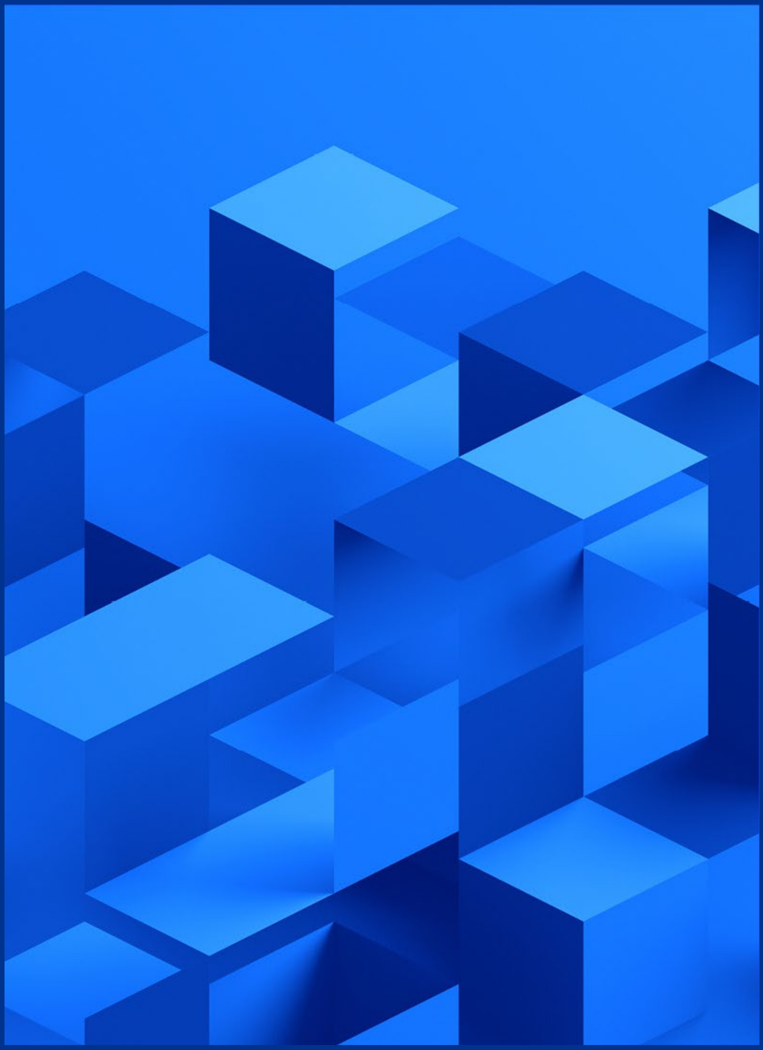
Long-duration contracts

Targeted improvements

Executive summary



US GAAP

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Targeted – but not simple – improvements

In August 2018, the FASB issued ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts, the culmination of a decade-long insurance accounting project. This standard changes how entities recognize, measure, present and disclose long-duration contracts. It is intended to improve, simplify and enhance the financial reporting of long-duration contracts – including providing users with more relevant information and a more current view of expected future cash flows.

The significance of the effort to implement this standard cannot be overstated, including changes to an entity's systems, processes and internal controls. And, data is collected and organized differently.

Our objective is to help you achieve a thorough understanding of this standard. Although some companies have implemented this standard, accounting and reporting issues and positions continue to evolve. Our objective is to help those companies tackle post-implementation challenges.

This Executive Summary provides an overview of the key areas of the standard. Our related KPMG Handbook, Long-duration contracts: Targeted improvements, makes it easier to identify the answers to questions you may already have, and providing information about the questions that you may not have thought about.

Liability for future policy benefits

ASU 2018-12 changes the accounting for the liability for future policy benefits related to traditional and limited-payment long-duration contracts. The accounting continues to use a net premium model; however, the cash flow assumptions are reviewed annually at the same time every year, or more frequently if suggested by experience. When assumptions are updated, changes are made using a catch-up method.

