instrument-specific credit risk would be recognized in other comprehensive income.

37. A market risk benefit would be a long-duration contract benefit that meets both of the following criteria:
    (a) *Contract*: The contract holder has the ability to direct funds to one or more separate account investment alternatives maintained by the insurance entity, and investment performance, net of contract fees and assessments, is passed through to the contract holder. The separate account need not be legally recognized or legally insulated from the general account liabilities of the insurance entity.
    (b) *Benefit*: The insurance entity provides a benefit protecting the contract holder from adverse capital market performance, exposing the insurance entity to other-than-nominal capital market risk. A nominal risk is a risk of insignificant amount or has a remote probability of occurring. A benefit is presumed to have other-than-nominal capital market risk and is considered to be a market risk benefit if the net amount at risk (that is, the guaranteed benefit in excess of the account balance, cash value, or similar amount) varies more than an insignificant amount in response to capital market volatility. Capital market risk includes equity, interest rate, and foreign exchange risk.

Feedback

Comment Letters

38. Feedback from comment letter respondents was mixed:
    (a) Many respondents agreed with the scope of the proposed amendments on the accounting for market risk benefits and on limiting the guidance to variable (or separate account) products.
    (b) Some respondents supported *expanding* the scope to include general account products, noting that market risk benefits should be accounted for consistently across variable products and nonvariable products. Those respondents noted that insurance entities may offer benefits in general account products that are in substance similar to benefits that are offered in separate account products.
    (c) Many respondents recommended *reducing* the scope to exclude guaranteed minimum death benefits. Those respondents noted that (i) not all guarantees on variable products share substantially similar risk and economics and (ii) death benefits are sufficiently different in form to warrant a different measurement model.
    (d) Some respondents opposed the proposed changes and recommended two measurement models for market risk benefits, distinguishing between life-contingent benefits and non-life-contingent benefits. Respondents noted that insurance entities typically record non-GAAP adjustments for benefits currently measured at fair value.

39. The respondents that supported a uniform measurement model for market risk benefits also generally supported fair value as the measurement model. Those respondents noted that fair value better reflects the economics of the liabilities and market risk benefits and are often hedged with derivatives, which are measured at fair value. Those respondents observed that existing accounting guidance generates noneconomic volatility to the extent certain market risk benefits are hedged because the hedging instruments are reported at fair value while certain market risk benefits are not.

40. Alternatively, some respondents supported the existing insurance accrual model as the single measurement model for all market risk benefits, with either a fair value option or disclosure of the fair

value of market risk benefits. To achieve the objective of comparability, respondents recommended disclosing the fair value of market risk benefits that are measured under the insurance accrual approach.

Investors

41. Most investors agreed with having a single model to account for market risk benefits, stating that having multiple measurement models adds confusion and hinders comparability across companies and benefit types, while the use of a single model would simplify the guidance and would improve comparability with the banking industry, which is especially beneficial for analysts that do not exclusively cover the insurance industry. Investors were mixed on whether equity-indexed annuities or other general account products should be included within the scope of the proposed amendments.

42. Of the two existing measurement models, most investors favored the fair value model over the insurance accrual model because it is more likely to provide more analytically useful information, and the profitability of market risk benefits is dependent on market levels and the accounting treatment should reflect that nuance. Some investors supporting the fair value model liked the notion of matching the measurement of market risk benefits to the measurement of the derivatives used to hedge capital market risk. Investors also pointed out that there is a disincentive to engage in hedging activities under the insurance accrual model because doing so may result in earnings volatility.

43. Other investors expressed concerns with relying on the fair value model to measure all market risk benefits and noted that either a modified fair value or some other measurement approach may be more appropriate given certain limitations of both existing models.

Questions for Participants
9. Scope expansion—Should the scope be expanded to include general account products? If so, what changes to the market risk benefit criteria would you suggest and why?
10. Scope reduction—Should the scope be reduced to exclude certain types of benefits? If so, what changes to the market risk benefit criteria would you suggest and why?

