Working Draft:

Targeted Improvements to Long-Duration Contracts Implementation Issue

Issue #9ABC: DAC amortization including:

- Considerations for evaluating whether the amortization on a constant-level basis for grouped contracts approximates straight-line amortization on an individual basis
- Interaction of the liability for future policy benefits cash flow assumption updates and DAC amortization assumption updates
- Updating of DAC experience as of the beginning of the period or end of period

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

Amortization of DAC

1. FASB ASU No. 2010-26, *Financial Services—Insurance* (Topic 944), notes that advertising costs should be included in DAC only if the capitalization criteria for direct-response advertising in FASB ASC 340-20 is met (per ASC 944–30–25–1A(d)). If those criteria are met, the direct-response advertising costs should be included as DAC for classification; subsequent measurement (that is, amortization); and premium deficiency purposes, in accordance with FASB ASC 944.

Short-Duration Contracts

2. The principal purpose of amortization is to systematically match costs with related contract revenues. As described in FASB ASC 944-30-25-1 and 944-30-35-1, acquisition costs relating to short duration contracts should be capitalized and charged to expense in proportion to premium revenue recognized. As described in FASB ASC 944-30-45-1, unamortized acquisition costs should be classified as assets.

3. As described in FASB ASC 944-30-30-1 and 35-2, if acquisition costs are determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and period used, once determined, should be applied to applicable unearned premiums throughout the period of the contracts.

Long-Duration Contracts

4. Paragraphs 35-3 through 35-3C of FASB ASC 944-30 state the following for subsequent measurement and amortization of capitalized acquisition costs for long duration insurance contracts including limited-payment contracts and universal life-type contracts:

    Capitalized acquisition costs shall be charged to expense using assumptions consistent with those used in estimating the liability for future policy benefits (or any other related balance) for the corresponding contracts (see Subtopic 944-40), as applicable (for example, terminations). For contracts with accumulation and payout phases, the payout phase shall be viewed as a separate contract under this Topic and shall not be combined with the accumulation phase for amortization of capitalized acquisition costs.

    Acquisition costs capitalized under paragraphs 944-30-25-1A through 25-1AA shall be charged to expense on a constant-level basis—either on an individual contract basis or on a grouped contract basis—over the expected term of the related contract(s) as follows:

    a. Individual contracts. Capitalized acquisition costs shall be charged to expense on a straight-line basis.
    b. Grouped contracts. Capitalized acquisition costs shall be charged to expense on a constant-level basis that approximates straight-line amortization on an individual contract basis. Contracts shall be grouped consistent with the grouping used in estimating the liability for future policy benefits (or any other related balance) for the corresponding contracts.

    The resulting amortization amount shall not be a function of revenue or profit emergence. The amortization method shall be applied consistently over the expected term of the related contract(s).

    The balance of capitalized acquisition costs shall be reduced for actual experience in excess of expected experience (that is, as a result of unexpected contract terminations). The effect of changes in future estimates (for example, revisions of mortality or lapse assumptions as required in paragraph 944-40-35-5(a)) shall be recognized over the remaining expected contract term as a revision of the future amortization amounts.

5. FASB ASC 944-30-35-3A states that grouped contracts should be amortized "on a constant-level basis that approximates straight-line amortization on an individual contract basis". Amortization amounts will differ between grouped contracts and individual contracts because of the write off of unamortized DAC for terminated contracts, even if actual results are in line with expectations. Therefore, FinREC believes that the focus of the assessment of whether grouped contract basis amortization approximates straight-line amortization on an individual contract basis is on the pattern of amortization. Further, FinREC believes that entities are not required to perform a quantitative materiality analysis to demonstrate that approximation. Rather, when determining the constant-level basis for grouped contracts, entities should consider the nature of the products underlying the grouped contracts to ensure an appropriate pattern of amortization will be realized.