Calculating the liability

To calculate the liability for future policy benefits for traditional and limited-payment long-duration contracts, an entity first puts contracts into contract groups. Contracts from different issue years cannot be grouped together.

The liability for future policy benefits is calculated as the present value of future benefits to be paid to (or on behalf of) policyholders and certain expenses less the present value of future net premiums receivable. The future benefits include:

- estimated future benefits;
- claim liabilities;
- liabilities for claims in the course of settlement;
- liability for incurred but not reported claims; and
- actual benefits paid.

This results in a single liability, so there is no longer a need for separate claims liability calculations.

Discount rate

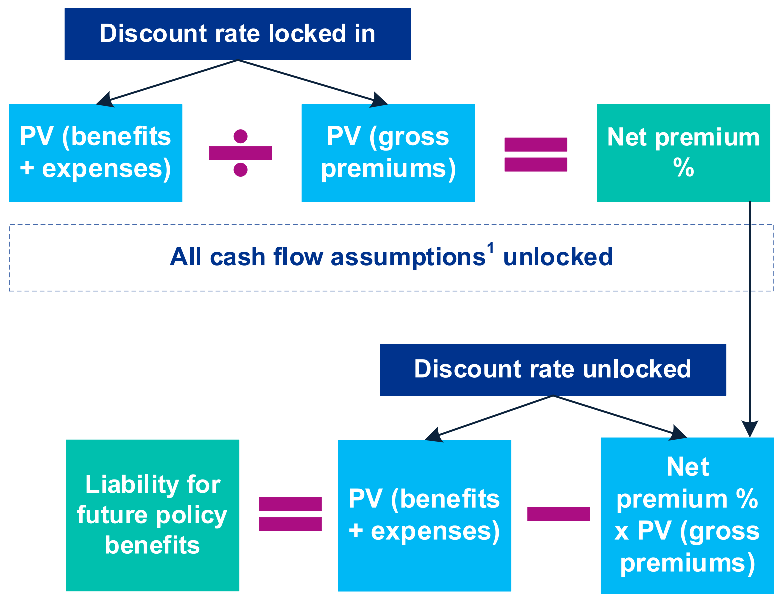
The discount rate is an upper-medium grade (low-credit-risk) fixed-income instrument yield.

- When measuring the liability for future policy benefits, this discount rate is updated each reporting period with the effect of rate changes recognized through other comprehensive income (OCI).
- When measuring interest accretion, this discount rate is locked in at contract issuance.

ASU 2018-12 did not specify how an entity should determine the upper-medium grade (low-credit-risk) fixed-income instrument yield, other than to maximize observable inputs. Therefore, management will need to apply judgment to determine the discount rate (as well as the expected duration of its liability under the contracts). We believe A-rated public corporate debt securities in the US market reflect an upper-medium grade (low-credit-risk) fixed-income instrument yield.

Net premium model

The net premium model is used to calculate the liability for future policy benefits.



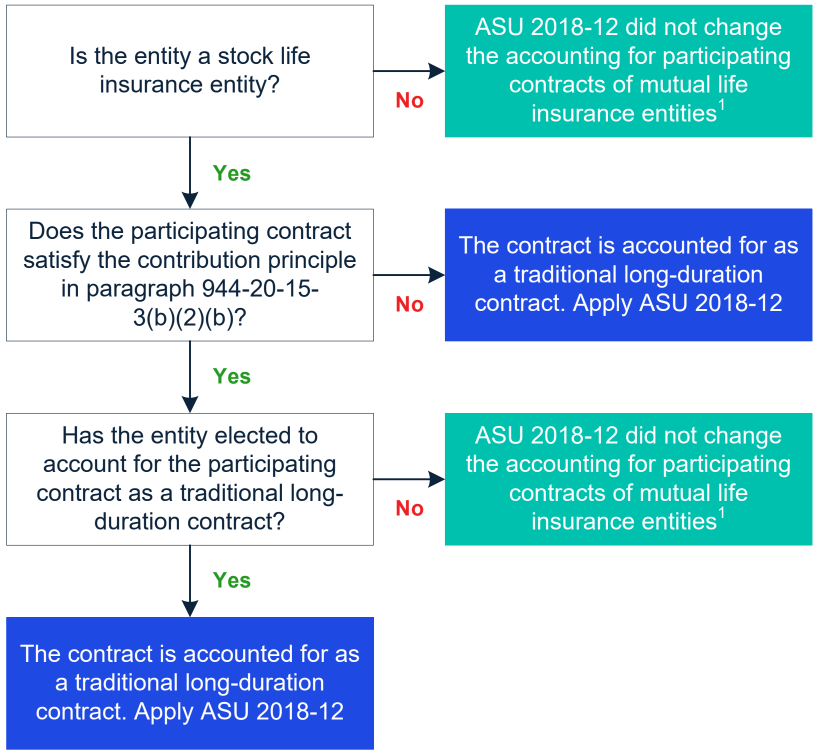
Note:

