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Technical Line

FASB – final guidance

A closer look at how insurers will have to change their accounting and disclosures for long-duration contracts

In this issue:

What you need to know

- The new guidance in ASU 2018-12 will significantly change how insurers account for and make disclosures about long-duration contracts.
- When measuring liabilities for future policyholder benefits, insurers will have to review and, if necessary, update the assumptions they use to project future cash flows, and the rate they use to discount those future cash flows so the discount rate reflects the yield on upper-medium grade fixed-income instruments.
- The guidance creates a new category of market risk benefits that insurers will have to measure at fair value and reduces the number of methods used to amortize deferred acquisition costs. It also significantly expands the related disclosures.
- Insurers will have to change their processes, systems and internal controls to apply the new guidance.
- SEC filers that are not smaller reporting companies are required to adopt the guidance for fiscal years beginning after 15 December 2022, including interim periods therein. All other entities must adopt it for fiscal years beginning after 15 December 2024, and interim periods a year later.

Overview

The new guidance the Financial Accounting Standards Board (FASB or Board) issued in Accounting Standards Update (ASU) 2018-12[1] will significantly change how insurers account for and make disclosures about long-duration contracts. The changes are intended to provide users

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of the financial statements with more meaningful information about the amount, timing and uncertainty of an insurer's cash flows related to long-duration contracts. To meet this objective, ASU 2018-12 changes the accounting and financial reporting for long-duration contracts by:

- Requiring insurers to more timely recognize changes in the liability for future policyholder benefits and modify the rate used to discount the liability
- Making the accounting for certain benefits embedded in deposit or account balance contracts simpler to apply and more consistent
- Simplifying the amortization of deferred acquisition costs (DAC)
- Requiring significantly more disclosures, including rollforwards of disaggregated balances for insurance liabilities and DAC, as well as quantitative and qualitative information about significant inputs, judgments and assumptions used in the measurement of such disaggregated amounts

The guidance is the final step in the FASB's insurance project. The FASB split the project into two parts, long-duration contracts and short-duration contracts, after the Board decided to change the direction from an earlier proposal to overhaul the accounting for insurance contracts that it worked on jointly with the International Accounting Standards Board (IASB). The FASB issued a final standard[2] in 2015 that requires insurers to make additional disclosures about their short-duration contracts. The IASB issued its new IFRS standard[3] for insurance contracts in May 2017.

This publication is designed to help entities better understand and interpret ASU 2018-12. Appendix A compares the new guidance with the existing guidance in Accounting Standards Codification (ASC) 944, *Financial Services — Insurance* and Appendix B provides a summary of the new disclosure requirements. The publication has been updated to reflect the revised effective dates of the new guidance and updated interpretations related to the liability for unpaid claims. This publication also includes, in Appendix C, implementation questions and answers.

Recognition and measurement

Liability for future policyholder benefits for traditional long-duration and limited-payment contracts

