Working Draft:

Targeted Improvements to Long-Duration Contracts Implementation Issue

Issue #1: Claim liabilities associated with long-duration traditional insurance contracts

Wording to be Included in the Audit and Accounting Guide: Life and Health Insurance Entities

1. For certain types of traditional long-duration insurance contracts, such as disability and long-term care (LTC) coverage, claims are expected to be paid over an extended period of time after the claim is incurred (i.e., after the disability event or morbidity event occurs). Claim payments may be required to be made until the insureds recover from their disability or illness, or for the remainder of their lives, and claim amounts may vary depending on the level of disability or illness. Claim payments also exist for other traditional long-duration insurance contracts, such as life insurance, but unlike disability and LTC claims, the time period between the incurral and payment of a claim is typically short and most often for a fixed amount.

2. Prior to the adoption of FASB ASU 2018-12, accounting practice was to account for long duration traditional insurance contracts as comprising two separate liability components within a single contract:

    a. a liability for future policy benefits for claims that have not yet been incurred and
    b. a liability for unpaid claims and claim adjustment expenses for benefits that have been incurred and are expected to be paid out over some estimated period, for example, while the person is disabled or sick in the case of a disability or LTC claim.

3. FASB ASC 944-40-25-8 requires that, "The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders—that is, a liability for future policy benefits—shall be accrued when premium revenue is recognized."

4. FASB ASC 944-40-25-9 requires that, "In addition, as discussed in paragraph 944-40-25-1 liabilities for unpaid claims and claim adjustment expenses shall be accrued when insured events occur."

5. FASB ASC 944-40-25-11 states that "the liability for future policy benefits represents the present value of future benefits to be paid to or on behalf of policyholders and certain related expenses less the present value of future net premium receivable under the insurance contracts."

6. FASB ASC 944-40-30-7 requires that:

> The liability for future policy benefits accrued under paragraph 944-40-25-8 shall be the present value of future benefits to be paid to or on behalf of policyholders and related expenses less the present value of future net premiums (portion of gross premium required to provide for all benefits and expenses, excluding acquisition costs or costs that are required to be charged to expense as incurred). That liability shall be estimated using methods that include assumptions, such as discount rate, mortality, morbidity, terminations, and expenses (see paragraphs 944-40-30-9 and 944-40-30-11 through 30-15). The liability also shall consider other assumptions relating to guaranteed contract benefits, such as coupons, annual endowments, and conversion privileges…

7. FASB ASC 944-40-35-6A requires that:

> ...Net premiums shall be updated for cash flow changes. An insurance entity shall update its estimate of cash flows expected over the entire life of a group of contracts using actual historical experience and updated future cash flow assumptions. An insurance entity shall recalculate net premiums by comparing the present value of actual historical benefits and related actual (if applicable) historical expenses plus updated remaining expected benefits and related expenses, less the liability carryover basis (if applicable), with the present value of actual historical gross premiums plus the updated remaining expected gross premiums…

8. Based on the guidance in FASB ASC 944-40 as excerpted in paragraphs 3 through 7 above, FinREC believes that "future benefits to be paid to or on behalf of policyholders and certain related expenses" represent all payments under the contract, including future expected claims and claims for which the disability, morbidity, or other insurance event has occurred but for which claims have not yet been paid, which obviates the need for a separate claim liability. However, FinREC believes that entities may elect to present the incurred claim component of the liability measurement separately from the liability for future policy benefits as a claim liability. An insurer may disclose quantitative information about known claims if it considers that information to be useful to users of the financial statements

9. FinREC believes that for new business written after the transition date and for contracts for which the retrospective transition method is applied (under FASB ASC 944-40-65-2e), the election to present the incurred claim component of the liability measurement separately from the liability for future policy benefits as a claim liability would produce the same total policyholder liability as of each reporting date, and the same total income, expense and other comprehensive income in each period (i.e., the difference is the separate balance sheet presentation of the claim liability component of the total policyholder liability, but measurement would be the same).