1. Expense assumptions are to be updated consistently with the updated methodology used for other cash flow assumptions unless an entity-wide election is made to not update expense assumptions.

Participating contracts

At contract issuance, an entity can elect to account for certain participating contracts as traditional long-duration contracts, which requires it to calculate the liability for future policy benefits based on the guidance summarized above.

The following steps can help determine whether an entity's accounting for participating contracts changes when adopting ASU 2018-12.



Note:

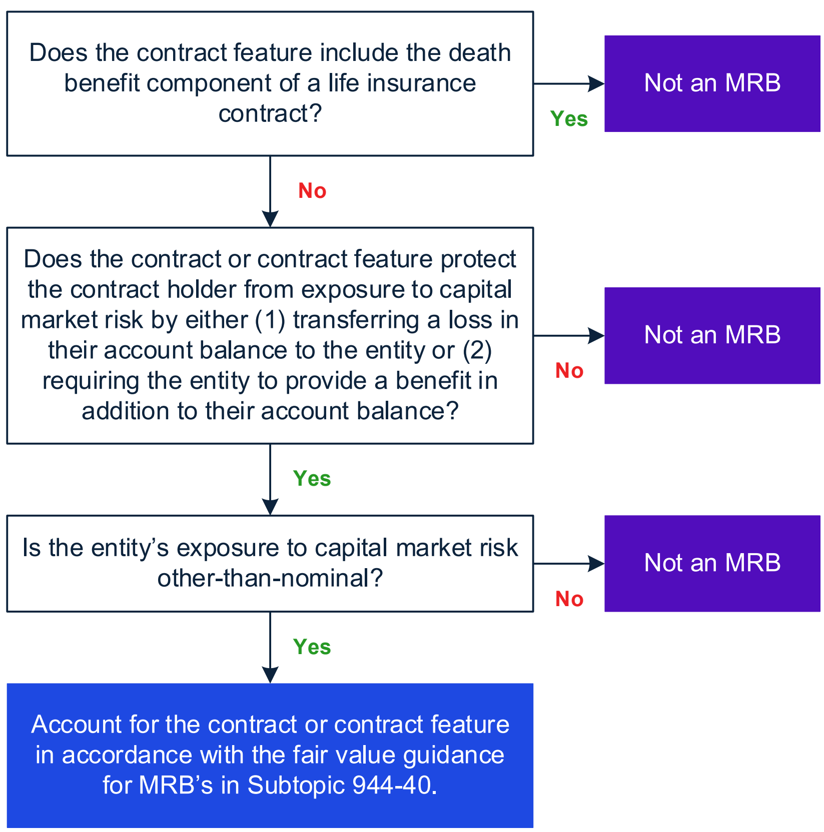
1. Except for terminal dividends.

Market risk benefits

Market risk benefits (MRBs) is a term introduced by ASU 2018-12. It defines an MRB as “A contract or contract feature in a long-duration contract issued by an insurance entity that both protects the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk.” The term was created to recognize that certain contracts or contract features provide benefits in addition to the contract holder’s account balance.