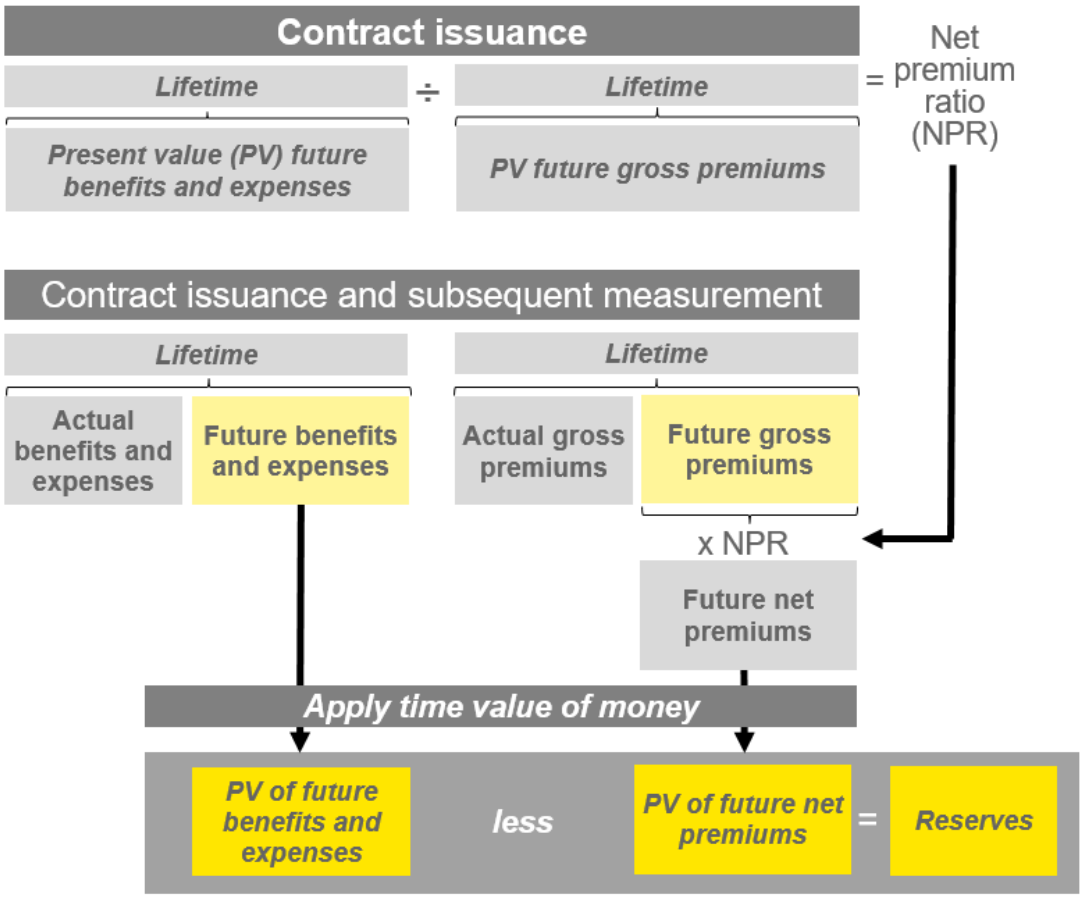
Although the new guidance retains the fundamental net premium model for traditional long-duration and limited-payment contracts, it requires insurers to review and update assumptions if necessary and record any resulting change to the liability for future policyholder benefits on a cumulative catch-up basis in the period in which assumptions are updated. That is, net premiums will continue to drive the measurement of the liability with related changes in the liability affecting net income.

When measuring reserves for future policyholder benefits under the net premium model, the following steps are applied. First, a net premium ratio is calculated at contract issuance by dividing the present value of the estimated lifetime policyholder benefits and certain related expenses by the present value of estimated lifetime gross premiums.

The net premium ratio is then multiplied by the future gross premiums to calculate the net premiums, which are the portion of the future gross premiums required to provide for all future policyholder benefits and certain related expenses. Both the future net premiums and the future policyholder benefits and certain related expenses are then discounted to present value.

The present value of the future net premiums is then subtracted from the present value of future policyholder benefits and certain related expenses to determine the reserve for future policyholder benefits.

The following table illustrates these steps:



Updating assumptions under current guidance

Under current guidance, the assumptions used in measuring reserves for policyholder benefits at contract issuance are "locked in" (i.e., not updated) unless a premium deficiency exists (i.e., loss recognition). These assumptions include a provision for adverse deviation to address reasonable unfavorable deviations from assumptions determined at contract issuance.

If a premium deficiency exists, the insurer updates its assumptions to current best estimates (i.e., without provision for adverse deviation). If a premium deficiency does not exist, the net premium remains unchanged over the life of the policy. This results in income recognition over the life of the contract as a level percentage of net premiums, with differences between initial expected and actual experience recognized in income in the periods incurred.

Updating of cash flow assumptions and the net premium ratio under ASU 2018-12

ASU 2018-12 requires cash flow assumptions used in the net premium model (e.g., mortality, morbidity, terminations) to be reviewed at least annually in the same period each year. These assumptions should be updated if warranted and a new net premium ratio should be calculated, rather than remaining unchanged absent a premium deficiency. Because insurers will update assumptions in the net premium model, the FASB concluded that a provision for risk of adverse deviation in the assumptions is no longer needed.