6. Paragraphs 35-19 through 35-23 of FASB ASC 944-30 state the following for subsequent measurement and amortization of deferred acquisition costs for investment contracts:

    The amortization method described beginning in paragraph 944-30-35-4 in paragraphs 944-30-35-3 through 35-3C shall be used to amortize acquisition costs deferred under paragraphs 944-30-25-1A through 25-1AA for investment contracts that include significant surrender charges or that yield significant revenues from sources other than the investment of contract holders' funds.

    Acquisition costs deferred under paragraphs 944-30-25-1A through 25-1AA for other investment contracts shall be amortized using an accounting method that recognizes costs as expenses at a constant rate applied to net policy liabilities and that is consistent with the interest method under Subtopic 310-20. The incidence of surrenders (if they are probable and can be reasonably estimated) can be anticipated for purposes of determining the amortization period. The rate of amortization shall be adjusted for changes in the incidence of surrenders to be consistent with the handling of principal prepayments under Subtopic 310-20.

Under some methods, the contract liabilities may be calculated net of deferred acquisition costs. In that event, the amounts of deferred acquisition costs and contract liabilities have to be determined separately.

7. Paragraphs 55-7 through 55-7B of FASB ASC 944-30 include the following example of the computation of amortization of deferred acquisition costs:

   This Example illustrates the computation of amortization on a constant-level basis. In this Example, a block of long-duration guaranteed-renewable five-year term life insurance contracts are grouped and amortized in proportion to the amount of insurance in force to derive an approximate level amortization amount on an individual contract basis. In 20X1, the insurance entity defers costs totaling $80 and projects the balance of insurance in force over 5 years. The insurance entity would need to include mortality and lapse assumptions to project the balance of insurance in force; however, for ease of illustration, no mortality or lapses are assumed (see paragraph 944-30-55-7B for subsequent changes to the mortality and lapse assumptions).

Schedule One

Year	Balance of Insurance in Force
20X1	$ 1,000
20X2	1,000
20X3	1,000
20X4	1,000
20X5	1,000
Total	$ 5,000 (x)
Capitalized acquisition costs	$ 80 (y)
Amortization rate = (y)/(x)	1.60% (z)

Schedule Two

Capitalized costs, year one	$ 80
Amortization, year one Balance of insurance in force of $1,000 (from Schedule One) at rate (z) above	(16)
Balance, end of year one	$ 64

At the beginning of 20X2, the entity incurs an additional $10 of deferrable acquisition costs and computes the amortization rate and expense for 20X2 as follows.

Schedule Three

Year	Balance of Insurance in Force
20X2	$ 1,000
20X3	1,000
20X4	1,000
20X5	1,000
Total	$ 4,000 (x)
Capitalized acquisition costs	$ 74 (y)
Amortization rate = (y)/(x)	1.85% (z)

At the end of 20X2, the entity experienced unexpected contract terminations that resulted in the write-off of deferred acquisition costs at the end of the reporting period. In addition, the entity updated the expected balance of insurance in force for the remaining periods.

Schedule Four

Capitalized costs, year two	$ 74
Amortization, year two Balance of insurance in force of $1,000 (from Schedule Three) at rate (z) above	(19)
Experience adjustment, end of year two Change in balance of insurance in force $55 × [(1,000 – 700) / 1,000]	(17)
Balance, end of year two	$ 38

Schedule Five

Year	Balance of Insurance in Force
20X3	$ 700
20X4	400
20X5	200
Total	$ 1,300 (x)

Capitalized acquisition costs	$ 38 (y)
Amortization rate =(y)/(x)	2.92% (z)

Schedule Six

Capitalized costs, year three	$ 38
Amortization, year three Balance of insurance in force of $700 (from Schedule Five) at rate (z) above	(20)
Balance, end of year three	$ 18

Schedule Seven
Deferred Acquisition Costs Rollforward

Year	Balance, Beginning of Year	Capitalization	Experience Adjustments	Amortization	Balance, End of Year
20X1	$ -	$ 80	$ -	$ (16)	$ 64
20X2	64	10	(17)	(19)	38
20X3	38	-	-	(20)	18
20X4	18	-	-	(12)	6
20X5	6	-	-	(6)	-
Total		$ 90	$ (17)	$ (73)	