10. FinREC believes that in applying the requirement in FASB ASC 944-40-35-6A to update net premiums and the liability for future policy benefits for actual historical experience and updated future cash flow assumptions, entities should include changes in actual and estimated future cash flows related to incurred claims as inputs to the ASC 944-40-35-6A calculation. Therefore, for purposes of determining the net premium ratio in accordance with FASB ASC 944-40-35-6A, "actual historical benefits and related actual (if applicable) historical expenses" include benefits paid. That is, the ultimate payout amount of a disability, LTC, or other insurance claim reflects the final historical benefit amount. Estimates of future claim payments and updates to those estimates are part of "updated remaining expected benefits and related expenses".

11. FASB ASC 944-40-30-9 requires that "the liability for future policy benefits shall be discounted using an upper-medium grade (low-credit-risk) fixed-income instrument yield … that reflects the duration characteristics of the liability for future policy benefits." Since incurred claim amounts are components of the liability for future policy benefits net premium calculations, FinREC believes that the discount rate requirement in FASB ASC 944-40-30-9 also applies to the claim liability component of the liability measurement. FinREC believes that future cash flows used to measure the claim liability component for determining claim expense should be discounted using the upper-medium grade fixed-income instrument yield at the inception of the insurance contract in accordance with FASB ASC 944-40-30-9, whether it is included as a component of the liability for future policy benefits or separately presented.

12. FASB ASC 944-40-35-5(b) requires that "the discount rate assumption referenced in paragraph 944-40-30-9 shall be updated for annual and interim reporting periods, as of the reporting date." FASB ASC 944-40-35-6A(b)(1) requires that "the difference between the updated carrying amount of the liability for future policy benefits (that is, the present

value of future benefits and expenses less the present value of future net premiums based on updated cash flow assumptions) measured using the updated discount rate assumption and the original discount rate assumption shall be recognized directly to other comprehensive income (that is, on an immediate basis).” FinREC believes that the requirements in FASB ASC 944-40-35-5(b) and ASC 944-40-35-6A(b)(1) to remeasure the liability using the reporting date discount rate with the difference recognized in other comprehensive income applies to a claim liability, whether it is included as a component of the liability for future policy benefits or separately presented.

Transition to FASB ASU 2018-12

13. If an entity is applying the guidance on a modified retrospective basis (that is, prospectively as of the transition date) an insurance entity, in accordance with FASB ASC 944-40-65-2(d)(1) “shall retain the discount rate assumption that was used to calculate the liability [for future policy benefits] immediately before the application of the pending content that links to this paragraph.” FinREC believes that the transition relief in ASC 944-40-65-2(d)(1) extends to claim liabilities that are linked to the measurement of the net premium and liability for future policy benefits as of the transition date. The required transition may effectively be achieved by computing a weighted average rate for the combined cash flows of the liability for future policy benefits and claim liability. As another alternative, an entity may retain the existing separate transition date discount rates when measuring the liability.

14. In addition, FinREC believes that the requirement in FASB ASC 944-40-65-2(d)(4) to compare the future policy benefits balance using the discount rate in ASC 944-40-65-2(d)(1) and the current discount rate, with any resulting difference recorded to opening accumulated other comprehensive income, would also apply to a claim liability that is linked to the measurement of the net premium and liability for future policy benefits, whether it is included as a component of the liability for future policy benefits or separately presented.

15. For business inforce at the transition date for which the modified retrospective transition method is applied (under paragraphs 65-2(c) and 65-2(d) of FASB ASC 944-40), subsequent to transition, presenting the claim liability separately or as part of the liability for future policy benefits should produce substantially similar but not necessarily equal results for the total policyholder liability as of each reporting date, and total income, expense and other comprehensive income in each period. Differences could exist in the subsequent measurement of the liability depending on whether the entity retains the existing separate transition date discount rates for the liability, uses weighted average discount rates, or uses some other reasonable method that reflects the transition date discount rate principle.

Comments should be received by April 10, 2020, and sent by electronic mail to Kim Kushmerick at kim.kushmerick@aicpa-cima.com, or you can send them by mail to attention: Kim Kushmerick, 1345 Avenue of the Americas, New York, N.Y., 10105.