In the Background Information and Basis for Conclusions of ASU 2018-12, the FASB clarified that insurers are not expected to revise the net premium ratio every quarter for actual experience and changes in future expectations unless evidence suggests that the cash flows should be updated. That is, on an interim basis, if the ultimate cash flows are not expected to

change, insurers will not be required to revise the net premium ratio. However, at least annually, insurers are required to recalculate the net premium ratio to reflect actual experience, as well as updated expected future cash flow assumptions if the required annual review of assumptions indicates the assumptions should be updated.

A review of assumptions should be performed more frequently (e.g., in an interim reporting period other than the one in which the insurer performs its annual review) if evidence suggests the assumptions should be updated. We generally believe all assumptions included in the measurement for a particular unit of account should be reviewed concurrently.

Under ASU 2018-12, insurers must determine the unit of account (also referred to as the cohort) for which the liability for policyholder benefits is measured. ASU 2018-12 does not provide specific guidance regarding grouping contracts from different product lines. Therefore, we expect that current practice will not change where insurers generally group contracts exhibiting homogenous characteristics (i.e., product lines). However, when determining the cohort under ASU 2018-12, insurers may group contracts issued in the same quarter or year but may not group contracts from different issue years. Insurers can elect for each cohort the date when they perform their annual review of assumptions.

Insurers will review cash flow assumptions on an annual basis and update them as needed, or more frequently if warranted.

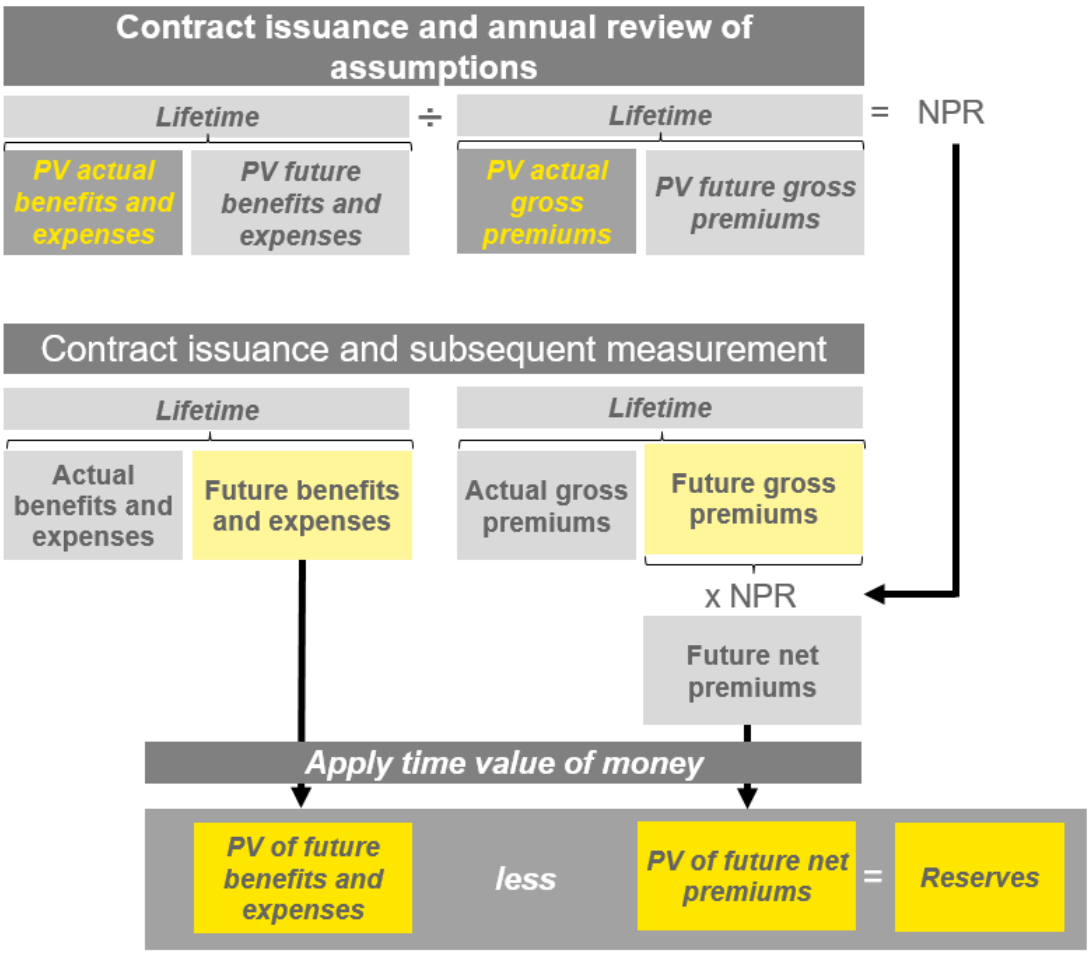
Implementation questions

Questions LFPB 1.1 through LFPB 1.4 in Appendix C address common implementation questions on how to define issue years and group contracts.

