Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts*

**Check (applicable entity):**

P/C Life Health

Modification of existing SSAP

New Issue or SSAP

Interpretation

Description of Issue: This agenda item has been drafted to consider *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts* for statutory accounting. The FASB issued ASU 2018-12 in August 2018 to improve the existing recognition, measurement, presentation and disclosure requirements for long-duration contracts issued by an insurance entity. The revisions captured in the ASU are summarized as follows:

1. Update Assumptions: The ASU requires assumptions to be updated, and eliminates the U.S. GAAP provisions for risk of adverse deviation and premium deficiency testing. (Under current U.S. GAAP, the liability would include a provision for risk of adverse deviation, and locked assumptions would be unlocked if a premium deficiency was to arise.)
   1. Cash Flow Assumptions – The ASU requires entities to review, and if there is a change, update the assumptions used to measure cash flows at least annually. Changes in the liability estimate from the changes in cash flow assumptions shall be recognized through net income.
   2. Discount Rate Assumptions – The ASU requires entities to update the discount rate assumption at each reporting date. The discount rate is required to reflect an upper-medium grade (low-credit risk) fixed-income instrument yield. (This generally reflects a single “A” rate.) Change in the discount rate shall be recognized through other comprehensive income.
2. Market Risk Benefits: The ASU requires all market risk benefits associated with deposit (or account balance contracts) to be measured at fair value. (This provision eliminates the “insurance-accrual method” from U.S. GAAP.)
   1. A market risk benefit is defined as “a contract or contract feature in a long-duration contract issued by an insurance entity that protects the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk.”
   2. Market risk benefits can be present in both general account or separate account products, and intend to capture situations in which an insurance entity is insuring a possible shortfall (caused by market performance) between a policyholder’s account balance and a guaranteed amount. (Noted products in the ASU include guaranteed minimum death benefits in general account indexed products with crediting rates that may go negative or guaranteed minimum lifetime withdrawal benefits in fixed income annuities.)
   3. With the guidance for market risk benefits, under U.S. GAAP, entities will no longer have to assess whether a market risk benefit is an embedded derivative subject to bifurcation. All market risk benefits will be captured under the insurance standard (ASC Topic 944) and will be excluded from the derivative guidance (ASC Topic 815).
3. Deferred Acquisition Costs: The ASU requires that deferred acquisition costs be amortized over a constant basis over the expected life of the contract.
   1. Deferred acquisition costs are required to be written off when actual experience in excess of expected experience (that is, for unexpected contract terminations), but are not subject to impairment assessments. (Impairment assessment is not required as there is no measurement uncertainty associated with deferred acquisition costs.)
   2. Under U.S. GAAP, the amortization pattern of deferred acquisition costs will no longer be impacted by investment performance or changes in expected future liability cash flows.
4. Disclosures: The ASU requires new disclosures, predominantly in the form of rollforwards, to enable users to evaluate the amount, timing and uncertainty of cash flows arising from long-duration contracts.
   1. The ASU requires disaggregated rollforwards of beginning to ending balance of the liability for future policy benefits, policyholder account balances, market risk benefits, separate account liabilities and deferred acquisition costs.
   2. The ASU requires an insurance entity to disclose information about significant inputs, judgments, assumptions, and methods used in measurement, including changes in those inputs, judgments, and assumptions and the effect of those changes on measurement.

ASU 2018-12 is effective for public entities Jan. 1, 2021. For nonpublic entities, the ASU is effective for Dec. 31, 2022. The ASU includes different transition provisions as follows:

* For the liability for future policyholder benefits and deferred acquisition costs, insurance entities should apply the amendments to contracts in force as of the beginning of the earliest period presented on the basis of their existing carrying amounts, adjusted for the removal of any related amounts in accumulated other comprehensive income. Insurance entities are permitted to apply the amendments retrospectively (with a cumulative catch-up adjustment to the opening balance of retained earnings), using actual historical experience information as of contract inception. (Estimates of historical experience may not be substituted for actual historical experience.) If electing retrospective application, it must be applied entity-wide for the same contract issue year, and all subsequent contract issue years. (Meaning, it must be used to all products and contracts issued in the first year in which retrospective application will be applied, and all subsequent products and contracts issued in later years.)
* For market risk benefits, insurance entities should apply the amendments retrospectively as of the beginning of the earliest year presented. An insurance entity may use hindsight in instances in which assumptions in a prior period are unobservable or otherwise unavailable and cannot be independently substantiated. The difference between fair value and the carrying value at the transition date, excluding the effect of changes in the instrument-specific credit risk, requires an adjustment to the opening balance of retained earnings.

