FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Memo

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Project	**Insurance Contracts**	
Topic	**FASB/IASB Joint Meeting: Insurance Contracts Project Update**	

Purpose

1. The purpose of this memo is to provide an update on the FASB's project on the accounting for insurance contracts.

Scope and Project Direction

2. In June 2013, the FASB issued proposed Accounting Standards Update, *Insurance Contracts* (Topic 834) (2013 proposed Update). The objectives of the amendments in the 2013 proposed Update were to (a) increase the decision usefulness of the information about a reporting entity's insurance liabilities including the nature, amount, timing, and uncertainty of cash flows related to those liabilities and the effect of those cash flows on the statement of comprehensive income and (b) improve comparability between reporting entities, regardless of the type of entity issuing the contract.

3. The 120-day comment period on the amendments in the 2013 proposed Update ended on October 25, 2013, and the Board received 206 comment letters. The Board also conducted extensive outreach with insurance industry trade groups, preparers, auditors, and financial statement users. The Board carefully evaluated the costs and benefits of various paths forward. Rather than move forward with the amendments in the 2013 proposed Update,

the Board decided to split the project into separate short-duration and long-duration projects. Additionally, the Board decided to limit the scope of the projects to insurance entities within the scope of Topic 944, Financial Services—Insurance.

Short-Duration Contracts

4. The feedback received from respondents overwhelmingly supported retaining in generally accepted accounting principles (GAAP) the existing recognition and measurement guidance for short-duration contracts. Those respondents noted that the existing accounting model for short-duration contracts works well and that no changes should be made to existing guidance other than to disclosure requirements.

5. Financial statement users commented that additional disclosures about the liability for unpaid claims and claim adjustment expenses would increase the transparency of significant estimates made in measuring those liabilities. Those disclosures would provide additional insight into an insurance entity's ability to underwrite and anticipate costs associated with claims.

6. The Board agreed and decided that for short-duration contracts, the insurance project should focus on making targeted improvements to existing disclosure requirements.

7. In May 2015, the FASB issued Accounting Standards Update No. 2015-09, *Financial Services—Insurance (Topic 944): Disclosures about Short-Duration Contracts*. This Update enhances disclosures for short-duration contracts by requiring insurance entities to disclose the following:

   (a) Incurred and paid claims development tables, presented on a disaggregated basis

   (b) The amount of incurred-but-not-reported liabilities, plus expected development on reported claims, included in each accident year presented in the claims development tables

   (c) A reconciliation of the claims development tables to the carrying amount of the liability on the balance sheet

   (d) Disaggregated information about the frequency of reported claims, unless obtaining this information is impracticable

(e) A disaggregated history of claims duration, presented as the average annual percentage pay out of incurred claims by age (except for health insurance claims).

8. The FASB issued an InFocus document summarizing the Update, which is included as Appendix A of this memo.

Long-Duration Contracts

Feedback and Project Scope

9. Many stakeholders agreed with the objectives of the guidance in the 2013 proposed Update to provide decision-useful information about a reporting entity's insurance contracts in its financial statements and to represent the economics of the transaction and improve comparability. Some stakeholders also stated that creating a single, high-quality global accounting and financial reporting standard is important and supported convergence of GAAP and IFRS, while other stakeholders indicated that convergence of GAAP and IFRS is secondary to improving existing GAAP.

10. Stakeholders who supported convergence noted that certain aspects of the amendments in the 2013 proposed Update needed to be converged. These aspects include the margin approach (that is, one margin or two margins), presentation of discount rate changes, accounting for participating contracts, and the types of cash flows that would be included in the measurement of fulfillment cash flows. If these aspects of the 2013 proposed Update cannot be converged with IFRS, then stakeholders generally supported only targeted improvements to existing GAAP because, overall, the costs would not justify the benefits of implementing the guidance in the 2013 proposed Update. Some respondents also were concerned that the guidance in the 2013 proposed Update would significantly diverge from U.S. Statutory Accounting Principles, and users were concerned that historical information and previous analyses would be lost and that certain valuation metrics used would no longer be relevant.

11. In considering the feedback received—including the overwhelming support to retain GAAP for short-duration contracts—the Board decided to focus on making targeted improvements to the accounting for long-duration contracts while considering decisions

reached by the IASB in its 2013 Exposure Draft, *Insurance Contracts*. These improvements were identified through stakeholder feedback in the form of comment letters, user outreach meetings, and other outreach discussions with stakeholders to identify current accounting issues for long-duration contracts and potential targeted improvements that may address those issues.