8. The example in paragraphs 55-7 through 55-7B of FASB ASC 944-30 illustrates one way to calculate constant-level amortization on a grouped contract basis that, for this specific fact pattern, FinREC believes approximates straight-line amortization on an individual contract basis for the group of contracts included

9. FASB ASC 944-30-35-3B requires that “the balance of capitalized acquisition costs shall be reduced for actual experience in excess of expected experience (that is, as a result of unexpected contract terminations).” FinREC believes that the rate used to amortize deferred acquisition costs for the current reporting period can be calculated either as of the beginning of the current reporting period (thereby excluding actual current reporting period experience) or as of the end of the current reporting period (thereby including actual current reporting period experience). Actual current reporting period experience includes terminations, such as those resulting from lapse or death. An entity should select one of these calculation methodologies and apply it consistently. FinREC believes that a reversal in the current period for amortization expense recorded in a previous period is prohibited.

10. If the amortization rate for the current reporting period is calculated as of the beginning of the current reporting period (thereby excluding actual current reporting period experience - i.e., the current period amortization is based on expectations as of the beginning of the period) and actual terminations exceed expectations, a separate experience adjustment to further reduce the DAC balance would be needed. However, no adjustment would be made under this calculation methodology if there were fewer than expected terminations. FASB ASC 944-30-55-7B includes an example of the computation of the experience adjustment under this methodology.

11. In contrast, if the amortization rate for the current reporting period is calculated as of the end of the current reporting period (thereby including current reporting period experience), no separate experience adjustment would exist. Following the example in FASB ASC 944-30-55-7, an entity that utilizes this calculation methodology would update Schedules Three through Six to reflect the actual experience in 20X2 insurance in force and calculate a new amortization rate as of the beginning of the current reporting period to apply for the period ending 20X2. These updates to Schedule Three and Four are shown for illustration below:

Schedule Three (from FASB ASC 944-30-55-7A revised to include current period experience)

Year	Balance of Insurance in Force
20X2 20X3	$ 700 700
20X4	400
20X5	200
Total	$ 2,000 (x)
Capitalized acquisition costs	$ 74 (y)
Amortization rate =(y)/(x)	3.70% (z)

Schedule Four (from FASB ASC 944-30-55-7B revised to include current period experience)

Capitalized costs, year two	$ 74
Amortization, year two Balance of insurance in force of $700 (from Schedule Three – revised to include current period experience) at rate (z) above	 (26)
Experience adjustment, end of year two N/A	 0
Balance, end of year two	$ 48

12. FASB ASC 944-30-35-3 requires that capitalized acquisition costs are amortized using assumptions consistent with those used in estimating the liability for future policy benefits. ASC 944-40-35-6 requires that the liability for future policy benefits is updated for actual experience at least on an annual basis and more frequently if cash flow assumptions are being updated. In accordance with FASB ASC 944-40-35-5a(1), to determine changes in the liability for future policy benefits, cash flow assumptions should only be updated in interim reporting periods if evidence suggests that the cash flow assumptions should be revised.

13. FASB ASC 944-30-35-3B requires that an entity update its DAC amortization for actual experience in excess of expected in the current reporting period. However, an entity may determine that the difference in actual experience from expectations does not warrant an update to the net premium ratio and other future cash flow assumptions associated with the liability for future policy benefits due to their long-term nature. In this situation, FinREC believes

that updating the DAC amortization in the current reporting period for actual experience without updating actual experience within the calculation of the liability for future policy benefits (prior to the entity's annual review of cash flow assumptions) would not violate the principle that the assumptions be consistent between the two measurements. That is, FinREC believes that the updating of the outstanding units (e.g. actual inforce amounts) for DAC amortization may not require an update to the net premium ratio or other cash flow assumptions used to calculate the liability for future policy benefits.

14. However, in all cases, as required by FASB ASC 944-40-35-5(a) actual experience should be analyzed to determine if a change is necessary to the future cash flow assumptions used to calculate the liability for future policy benefits, and, if updated, corresponding changes should also be made to the estimate of future amortization of deferred acquisition costs.

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.