Existing Authoritative Literature:

The key changes reflected in ASU 2018-12 revised U.S. GAAP guidance previously rejected for statutory accounting. (In a couple instances, the prior U.S. GAAP guidance was not reviewed for SAP - as the guidance was not Board Directed, or was still pending SAP review.)

References from Appendix D – Cross-Reference to SAP:

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| --- | --- |
| **U.S. GAAP** | **SAP Accounting Provisions** |
| *FAS 60, Accounting and Reporting by Insurance Entities* | Rejected in SSAP No. 40R, SSAP No. 50, SSAP No. 51R, SSAP No. 52, SSAP No. 53, SSAP No. 54R, SSAP No. 57, SSAP No. 59 and SSAP No. 71 |
| *FAS 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* | Rejected in SSAP No. 50, SSAP No. 51R, SSAP No. 52 and SSAP No. 71 |
| *FSP FAS 97-1, Situations in Which Paragraphs 17(b) and 20 of FAS 97 Permit or Require Accrual of an Unearned Revenue Liability* | Not Board Directed |
| *SOP 95-1, Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises* | Rejected in SSAP No. 51R and SSAP No. 52 |
| *SOP 03-1, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* | Rejected in SSAP No. 56 |
| *SOP 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchange of Insurance Contracts* | Rejected in SSAP No. 71 |
| *SOP 00-3, Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts* | Pending SAP |
| *AICPA Practice Bulletin 8, Application of FAS 97 to Insurance Enterprises* | Rejected in SSAP No. 51R and SSAP No. 52R |

**Other U.S. GAAP revised as a result of the ASU include:**

* *FAS 133, Accounting for Derivative Instruments and Hedging Activities* (and related DIGs) – The framework of FAS 133 was adopted with modification in *SSAP No. 86—Derivatives*. The revisions from ASU 2018-12 indicate that contracts with market risk benefits do not need to be bifurcated as embedded derivatives, as the guidance in ASU 2018-12 requires market risk benefits to be measured at fair value. The ASU revisions also delete or revise related implementation guidance for assessing whether embedded derivatives shall be bifurcated under U.S. GAAP. **This guidance will not impact the FAS 133 guidance adopted with modification, as SSAP No. 86 specifies that embedded derivatives shall not be separated from the derivative instrument.**
* *FAS 130, Other Comprehensive Income* – FAS 130 was rejected as not applicable under statutory accounting. The revisions from ASU 2018-12 modify FAS 130 to specify the additional components (e.g., changes in discount rate assumptions) that are recognized through OCI. These modifications will not impact the prior statutory accounting decision to reject FAS 130 for statutory accounting.

**The following relevant SAP guidance is noted:**

* ***SSAP No. 51—Life Contracts*:** This SSAP establishes statutory accounting principles for income recognition and policy reserves for life contracts. This SSAP identifies that policy reserves shall be established as required in *Appendix A-820, Minimum Life and Annuity Reserves* and *Appendix A-822, Asset Adequacy Analysis Requirements* or the *Valuation Manual.*
* ***SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses:*** This SSAP establishes statutory accounting principles for recording liabilities for unpaid claims and claim adjustment expenses for life insurance contracts and accident and health contracts. (It also addresses unpaid losses and LAE for property and casualty contracts.) Pursuant to the guidance in paragraph 12, for each line of business, and for all lines of business in the aggregate, management shall record its best estimate of its liabilities for unpaid claims, unpaid losses and loss/claim adjustment expenses. This guidance identifies that management shall follow the concept of conservatism when determining estimates, but there is not a specific requirement to include a provision for adverse deviation in claims.With the revisions reflected in ASU 2018-12, the U.S. GAAP guidance has been revised to specify that the assumptions used in determining a liability for future policy benefits shall not include a provision for the risk of adverse deviation. Prior to these revisions, the guidance in ASC 944-40-30-7 specifically stated that the assumptions shall include a provision for the risk of adverse deviation. *(Note, as detailed in the proposed statutory accounting modifications, reference to the old U.S. GAAP guidance for adverse deviation is included in the Preamble and is proposed to be deleted.)*
* ***SSAP No. 71—Policy Acquisition Costs and Commissions*:** This SSAP establishes statutory accounting principles for policy acquisition costs and commissions. Pursuant to SSAP No. 71, all policy acquisition costs and commissions shall be expensed when incurred. Although the ASU is streamlining the amortization of capitalized deferred acquisition costs, this revision will not impact statutory accounting. *(Note, as detailed in the proposed statutory accounting modifications, reference to the old U.S. GAAP guidance is included in the Preamble and is proposed to be modified to reflect the new guidance.)*