12. In particular, stakeholders expressed concerns over the locking in (at contract inception) of assumptions used to measure the liability for future policy benefits for traditional long-duration contracts, limited payment contracts, and participating life insurance contracts. Because these contracts may remain in force for several decades, this may result in significant differences between initial assumption estimates and current assumption estimates.

13. Stakeholders also cited concerns about the complexity of the methodologies for amortizing deferred acquisition costs (DAC)—in particular, the estimated gross profits and estimated gross margin amortization methods and shadow adjustments. These complex amortization methodologies complicate the understandability of financial statements.

14. Additionally, stakeholders raised concerns about the current accounting models for certain benefit guarantees included in nontraditional long-duration contracts. Specifically, some of these features are accounted for as insurance following a benefit ratio approach, while other features are accounted for as embedded derivatives and fair valued. Stakeholders commented on the complexity of applying the current guidance, which explicitly addresses only certain types of benefits and results in guarantees with similar risks being accounted for differently.

15. As a result of this feedback, the following improvement areas were identified:

    (a) Whether and how assumptions used to determine the liability for future policy benefits should be updated

    (b) Simplifying the amortization of DAC

    (c) Measurement of certain options and guarantees embedded in nontraditional contracts

    (d) Disclosure enhancements.

Assumptions

Unlocking

16. The Board discussed whether assumptions should be updated periodically. Given the volume of stakeholder feedback citing issues with the current traditional model, which locks in assumptions at inception, the Board voted to require the periodic update of all assumptions used in calculating the liability for future policy benefits for traditional long-duration contracts, limited payment contracts, and participating life insurance contracts.

Update Frequency

17. The Board also discussed the frequency with which insurance entities should update their assumptions. The Board considered the costs and benefits of requiring (or allowing the option for) assumption updates on an interim basis. To facilitate the operability of a requirement to update assumptions, the Board decided that assumptions used to calculate the liability for future policy benefits should be updated annually during the fourth quarter. As a result of voting in favor of periodic assumption updates, the Board voted to eliminate premium deficiency testing and provisions for adverse deviation.

Update Method

18. The Board also discussed what method should be used to calculate and record the effect of updating assumptions used in determining the liability for future policy benefits for traditional and limited payment long-duration contracts. The Board decided on the following:

    (a) *Cash flow assumption changes*: The Board decided to require the updating of cash flow assumptions using a retrospective approach. Under this assumption-update method, a revised net premium ratio is calculated as of contract inception using actual historical experience and updated future cash flow assumptions. The revised net premium ratio is then applied to derive a cumulative catch-up adjustment to be recorded in current-period earnings. In subsequent periods, the revised net premium ratio is used to accrue the liability for future policy benefits. As a result of the Board’s prior decision to eliminate premium deficiency testing, the net premium ratio is capped at 100 percent so that losses are not deferred into future periods.

(b) *Discount rate assumption changes*: The Board decided to require the updating of discount rate assumptions using an immediate approach. The net premium ratio is not updated for discount rate assumption changes. Rather, the effect of discount rate changes is recorded immediately in other comprehensive income. The amount included in accumulated other comprehensive income represents the difference between the carrying amount of the liability for future policy benefits measured using an updated discount rate and the discount rate at contract inception.

Discount Rate

19. The Board also discussed the discount rate that should be used to reflect the time value of money in the calculation of the liability for future policy benefits. The Board considered issues such as the operability of liquidity adjustments, proxies for liability rates, and the applicability of high-quality fixed-income instrument rates to measure long-duration liabilities. The Board ultimately decided that balances that are currently discounted using an expected investment yield should be discounted using a rate based on a portfolio of high-quality fixed-income instruments.

Amortization of DAC

20. The Board decided that DAC relating to certain investment contracts issued by insurance entities would continue to be amortized using an effective interest method. DAC for all other types of long-duration contracts issued by insurance entities would be amortized over the expected life of a book of contracts in proportion to the amount of insurance in force. When the amount of insurance in force is variable and cannot be reliably predicted or is otherwise not readily determinable, a straight-line method in proportion to the number of contracts outstanding would be used. In determining the expected life, entities would consider assumptions such as mortality, morbidity, and persistency. In computing amortization, no interest would accrue to the undiscounted balance of capitalized acquisition costs.

