September 29, 2016

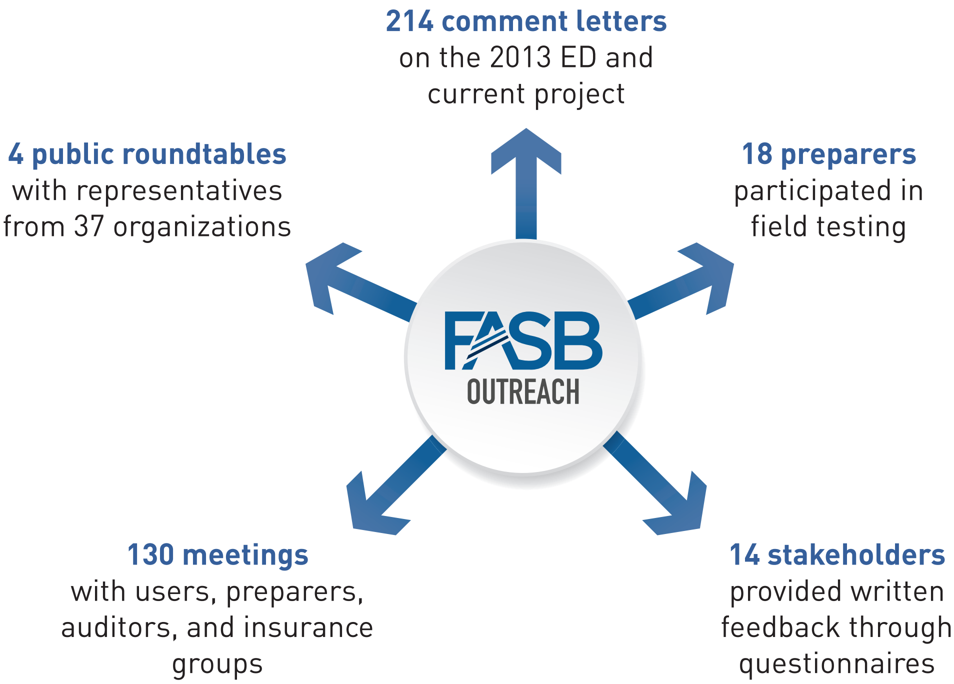
FASB In Focus

Proposed Accounting Standards Update

Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts

On September 29, 2016, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update (ASU) intended to improve financial reporting for insurance companies that issue long-duration contracts such as life insurance and annuities.

The objective of the proposed ASU is to improve, simplify, and enhance the financial reporting of long-duration contracts, thus providing financial statement users with more useful information about the amount, timing, and uncertainty of cash flows related to those contracts.



Why Is the FASB Making Targeted Improvements to the Accounting for Long-Duration Contracts?

The FASB, with the International Accounting Standards Board, undertook a project intended to comprehensively improve the accounting for insurance contracts for all public and private companies.

In 2013, the FASB issued proposed Accounting Standards Update, *Insurance Contracts (Topic 834)*, which introduced new accounting models and qualitative and quantitative disclosures.

The feedback received from stakeholders overwhelmingly supported making targeted improvements to the existing insurance accounting model instead of introducing a completely new and complex accounting model. Stakeholders also overwhelmingly supported limiting the scope of insurance accounting to insurance companies.

Who Would Be Affected by the Proposed Changes?

The proposed changes would apply only to insurance companies that issue long-duration contracts such as life insurance, disability income, long-term care, and annuities. The proposed changes do not apply to policyholders.

What Aspects of the Insurance Accounting Model Are the FASB Targeting?

Based on its extensive stakeholder outreach, the FASB decided to focus on improving the following aspects of the current insurance accounting model:

1. ***Assumptions used to measure the liability for future policy***

benefits: For certain contracts, the insurance liability is measured using out-of-date assumptions that were established when the contracts were issued, which could go back several decades. Also, an expected investment portfolio yield is used to discount the liability.

2. ***Measurement of market risk benefits***: Two very different measurement models exist for similar variable product benefits that provide protection from adverse capital market performance, such as guaranteed minimum death, accumulation, income, and withdrawal benefits.

3. ***Amortization of deferred acquisition costs***: Current methods of amortizing deferred acquisition costs are complex and difficult to understand.

4. ***Disclosures***: Current disclosures provide limited useful information.

How Will the Proposed Changes Improve Insurance Accounting?

The proposed changes would result in the following improvements:

1. ***Updated assumptions used to measure the liability for future policy benefits:*** The liability for traditional, limited-payment, and participating contracts would be measured using periodically-updated assumptions, and the liability would be discounted at a high-quality fixed-income instrument yield independent of an insurance company's expected investment performance. In addition:

AREA OF FOCUS	TARGET	IMPROVEMENT
Liability for future policy benefits	Original assumptions remain "locked"	Assumptions periodically updated
	Discount rate is the insurer's expected investment yield	Discount rate is high-quality fixed-income instrument yield
Market risk benefits (variable products)	Two measurement models	One measurement model
Deferred acquisition costs	Complex amortization	Simplified amortization
Disclosures	Limited disclosures	Enhanced disclosures

a. Cash flow assumptions would be updated at least annually, on a retrospective basis (that is, with a cumulative catch-up adjustment to current-period benefit expense).

b. Discount rate assumptions would be updated at each reporting date, with changes reflected in other comprehensive income.

c. Because assumptions would be periodically updated, the insurance liability would no longer include a provision for risk of adverse deviation, and premium deficiency (or loss recognition) testing would be eliminated.

2. ***Consistent measurement of market risk benefits***: All market risk benefits would be measured at fair value, with changes in credit risk recognized in other comprehensive income. In other words, the second (insurance accrual) measurement model would be eliminated.

3. ***Simplified amortization of deferred acquisition costs***: Deferred acquisition costs 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. As a result, the expense pattern will be more easily predictable and will no longer fluctuate in tandem with an insurance company's investment or underwriting performance. Also, deferred acquisition costs would not be subject to impairment testing; instead, deferred costs would be amortized as long as the related contracts remain outstanding.

4. ***Enhanced disclosures***: Several new disclosures would be required, including liability rollforwards and qualitative and quantitative information about significant inputs, judgments, and assumptions used in measurement.

When Would the Proposed Changes Be Effective?

The effective date will be determined after the Board considers stakeholder feedback on the proposed changes.

How Can Stakeholders Participate in the Board's Deliberation Process?

Stakeholders are encouraged to review and provide comment on the proposal by December 15, 2016. The Board also plans to hold public roundtable meetings on the proposed Update in the first quarter of 2017. Those interested in participating are asked to submit written comments by the comment deadline.

What About Transition?

Changes to the liability for future policy benefits would apply retrospectively, as if the new guidance was in effect when the contract was originally issued. In other words, a cumulative catch-up adjustment to the opening balance of retained earnings would be recognized as of the beginning of the earliest period presented. A practical expedient is provided for situations in which retrospective adoption is impracticable.

Similarly, market risk benefits would be measured at fair value at the beginning of the earliest period presented. A cumulative catch-up adjustment would be recognized in two pieces:

1. The cumulative effect of changes in credit risk would be recognized in accumulated other comprehensive income.
2. The difference between fair value and carrying value at the transition date, excluding the effect of credit risk changes, would be recognized in the opening balance of retained earnings.

In contrast, an insurance company would begin amortizing the existing balance of deferred acquisition costs under the new approach starting on the earliest period presented, without needing to go back in time to when those costs were first capitalized. Any related amounts in accumulated other comprehensive income (commonly referred to as "shadow DAC") would be removed as of the transition date.

For more information about the project, please visit the FASB's website at www.fasb.org.

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