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:** None

**Convergence with International Financial Reporting Standards (IFRS):** In 2008, the FASB undertook an insurance contracts project jointly with the International Accounting Standards Board (IASB). In 2013, after considering comments from the exposure of a 2010 Discussion Draft and a 2013 Proposed Update, the FASB decided to separate from the IASB project, and instead focus on targeted improvements to existing U.S. GAAP concepts. The decision to focus on targeted-improvements to existing U.S. GAAP guidance, with the continued limitation of the guidance to insurance companies, was strongly supported by commenters in lieu of introducing a completely new accounting model that would apply to all entities that issued “insurance contracts.”

Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose proposed revisions as follows:

* Modifications to paragraph 20 of the Preamble to update the applicable U.S. GAAP guidance.
* Rejection of ASU 2018-12 for statutory accounting in the following SSAPs:
  + *SSAP No. 50–Classifications of Insurance or Managed Care Contracts*
  + *SSAP No. 51R—Life Contracts*
  + *SSAP No. 52—Deposit-Type Contracts*
  + *SSAP No. 56—Separate Accounts*
  + *SSAP No. 71—Policy Acquisition Costs and Commissions*
  + *SSAP No. 86—Derivatives*
* Consider new SAP disclosures to capture reconciliations of liabilities for life contracts.

Staff Note – These are pending discussion with industry and AICPA representatives. If disclosures are incorporated, they are not expected to be effective until 2021 or 2022 to mirror the GAAP effective date.

* + Rollforward of the liability for future policy benefits.
  + Rollforward of the liability for policyholder’s account balances (excluding separate accounts)
  + Rollforward of market risk benefits

*(Since acquisition costs are expensed as incurred, revisions are not proposed to capture rollforward information on acquisition costs.)*

Staff Review Completed by:

Julie Gann, NAIC Staff – August 20, 2018

**Proposed Revisions to Statutory Accounting:**

***Preamble:***

20. The objectives of GAAP reporting differ from the objectives of SAP. U.S. GAAP is designed to meet the varying needs of the different users of financial statements. SAP is designed to address the concerns of regulators, who are the primary users of statutory financial statements. As a result, U.S. GAAP stresses measurement of emerging earnings of a business from period to period, (i.e., matching revenue to expense), while SAP stresses measurement of ability to pay claims in the future. This difference is illustrated by the fact that statutory policy reserves are intentionally established on a conservative basis emphasizing the long-term nature of the liabilities. Under U.S. GAAP, the experience expected by each company, is used to determine the reserves it will establish for its policies. U.S. GAAP reserves may be more or less than the statutory policy reserves. In addition, another primary difference is that U.S. GAAP has recognized certain assets which, for statutory purposes, have been either nonadmitted or immediately expensed. For example, policy acquisition costs are expensed as incurred under SAP since the funds so expended are no longer available to pay future liabilities. Insurance company financial statements prepared in accordance with U.S. GAAP defer qualifying costs incurred in the successful acquisition of new or renewal insurance contracts and amortize them over the expected life of the insurance contract.

***SSAP No. 50–Classifications of Insurance or Managed Care Contracts***

46. This statement rejects the GAAP classifications (i.e., short-duration and long-duration) found in *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts, FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long Duration Participating Contracts.*

***SSAP No. 51R—Life Contracts***

1. This statement incorporates the requirements of Appendices A-225, A-235, A-585, A-620, A-641, A-695, A-812, A-815, A-817, A-820, A-821, A-822, A-830, the Actuarial Standards Board *Actuarial Standards of Practice,* and the actuarial guidelines found in Appendix C of this Manual.
2. This statement rejects *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts*, *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, FASB Statement 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts,* AICPA *Practice Bulletin No. 8, Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses From the Sale of Investments, to Insurance Enterprises,* the AICPA *Audit and Accounting Guide—Audits of Stock Life Insurance Companies,* AICPA *Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises* relating to accounting and reporting for policy reserves for short and long duration contracts, and *FASB Interpretation No. 40, Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises, an interpretation of FASB Statements No. 12, 60, 97, and 113.*