B. DISCLOSURES

Proposed Changes

44. The following disclosure requirements were proposed for market risk benefits:
    (a) Disaggregated tabular rollforward
    (b) The guaranteed benefit amounts in excess of the current account balance (commonly referred to as the net amount at risk)
    (c) Qualitative and quantitative information about significant measurement assumptions, including ranges, weighted averages, and comparison to actual experience
    (d) Qualitative and quantitative information about any related hedging activity.

45. As noted in the amendments to the proposed Update, to the extent that the tabular rollforward achieves the fair value disclosure requirements described in Section 820-10-50, Fair Value Measurement—Overall—Disclosure, an insurance entity need not duplicate the related fair value disclosures (see paragraph 944-40-55-13K in the proposed Update).

Feedback

Comment Letters

46. Some respondents agreed with the proposed disclosures on market risk benefits. However, several respondents commented that the proposed disclosures would be redundant with existing fair value disclosures and disclosing information about hedging activity would be better suited for the Management Discussion and Analysis (MD&A) section of the financial statements.

Investors

47. Substantially all investors supported enhancing the current disclosure requirements. Some stated that the current disclosure requirements are limited and there is diversity in practice with varying quality, making comparability across companies challenging. Investors stated that the proposed disclosures would improve consistency, noting that certain entities currently provide good disclosures on hedging market risk benefits and that type of information should be provided more consistently by all types of entities.

Question for Participants
11. Do you support the proposed disclosure requirements for market risk benefits? If not, what changes do you recommend and why?

C. CHANGE IN ACCOUNTING—INITIAL APPLICATION

48. An insurance entity would measure market risk benefits at fair value at the beginning of the earliest period presented. The cumulative effect of changes in the instrument-specific credit risk between contract inception date and transition date would be recognized in the opening balance of accumulated other comprehensive income. The difference between fair value and carrying value at the transition date, excluding the effect of changes in the instrument-specific credit risk, would require an adjustment to the opening balance of retained earnings.

Feedback

Comment Letters

49. Some respondents agreed with the proposed transition requirements, noting that one may be able to estimate the fair value of market risk benefits at contract inception by leveraging historical pricing models for those benefits that are currently measured at fair value.
50. However, many respondents preferred a prospective approach or a modified retrospective approach. Comments included the following:
    (a) Retrospective transition would be difficult without the use of hindsight, and, therefore, entities should be allowed to use estimates of historical information derived from objective information to determine attributed fees.
    (b) The calculation of the attributed fee should be calculated as of the transition date such that the initial fair value equals the current carrying value.
    (c) Use the actual contract fees (as opposed to attributed fees) in the fair value measurement of the liability.

(d) Determine the terms of the contract at inception using current assumptions and inputs as of the transition date that are applicable to a contract with the same benefit features.

Question for Participants
12. What changes to the proposed transition guidance for market risk benefits do you recommend and why?

Topic 3: Deferred Acquisition Costs

A. INVESTMENT CONTRACTS AND OTHER BALANCES

Proposed Changes

51. The amendments in the proposed Update would simplify the amortization of deferred acquisition costs (DAC). DAC currently amortized in proportion to premiums, gross profits, or gross margins would instead be amortized in proportion to the amount of insurance in force or on a straight-line basis if the amount of insurance in force over the expected term of the related contract cannot be reasonably estimated.

52. The proposed simplification would not apply to investment contracts with DAC currently amortized using the interest method of amortization.

Feedback

Investment Contracts

53. Both investors and comment letter respondents broadly supported the proposed simplified method for amortizing DAC.

54. Feedback from comment letter respondents on its application to investment contracts was mixed. Three alternatives were identified:
    (a) *Proposal*. Maintain the separation of investment contracts under existing GAAP:
        (i) Investment contracts that include significant surrender charges or that yield significant revenues from sources other than the investment of contract holders' funds would follow the proposed simplified method of amortization.
        (ii) All other investment contracts would follow the interest method of amortization.
    (b) *Consistency across long-duration contracts*. Have all investment contracts follow the same amortization method as insurance contracts (that is, consistency across long-duration contracts issued by an insurance entity).
    (c) *Consistency across industries*. Have all investment contracts follow the effective interest method (that is, harmonize investment accounting between insurance and noninsurance entities).

