January 21, 2020

Financial Reporting Center –
Long-Duration Contracts Issued by Insurance Entities

Working Draft:

Targeted Improvements to Long-Duration Contracts Implementation Issue

Issue #4AB: Market Risk Benefits - Considerations related to transition, including the use of hindsight and clarification on the application of the fair value framework of FASB ASC 820 to the initial and subsequent measurement of market risk benefits at fair value.

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

1. FASB 944-40-65-2 states,

    The following represents the transition and effective date information related to Accounting Standards Update No. 2018-12, *Financial Services – Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts:*

    f. At the beginning of the earliest period presented (that is, the transition date), an insurance entity shall apply the pending content that links to this paragraph on market risk benefits by means of retrospective application to all prior periods. An insurance entity shall maximize the use of relevant observable information as of contract inception and minimize the use of unobservable information in determining the market risk benefits balance at the beginning of the earliest period presented. If retrospective application requires assumptions in the prior period that are unobservable or otherwise unavailable and cannot be independently substantiated, the insurance entity may use hindsight in determining those assumptions. The transition adjustment shall be recognized as follows:

    1. The cumulative effect of changes in the instrument-specific credit risk between contract issue date and transition date shall be recognized in accumulated other comprehensive income as of the transition date.
    2. The difference between fair value and carrying value at the transition date, excluding the amount in (f)(1), shall be recognized as an adjustment to the opening balance of retained earnings as of the transition date.

2. Upon adoption of FASB ASU 2018-12, entities are required to apply the recognition and measurement guidance for market risk benefits on a retrospective basis to the earliest period presented in the financial statements. FASB ASC

944-40-30-19C states “a market risk benefit shall be measured at fair value ”. Fair value is defined in FASB ASC 820-10-20 and FASB ASC 944-20-20 glossaries as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” To comply with this definition, entities should apply the FASB ASC 820 fair value framework to the initial and subsequent measurement of market risk benefits at fair value.

3. In accordance with the fair value hierarchy established in FASB ASC 820-10-35, in determining fair value the highest priority should be to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs), then Level 2 inputs that are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, and the lowest priority to unobservable inputs (Level 3 inputs). FinREC believes that maximizing the use of “observable information” as stated in FASB ASC 944-40-65-2(f) means identifying historical information which would have been used in determining assumptions at contract issuance had the entity been measuring the market risk benefits under a fair value framework. Thus, it would be inappropriate for an entity to use actual historical experience as a single or deterministic scenario when determining the assumption(s) used to measure a market risk benefit in a retrospective period.

4. FinREC believes that before implementing the use of hindsight, entities should make reasonable efforts to determine whether retrospective information is available from any number of other sources, such as market sources, pricing, other models (e.g., previous embedded derivative valuations or Enterprise Risk Management) or other projections (e.g., regulatory capital calculations) to the extent they represent market participant assumptions. If entities are unable to obtain the necessary information through reasonable efforts, or the information would require assumptions about management’s intent at contract inception (i.e., unable to be independently substantiated without contemporaneous documentation), entities would then be permitted to use hindsight in determining the assumptions.

5. FinREC believes that in determining the level of effort implied by the terms “otherwise unavailable” and “cannot be independently substantiated” in FASB ASC 944-40-65-2(f), an insurance entity should, similar to the guidance in the impracticability framework in FASB ASC 250, *Accounting Changes and Error Corrections*, make every reasonable effort to determine its assumptions without the use of hindsight. FinREC believes that an insurance entity may, in various scenarios, conclude that, after making every reasonable effort, certain information is “otherwise unavailable” and “cannot be independently substantiated” and therefore that the use of hindsight is necessary for at least certain assumptions and certain prior periods.

6. FinREC believes an entity’s determination whether the use of hindsight is required should be made separately for each assumption and input. This evaluation approach is consistent with FASB ASC 944-40-65-2(f) that requires that an entity “maximize the use of relevant observable information”. For example, in some scenarios an entity may obtain observable capital market information sufficient for purposes of determining retrospective capital market assumptions, but are unable to obtain the information needed to determine retrospective policyholder behavior assumptions (e.g., lapses). In this instance, the entity should only use hindsight when determining the retrospective policyholder behavior assumptions.

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.