Disclosures

21. The Board also voted to require the disclosure of information about the liability for future policy benefits, including the assumptions used to compute the carrying amount of the liability. These disclosures include:

    (a) Disaggregated balance of the liability for future policy benefits and the weighted-average discount rates used to measure the liability for future policy benefits and any additional information about amounts and rates that significantly affect the discount rates.

    (b) Disaggregated quantitative and qualitative information about the methods and inputs used to develop the measurement of the liability for future policy benefits, including disclosure of assumptions used (such as discount rate, mortality, morbidity, termination [lapse], and expense assumptions).

    (c) Disaggregated reconciliations from the opening balance to the closing balance of the liability for future policy benefits, with separate disclosure of changes in the liability for future policy benefits because of new contracts, benefit payments, changes in assumptions, and derecognition of contracts.

22. Additional disclosure requirements will be discussed at future meetings.

Next Steps

23. In future meetings, the Board will discuss the following:

    (a) Accounting for certain options or guarantees embedded in nontraditional insurance contracts

    (b) Conforming changes to the accounting model for participating contracts

    (c) Disclosures

    (d) Transition.

May 21, 2015

FASB In Focus

Financial Services—Insurance (Topic 944): Disclosures about Short-Duration Contracts

On May 21, 2015, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) No. 2015-09 *Financial Services—Insurance (Topic 944): Disclosures about Short-Duration Contracts,* to make targeted improvements to disclosure requirements for insurance companies that issue short-duration contracts—in which insurance coverage is provided for a fixed period of short duration (typically one year or less).

Why Is FASB Improving GAAP for Short-Duration Insurance Contracts?

The FASB, with the International Accounting Standards Board (IASB), undertook a project intended to comprehensively improve the accounting for insurance contracts, both long-duration (life insurance and annuities) and short-duration (auto and home insurance), for all public and private companies.

In June 2013, the FASB issued proposed Accounting Standards Update, Insurance Contracts (Topic 834), which introduced new accounting models and qualitative and quantitative disclosures to help users of financial statements understand the amount, timing, and uncertainty of future insurance contract cash flows.

Stakeholders said that the existing accounting model for short-duration contracts works well and should continue to apply only to insurance companies. They said that changes to the guidance should be limited to improvements to required disclosures.

At the same time, the IASB issued a proposal for insurance contracts, which also introduced new accounting models as well as qualitative and quantitative disclosures. Although the objective of the joint project was to develop common guidance, several aspects of the proposed amendments differed between the FASB and the IASB.

The feedback received from stakeholders on the proposal overwhelmingly supported retaining current recognition and measurement guidance for short-duration contracts under Generally Accepted Accounting Principles (GAAP).

Stakeholders said that the existing accounting model for short-duration contracts works well and should continue to apply only to insurance companies. They said that changes to the guidance should be limited to improvements to required disclosures. The Board considered this feedback and decided to address accounting and disclosure improvements for long-duration insurance contracts in a separate project.

For the short-duration contract project, the FASB focused on making targeted improvements to existing disclosure requirements to provide users with additional information about insurance liabilities. The disclosures will help users assess the following:

- The nature, amount, timing, and uncertainty of future cash flows related to insurance liabilities, and
- The effect of those cash flows on the statement of comprehensive income.

Additional disclosures about the liability for unpaid claims and claim adjustment expenses would provide transparency and additional insight into an insurance company's ability to underwrite and anticipate costs associated with claims.

Users of financial statements commented that additional disclosures about the liability for unpaid claims and claim adjustment expenses would provide transparency and additional insight into an insurance company's ability to underwrite and anticipate costs associated with claims.

In addition, the ASU will improve comparability by requiring consistent disclosure of information in the financial statements.

Table 1

Accident Year	Incurred Claims and Allocated Claim Adjustment Expenses, Net of Reinsurance										As of December 31, 20Y6	
	For the Years Ended December 31										Total of Incurred-but-Not-Reported Liabilities Plus Expected Development on Reported Claims	Cumulative Number of Reported Claims
	20X7	20X8	20X9	20Y0	20Y1	20Y2	20Y3	20Y4	20Y5	20Y6		
20X7	$ 10,000	$ 9,900	$ 9,700	$ 9,800	$ 9,750	$ 9,750	$ 9,600	$ 9,650	$ 9,575	$ 9,550	$ 5	39
20X8		10,950	11,000	10,500	10,750	10,850	10,600	10,250	10,150	10,250	30	37
20X9			12,000	11,750	11,500	10,900	10,900	10,850	10,750	10,500	90	38
20Y0				12,250	12,500	12,550	12,400	12,200	12,150	12,000	300	36
20Y1					12,300	12,500	12,650	12,750	12,800	12,850	900	35
20Y2						12,800	12,900	12,750	12,700	12,700	1,100	34
20Y3							13,000	13,250	13,100	13,150	1,500	31
20Y4								13,150	13,250	13,300	2,100	29
20Y5									13,500	13,250	3,100	26
20Y6										13,750	5,000	22
									Total	$ 121,300		