For contracts acquired in a business combination, insurers must use the acquisition date as the contract issuance date for purposes of determining the unit of account that will be measured. That is, a cohort of acquired contracts could include contracts from different issue years. Insurers may consider applying this guidance by analogy when determining the unit of account for blocks of in force insurance acquired in a reinsurance arrangement.

When updating assumptions, insurers are not required under ASU 2018-12 to update the expense assumptions in the net premium model. Insurers may make an entity-wide election to retain the expense assumptions determined at contract issuance in the net premium model. An insurer making this entity-wide election would immediately recognize in income the effect of actual expense experience that deviates from its expectation at contract issuance, without affecting the liability for policyholder benefits. The expense assumptions often reflect an allocation of certain expenses related to the insurer's activity to fulfill its obligation under the insurance contracts, and we would generally expect that updating these assumptions would not have a material effect on the calculation of the net premium ratio. In considering this, the Board indicated that the costs to update the expense assumptions outweighed the benefits.

Consistent with current guidance, the expense assumptions used in estimating the liability under ASU 2018-12 should include estimates of expected nonlevel costs, including termination or settlement costs, costs after the premium-paying period and the effect of inflation on renewal expenses. However, the FASB clarified in the new guidance that "expense assumptions shall not include acquisition costs or costs that are required to be charged to expense as incurred, such as those relating to investments, general administration, policy maintenance, product development, market research and general overhead."



As shown in the graphic above that illustrates revisions to the net premium model as a result of ASU 2018-12, the annual recalculation of the net premium ratio considers all lifetime cash flows (actual and expected future cash flows discounted at the discount rate determined at contract issuance) for a group of contracts. As a result, the recalculated net premium ratio used in remeasuring the liability for policyholder benefits results in a liability that reflects the insurer's current cash flow assumptions. An insurer will apply the revised net premium ratio until the ratio determined during the annual review of assumptions is revised in a future reporting period. See the *Measuring and accounting for changes in discount rate assumptions* section for details on the discount rate used in the initial and subsequent measurement of the liability.

Implementation questions

Questions LFPB 2.1 through LFPB 2.5 in Appendix C address common implementation questions on updating assumptions under the new guidance.

For contracts that are transitioned using the modified retrospective transition approach, the lifetime present value of cash flows (both actual cash flows and expected future cash flows) should represent those cash flows after the transition date with an adjustment for the related balances recorded before transition. See the *Transition and effective date* section for details on the net premium ratio calculation under the modified retrospective transition approach, which will continue to be applied in subsequent periods after an insurer adopts ASU 2018-12.