***SSAP No. 52—Deposit-Type Contracts***

1. This statement incorporates the requirements of Appendices A-235, A-695, A-820, A-822, the Actuarial Standards Board *Actuarial Standards of Practice*, and the actuarial guidelines found in Appendix C of this Manual.
2. This statement rejects *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts*, *FASB Statement No. 60,* *Accounting and Reporting by Insurance Enterprises*, *FASB Statement No. 97,* *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, *FASB Statement 120,* *Accounting and Reporting by Mutual Life Insurance* Enterprises *and by Insurance Enterprises for Certain Long-Duration Participating Contracts*,AICPA *Practice Bulletin No. 8, Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses From the Sale of Investments, to Insurance Enterprises,* the AICPA *Audit and Accounting Guide—Audits of Stock Life Insurance Companies*, AICPA *Statement of Position 95-1,* *Accounting for Certain Activities of Mutual Life Insurance Enterprises* relating to accounting and reporting for policy reserves for short and long duration contracts, and *FASB Interpretation No. 40, Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises, an interpretation of FASB Statements No. 12, 60, 97, and 113*.

***SSAP No. 56—Separate Accounts***

1. This statement rejects *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts*, AICPA *Statement of Position 03-1, Accounting and Reporting by* InsuranceEnterprises *for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* (SOP 03-1). The disclosure elements included within this SSAP are derived from the criteria for separate account reporting under SOP 03-1; however, this SSAP does not restrict separate account reporting pursuant to the criteria established in SOP 03-1.
2. This statement incorporates the requirements of Appendices A-200, A-250, A-255, A-270, A-585, A-588, A-620, A-695, A-812, A-820, A-821, A-822 the Actuarial Standards Board *Actuarial Standards of Practice*, and the actuarial guidelines found in Appendix C of this Manual.

***SSAP No. 71—Policy Acquisition Costs and Commissions***

*(Note – The modifications also update the title for ASU 2010-26 to reflect the nature of the ASU and not the ASC Topic / Subtopic in which the revisions were reflected.)*

6. This statement rejects *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts*, *ASU 2010-26, Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts, FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, and Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*.

***SSAP No. 86—Derivatives***

1. This statement adopts revisions to ASC 815-20 as reflected within *ASU 2013-10, Derivatives and Hedging, Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a benchmark interest rate for Hedge Accounting Purposes*. These revisions define a benchmark interest rate, clarify what can be used in the U.S. for a benchmark interest rate, and eliminate the prior restriction on using different benchmark rates for similar hedges.
2. This statement adopts U.S. GAAP guidance for determining whether short sales are considered a derivative instrument including the regular-way security trade exception. The adopted GAAP guidance includes ASC 815-10-55-57 through 59 and 815-10-15-15 through 17. As a result, short sales shall generally be accounted for in accordance with *SSAP No. 103R—Short Sales*. Contracts that may resemble “short sales” but do not meet the criteria may be in scope of SSAP No. 86 as forward contracts.
3. This statement adopts with modification *ASC Topic 815-45: Weather Derivatives.* Weather derivatives are within the scope of SSAP No. 86 and shall be accounted and reported as other derivatives. The guidance in this statement does not apply to contracts written by insurance entities that entitle the holder to be compensated only if, as a result of an insurable event, the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk.
4. This statement rejects revisions to ASC 815-15, as reflected within *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts*. Pursuant to the ASU, market risk benefits are excluded from the U.S. GAAP embedded derivative bifurcation requirements. However, under SSAP No. 86, embedded derivatives shall not be separated from the host contract.
5. This statement rejects *ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities*, and *ASU 2016-03, Intangibles—Goodwill and Other, Business Combinations, Consolidation, Derivatives and Hedging*.

**Status:**

On April 6, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to reject *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts* in *SSAP No. 50—Classifications of Insurance or Managed Care Contracts, SSAP No. 51R—Life Contracts, SSAP No. 52—Deposit-Type Contracts, SSAP No. 56—Separate Accounts, SSAP No. 71—Policy Acquisition Costs and Commissions and SSAP No. 86—Derivatives.* Revisions also modify paragraph 20 of the Preamble to update the applicable U.S. GAAP guidance. With the exposure, comments are requested on whether new disclosure reconciliations of liabilities should be captured for statutory accounting.

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