Other Balances

55. Several comment letter respondents noted that certain balances amortized on a basis consistent with DAC may require further consideration:
    (a) *As a result of explicit guidance*. Amortization of deferred sales inducement assets and unearned revenue liabilities associated with universal life-type insurance contracts is based on the same methodology used to amortize DAC. Some respondents supported extending the DAC simplification to these balances. Other respondents noted that the unearned revenue liability reserve should be amortized on a basis more consistent with the deferred profit liability for limited-payment contracts.
    (b) *As a result of industry practice*. Several respondents noted that there are certain balances that are amortized on a basis consistent with DAC as a result of industry practice rather than explicit guidance (for example, cost of reinsurance or business combination intangibles). Some respondents requested clarification on whether the Board intended the proposed DAC simplification amendments to apply to these situations.

Question for Participants
13. What changes to the applicability of the DAC simplification proposal do you recommend and why?

B. IMPAIRMENT

Proposed Changes

56. The carrying amount of DAC would be reduced as a result of unexpected terminations but not as a result of changes in contract profitability. In reaching its decision, the Board observed that a long-duration contract is akin to a financing arrangement in which a contract holder provides cash to the insurance entity (in the form of a premium or deposit) and the insurance entity agrees to return cash to a contract holder or beneficiary at a future date, subject to the terms of the contractual arrangement, and, therefore, establishes a liability to recognize that obligation. In this regard, DAC is similar to a debt issuance cost. Under current GAAP, a debt issuance cost is deferred and amortized over the borrowing term, independent of how that entity chooses to utilize the borrowing proceeds. No impairment assessment is performed on deferred borrowing costs; rather, those costs are amortized as long as the borrowing remains outstanding, and those costs are viewed as part of the total funding cost.

Feedback

Comment Letters

57. Many respondents commented that DAC (or other asset balances amortized on a similar basis) should be tested for recoverability. These respondents recommended a simplified method of assessing impairment on the basis of margins remaining in gross premiums or assessments.
58. Other respondents agreed that DAC should not be subject to impairment testing if the Board's rationale is that a long-duration contract is akin to a financing arrangement and DAC is analogous to debt issuance costs. Other respondents noted that the elimination of impairment testing would reduce complexity.

Investors

59. Investors had mixed views about the elimination of impairment testing. Some stated that DAC is a historical cash outflow and should be expensed as incurred at contract inception or should match to periods in which the contract is still outstanding (regardless of contract profitability).

60. Other investors did not agree with continuing to record amortization for unprofitable contracts, which would have otherwise been written off under the current impairment testing method.

Question for Participants
14. Should DAC (or other asset balances amortized on a basis consistent with DAC) be subject to impairment testing? If yes, what alternative or alternatives do you recommend and why?

C. DISCLOSURES

Proposed Changes

61. The following disclosure requirements were proposed for DAC:
    (a) Disaggregated tabular rollforward
    (b) Qualitative and quantitative information about assumptions used to determine amortization amounts.

Feedback

Comment Letters

62. Some comment letter respondents recommended a summarized rollforward as opposed to a rollforward disaggregated by product type.

Investors

63. Substantially all investors supported enhancing the current disclosure requirements. Some stated that current disclosure requirements are limited and there is diversity in practice with varying quality, making comparability across companies challenging. Investors also stated that the proposed disclosures would improve consistency.

Question for Participants
15. What changes to the proposed DAC disclosure requirements do you recommend and why?

D. CHANGE IN ACCOUNTING—INITIAL APPLICATION

64. An insurance entity would begin to apply the proposed amendments on amortizing DAC as of the transition date to the existing carrying amounts at that date, adjusted for the removal of any related amounts in accumulated other comprehensive income.

Feedback

Comment Letters

65. Respondents were mixed on the proposed transition for the accounting for DAC. Those supporting the proposal stated that prospective application is consistent with other changes to accounting relating to revised amortization patterns for nonfinancial assets. Other respondents preferred an option to apply the transition guidance on a retrospective basis.

Question for Participants
16. Do you agree with the proposed DAC transition requirements? Why or why not?