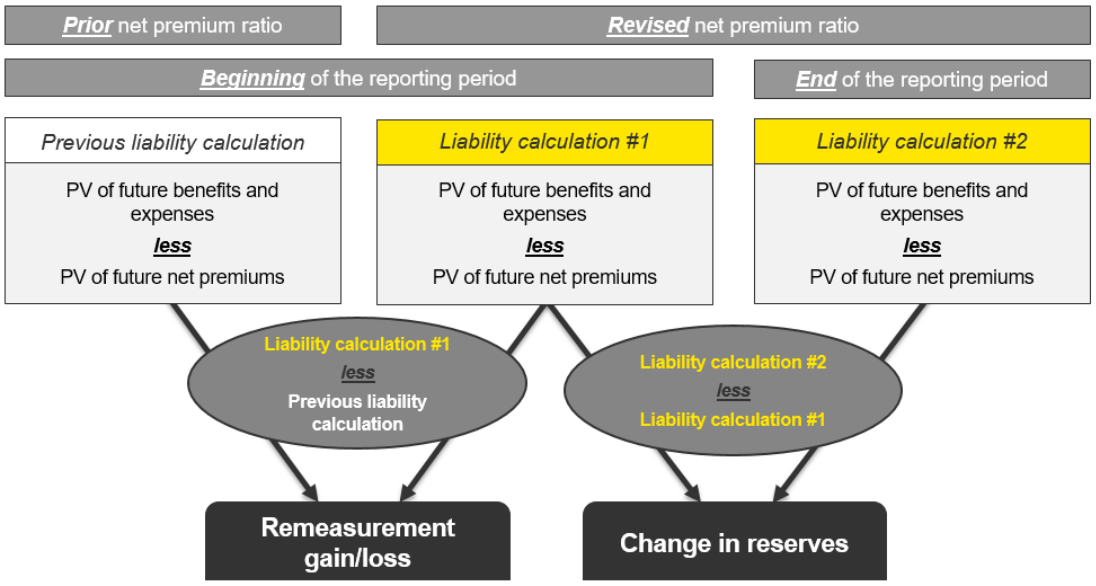
How we see it

- Insurers will have to maintain more detailed records about their actual experience since contract issuance, including information on contracts that have expired due to mortality or lapse, to calculate the revised net premium ratio. An insurer will need to change its processes, systems and controls to retain the necessary information.
- Expenses included in the estimate of the liability for future policyholder benefits will be limited to nonlevel costs (e.g., termination or settlement costs), costs after the premium-paying period and the effect of inflation on renewal expenses. This may be a change for some insurers.

The effect of updated cash flow assumptions will be recorded as a cumulative catch-up adjustment in the current reporting period.

Determining the cumulative catch-up adjustment

Under ASU 2018-12, in a period when the net premium ratio has been recalculated, insurers will use the recalculated net premium ratio to remeasure the liability for future policyholder benefits (i.e., change the liability due to updates for experience and expected future cash flow assumptions discounted using the discount rate at contract issuance) as of the beginning of the current reporting period. The difference between the current and previous liability measurement represents a cumulative catch-up reported separately as a component of total benefit expense in net income as a "remeasurement gain or loss" in the period. The insurer will also use the same recalculated net premium ratio to calculate the liability for future policyholder benefits as of the end of the reporting period. The difference between the liability remeasured as of the beginning of the reporting period and the liability measured as of the end of the reporting period will be recognized in net income as a component of benefit expense (e.g., change in reserves). The following diagram summarizes these steps.



The Board determined that this approach will more accurately depict the insurer's current liability for future policyholder benefits and better reflect the effect of the updated assumptions for the entire contract period. This is because insurers will recognize a portion of the effect related to prior periods as a cumulative catch-up adjustment in income and a portion of the effect in future periods, thus resulting in a best estimate of profit emergence over the remaining contract period.

Illustration 1 — Updating assumptions used in the measurement of the liability for future policyholder benefits

Consider an example in which an insurer has unfavorable mortality experience on a block of 10-year level premium term life insurance contracts. The policies lapse with declining frequency over time until the end of year 10, when all remaining policies lapse.

The following table demonstrates the expected benefits and expenses and projected reserve balance at each year end, as of the contract issue date. For simplicity purposes, the discount rate is kept constant at 3%, and therefore the example demonstrates the effects of updating cash flow assumptions and the cumulative catch-up application of the model.

Year	Premiums received	Benefits and expenses paid	Reserve balance
1	$ 16,000	$ 4,349	$ 5,495
2	13,598	5,414	8,559
3	11,962	6,179	9,908
4	10,881	6,354	10,444
5	10,114	6,634	10,229
6	9,401	6,831	9,360
7	8,737	6,949	7,930
8	8,120	7,050	5,967
9	7,546	7,289	3,342
10	7,011	7,585	-
Total present value	$ 92,781	$ 56,150	

At contract issuance, using the constant discount rate of 3%, the insurer estimates the present value of lifetime gross premiums to be $92,781 and the present value of lifetime benefits and expenses to be $56,150. These estimated cash flows result in a net premium ratio of 60.52% (56,150 divided by 92,781). During year 1, actual experience is in line with the insurer's expectations. Net premiums are determined using the original net premium ratio, and as of the end of year 1, the liability for future policyholder benefits is measured as follows:

Benefits and expenses (for years 2–10) discounted at 3%	(a)	$ 53,355
Net premiums (for years 2–10) discounted at 3%	(b)	47,860
Measured liability = (a) − (b)	(c)	5,495

In year 2, the insurer experiences unfavorable mortality, resulting in actual benefits and expenses of $7,341, which are $1,927 higher than the $5,414 originally expected. The insurer concludes that an update to future cash flow assumptions is not needed.