Table 2

Accident Year	Cumulative Paid Claims and Allocated Claim Adjustment Expenses, Net of Reinsurance									
	For the Years Ended December 31									
	20X7	20X8	20X9	20Y0	20Y1	20Y2	20Y3	20Y4	20Y5	20Y6
20X7	$ 3,000	$ 5,000	$ 5,500	$ 6,000	$ 6,800	$ 7,500	$ 8,500	$ 9,000	$ 9,050	$ 9,075
20X8		3,500	5,750	6,500	7,500	7,750	8,250	8,500	9,000	9,500
20X9			3,750	6,000	6,500	7,500	7,900	8,250	8,950	9,700
20Y0				3,750	6,250	7,250	7,750	8,900	9,700	9,950
20Y1					4,250	5,500	6,750	8,000	8,950	9,250
20Y2						4,125	5,250	7,000	8,000	9,000
20Y3							4,500	5,750	7,250	7,750
20Y4								4,600	6,000	6,950
20Y5									4,750	6,125
20Y6										4,850
									Total	$ 82,150
						All outstanding liabilities before 20X7, net of reinsurance				1,400
						Liabilities for claims and claim adjustment expenses, net of reinsurance				$ 40,550

Who Would Be Affected by the Changes in This Proposed ASU?

The amendments apply only to insurance companies that issue short-duration insurance contracts. Auto, homeowners, renters, and catastrophe insurance are all typical examples of short-duration insurance contracts subject to the enhanced disclosure requirements.

The amendments do not apply to policyholders of short-duration contracts.

The amendments apply only to insurance companies that issue short-duration insurance contracts.

What Are the Main Provisions of This ASU?

This update to the disclosure requirements includes five main provisions:

1. An insurance company will now provide tables (see table examples 1 and 2) illustrating the amount of insurance claims that have been incurred, as well as the amounts the insurance company has paid out on these claims. These claims development tables, presented on a disaggregated basis, will show how the insurance company's liabilities change over time.
2. An insurance company will now reconcile the claims development tables to the amount of the liability presented on the balance sheet.
3. For each accident year presented in the claims development tables, an insurance company will now disclose the total of incurred claims that have yet to be reported to it plus its estimate of whether reported claim amounts will increase. This disclosure will include the company's methodologies for determining these amounts.
4. An insurance company also will provide disaggregated information about the frequency of reported claims, unless obtaining this information is impracticable.
5. For all claims other than health insurance claims, an insurance company also will provide a disaggregated history of claims duration, presented as the average annual percentage payout of incurred claims by age. This data will show, on average,

- the percentage of claims that are paid in the first year after a claim is incurred, the percentage of claims that are paid in the second year after a claim is incurred, and so on.

Disaggregated disclosures are presented so 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.

The amendments also require an insurance company to disclose information about significant changes in methodologies and assumptions used to calculate the liability for unpaid claims and claim adjustment expenses. These disclosures also include reasons for the change and the effects on the financial statements.

How Do These Changes to GAAP Compare with IFRS?

The IASB currently has a project on its agenda for insurance contracts which, when finalized, may share some similar disclosure requirements.

The claims development tables, the main provision of this ASU, are currently required by IFRS—but are disclosed for the entire consolidated organization and do not require disaggregation.

For example, the claims development tables are not disaggregated by product, geography, or the way a company's management looks at their business. The FASB's ASU will require organizations to provide disaggregated, more-detailed information.

The IASB also decided to pursue changes to the recognition and measurement models of short-duration insurance contracts, while the FASB is retaining existing GAAP. The revisions to recognition and measurement may make the final IASB disclosures more converged or less converged with the requirements in the FASB ASU.

When Will the Amendments in This ASU Be Effective?

For public companies, the amendments in this ASU are effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016.

For private companies, the amendments in this ASU are effective for annual periods beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017.

The Accounting Standards Update is available at www.fasb.org.

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

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