Identifying MRBs

Identifying MRBs requires judgment; however, the following decision tree is a helpful guide.



When there are multiple contract features in an individual contract, each feature is separately evaluated to determine if it meets the definition of an MRB.

Measuring MRBs

Prior to the ASU, two measurement models were used to value benefits in addition to the account balance:

- fair value model for an embedded derivative; or
- the insurance benefit model, sometimes referred to as the SOP 03-1 model.

The model used depended on the characteristics of the benefit.

Under the ASU, an entity applies just one measurement model – the fair value model – for all MRBs associated with deposit (or account balance) contracts.

To estimate the fair value of an MRB as a stand-alone feature, it is separated from the underlying insurance contract. We believe an entity uses its judgment to determine the appropriate valuation approach based on the specific facts and circumstances of each MRB. Two methods to measure the fair value of the MRB when separated from the underlying insurance contract are the nonoption valuation approach and the option-based valuation approach. If a contract includes multiple MRBs, those benefits are aggregated and measured as a single compound MRB.

Presenting MRBs

Changes in the fair value of MRBs are presented separately in the income statement, except for changes attributable to instrument-specific credit risk. The latter type of changes are presented separately in OCI.

Derecognizing MRBs

An MRB is derecognized in the financial statements upon annuitization (for annuitization benefits) or upon extinguishment of the account balance (for withdrawal benefits). The MRB is derecognized at the end of the initial accounting contract. This is also the issue date of a new distinct accounting contract representing the payout phase of the underlying contract.

Reinsurance

An MRB can also exist in a reinsurance arrangement. A reinsurer may assume all or a portion of an MRB. Both the ceding entity and the assuming reinsurer follow the MRB guidance in ASU 2018-12, including the prescribed ordering to determine the appropriate accounting treatment for the contract or contract feature.

Deferred acquisition costs

ASU 2018-12 simplified the amortization method for deferred acquisition costs (DAC) for long-duration contracts. An entity amortizes those costs over the expected term of the related contract(s) on a constant level basis. This amortization method is a departure from the historical amortization method because it is unrelated to revenue or profit emergence.

Capitalization of costs

While ASU 2018-12 did not change the definition of acquisition costs, it did clarify:

- costs that are not eligible to be capitalized and should be expensed as incurred; and
- that acquisition costs, including future contract costs, are not capitalized or amortized before the costs are actually incurred.

The criteria for capitalizing sales inducements did not change with ASU 2018-12. However, the requirement to evaluate whether the crediting rate (excluding the inducement) is consistent with future profit emergence was removed.

ASU 2018-12 also changed accounting for maintenance costs. Historically, maintenance costs related to universal-life-type contracts and certain long-duration participating life insurance contracts were expensed as incurred, including those that:

- varied in a constant relationship to premiums or to insurance in force – e.g. premium taxes;
- were recurring in nature; or
- tended to be incurred in a level amount from period to period – e.g. recurring premium taxes and ultimate level commissions.

The ASU extended this expensing requirement to all long-duration contracts.

Amortization

Under legacy US GAAP, DAC was amortized using amortization models linked to revenue or profit of the related insurance contracts – e.g. premiums, gross profits or gross margins.

In contrast, under ASU 2018-12, capitalized acquisition costs are amortized on a constant level basis over the expected term for either an individual contract or a group of contracts. For an individual contract, amortization expense is recognized on a straight-line basis over the contract's expected term. For grouped contracts, the constant level basis amortization expense should approximate a pattern of straight-line amortization on an individual contract basis.

This change separates the amortization of capitalized acquisition costs from the liability for future policy benefits and from the recognition of the related revenue, gross profit or gross margin.

Additionally, under ASU 2018-12, interest is not accrued on the unamortized DAC balance.

Recoverability

Under ASU 2018-12, DAC is viewed as historical cash flows incurred when the contract was initially issued or renewed. Therefore, DAC is no longer evaluated for recoverability. Instead, the DAC balance is reduced when actual experience is in excess of expected experience – e.g. when contract terminations exceed expectations. Amortization expense recognized in previous closed reporting periods cannot be reversed.

Elimination of shadow DAC

Legacy US GAAP required DAC balances for long-duration contracts to be adjusted for unrealized capital gains and losses because they were amortized using estimated gross profits. The pattern of the cash flows generated by the related contracts (gross profit stream) was adjusted as if the unrealized gains and losses on available-for-sale securities had been realized.

Under ASU 2018-12, this shadow DAC adjustment is eliminated because unrealized investment gains and losses are not considered in DAC amortization.

Reinsurance contracts

The amortization of capitalized acquisition costs for assumed reinsurance contracts follows the simplified guidance in ASU 2018-12. Therefore, capitalized costs are recognized in earnings on a constant level basis using a measure other than premiums or profit emergence. However, the ASU did not change the requirement to account for the net cost to the assuming insurance entity as an acquisition cost.

Other accounting items

ASU 2018-12 may have affected other accounting balances, such as the deferred profit liability for limited-payment contracts, unearned revenue reserves, deferred sales inducements and other balances amortized on a basis consistent with DAC.

Deferred profit liability for limited-payment contracts

For limited-payment contracts, a deferred profit liability (DPL) is recorded for gross premium received in excess of the net premium. The DPL is recognized in income in a constant relationship with insurance in force (for life insurance contracts) or with the amount of expected future benefit payments (for annuity contracts). ASU 2018-12 did not change this guidance, except to provide explicit guidance on the costs to be excluded from net premium.

Under ASU 2018-12, the cash flow assumptions used to measure the DPL are consistent with those used to measure the liability for future policy benefits. Therefore, they are reviewed annually at the same time every year, or more frequently if suggested by experience. When cash flow assumptions are updated, changes are made using a catch-up method.

Under ASU 2018-12, the unamortized DPL balance accrues interest. Additionally, the amount of insurance in force or the amount of expected future benefit payments is discounted using the same locked-in upper-medium grade (low-credit-risk) fixed-income instrument yield as the liability for future policy benefits.

The current period change in the DPL estimate (i.e. liability remeasurement gain or loss) is presented separately in net income, either parenthetically or in a separate line item.

Other balances amortized on a basis consistent with DAC

Certain balances may be amortized on a basis consistent with DAC because Topic 944 prescribes the amortization method or as a result of an accounting policy election.

Topic 944 prescribes that unearned revenue reserves and deferred sales inducements are amortized on a basis consistent with DAC. Therefore, under ASU 2018-12, these balances are amortized using the simplified DAC amortization method.

ASU 2018-12 does not prescribe a specific amortization method for balances historically amortized on a basis consistent with DAC because of an accounting policy election. These balances may include the present value of future profits, value of business acquired and cost of reinsurance. Under ASU 2018-12, the amortization of these balances is either calculated using the legacy US GAAP amortization methodology or changed to the simplified DAC amortization method.

Shadow adjustments

US GAAP requires shadow adjustments be made to the carrying amount of certain financial statement balances to reflect unrealized investment gains or losses as if they had been realized. This adjustment is made when realized investment gains or losses would change the measurement of those balances. When recorded, this shadow adjustment offsets the gross unrealized investment gains or losses in AOCI.

ASU 2018-12 eliminates the consideration of unrealized investment gains and losses in DAC amortization. Because Topic 944 prescribes that unearned revenue reserves and deferred sales inducements are amortized on a basis consistent with DAC, shadow adjustments are not made for these balances.

Under ASU 2018-12, shadow adjustments continue to be made for certain other balances, including:

- the present value of future profits, value of business acquired and cost of reinsurance, if the amortization method considers unrealized investment gains and losses;
- the additional liability for death or other insurance benefit features, including profits followed by losses, if the measurement of the additional liability considers investment performance; and
- any loss recognition, premium deficiency reserves and policyholder dividend obligation reserves for closed block participating contracts, if they meet certain requirements.

Enhanced disclosure requirements

The disclosures in ASU 2018-12 are intended to improve the decision-usefulness of information about long-duration contracts. Disclosures include quantitative information in rollforwards for the liability for future policy benefits, policyholder account balances, MRBs, separate account liabilities and DAC – as well as information about the significant inputs, judgments, assumptions and methods used in measurement.

The new requirements introduce decision points about the level of (dis)aggregation of information to disclose.

The table describes the new disclosures required by ASU 2018-12.

Disclosure	Description
Balance rollforwards for the liability for future policy benefits, policyholder account balances, MRBs, separate account liabilities and DAC	Disaggregated tabular rollforwards reconciled to the balance sheet.
Measurement assumptions or inputs	Information about significant inputs, judgments, assumptions and methods used in measurement, including the technique(s) used to determine unobservable discount rates.
Other items	Information about gross premiums, gross benefits, actual deviations from expected experience, crediting rates, sales inducements, balances amortized like DAC, and the methodology and results of premium deficiency testing for certain long-duration contracts.

Effective dates and transition

Effective dates	SEC filers, except smaller reporting companies[1,2]	Other entities
Annual periods – Fiscal years beginning after:	Dec. 15, 2022	Dec. 15, 2024
Interim periods – In fiscal years beginning after:	Dec. 15, 2022	Dec. 15, 2025
Early adoption allowed?	Yes. If early adoption is elected, the transition date is either the beginning of the prior period presented or the beginning of the earliest period presented.	
Transition method		
Liability for future policy benefits[3]	The modified retrospective method (carryover basis transition) is applied to contracts in force at the transition date using updated future cash flow assumptions and eliminates any related amounts in AOCI. The transition date is either the beginning of the prior period presented or the beginning of the earliest period presented. Any transition adjustment is recognized on that date. Retrospective application may be elected, if certain criteria are met. This election requires the use of both actual historical experience information as of contract issuance and the same contract issue-year level on an entity-wide basis for that issue year and all subsequent issue years for all product lines. The availability of historical experience may limit when retrospective adoption can be used.	
Market risk benefits	The retrospective method is applied at the transition date. Determining the assumptions at original contract issuance requires judgment and	

	an evaluation of the availability and relevance of observable data. The use of relevant observable information as of contract issuance is maximized and the use of unobservable information is minimized. If assumptions are unobservable or unavailable and cannot be independently substantiated, hindsight may be used to determine these assumptions.
Deferred acquisition costs[3]	The modified retrospective method (carryover basis transition) is applied to contracts in force at the transition date. Any transition adjustment is recognized on that date. Retrospective application may be elected, if certain criteria are met. This election requires the use of actual historical experience information as of contract issuance.
Exclusions	
Contracts derecognized before the effective date because of sale or disposal	At transition, an entity can make an accounting policy election to exclude certain contracts from applying the amendments in ASU 2018-12 when the contracts have been derecognized before the effective date and the entity has no significant continuing involvement. An entity may apply the election on a transaction-by-transaction basis to all contracts in a sale or disposal transaction, if certain criteria are met.

Notes:

1. An SEC filer is an entity that is required to file or furnish its financial statements with either (1) the SEC or (2) with respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section. Financial statements for other entities that are not otherwise SEC filers whose financial statements are included with another filer's SEC submission are not included in this definition.
2. A company's determination about whether it is eligible to be a 'smaller reporting company' is based on its most recent filing determination in accordance with SEC regulations as of November 15, 2019.
3. The transition method, issue year level, and transition date used for the liability for future policy benefits and DAC should be the same.

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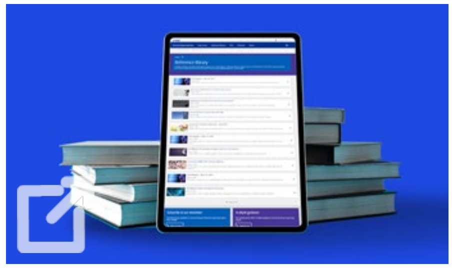

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