As required by the guidance, the insurer calculates a revised net premium ratio as of the contract issue date with the inclusion of the additional $1,927 of actual claims experience. The present value of the additional year 2 claims is $1,870, and the resulting revised net premium ratio is 62.53% (present value of benefits and expenses of $58,020 (total of $56,150 in original calculation plus $1,870) divided by present value of gross premiums of $92,781), and the insurer applies this revised ratio to calculate a remeasured reserve as of the beginning of the reporting period (i.e., beginning of year 2 calculation).

Benefits and expenses (for years 2–10) discounted at 3%	(a)	$ 55,282
Net premiums (for years 2–10) discounted at 3%	(b)	49,455
Remeasured liability = (a) − (b)	(c)	5,827

The following table compares the expected premiums, benefits and expenses, and projected reserve balance at each year end as of the contract issue date with those as of the end of year 2.

	At contract issuance			Updated for year 2		
Year	Premiums received	Benefits and expenses paid	Reserve balance	Premiums received	Benefits and expenses paid	Reserve balance
1	$ 16,000	$ 4,349	$ 5,495	$ 16,000	$ 4,349	$ 5,827
2	13,598	5,414	8,559	13,598	7,341	7,199
3	11,962	6,179	9,908	11,962	6,179	8,756
4	10,881	6,354	10,444	10,881	6,354	9,483
5	10,114	6,634	10,229	10,114	6,634	9,449
6	9,401	6,831	9,360	9,401	6,831	8,752
7	8,737	6,949	7,930	8,737	6,949	7,485
8	8,120	7,050	5,967	8,120	7,050	5,678
9	7,546	7,289	3,342	7,546	7,289	3,201
10	7,011	7,585	-	7,011	7,585	-

The first three columns represent the original assumptions and demonstrate the projected reserves at contract issuance, while the last three columns represent projections updated after year 2 experience. For simplicity purposes, the projected premiums are unchanged and the only difference in benefits is an increase in year 2. The difference between the remeasured reserve balance as of the beginning of the current reporting period (using the revised net premium ratio) and the recorded reserve balance as of the same period of $332 ($5,827 less $5,495) is the remeasurement loss for the period.

The same revised net premium ratio is used to measure the liability at the end of year 2, resulting in a change in reserves of $1,372 ($7,199 less $5,827). The applicable amounts for year 2 are highlighted in the table above, and total benefit expense for the period is calculated as follows:

Reserve calculations		**Amount included in benefit expense**
Original reserve, beginning of year 2	$ 5,495	
Remeasured reserve, beginning of year 2*	5,827	$ 332 (remeasurement loss)
Reserve, end of year 2	7,199	1,372 (change in reserves)
		7,341 (benefits paid)
	Total benefit expense	$ 9,045

* **Note:** For simplicity purposes, the beginning of the annual period is used for purposes of determining the remeasurement loss. However, insurers that prepare quarterly financial statements may elect to use the beginning of a quarterly period for purposes of determining the remeasurement gain or loss.

As previously noted, the year 2 benefits and expenses were $1,927 higher than originally expected. However, this increase in cash payments was offset by a $1,360 drop in reserves to $7,199, which was actually recorded as of the end of year 2 using the revised net premium ratio from $8,559, which was originally expected as of the end of year 2. This mitigation is a result of the cumulative catch-up mechanism under the new guidance and can exist when experience deviates from original expectations, but not to a degree requiring a change to future cash flow assumptions.

To further extend the example, assume in year 3 the insurer experiences a second consecutive year of unfavorable mortality and the insurer concludes an update to future cash flow assumptions is needed.

	Amounts updated as of year 2			Updated for year 3		
Year	Premiums	Benefits and expenses	Reserve balance	Premiums	Benefits and expenses	Reserve balance
1	$ 16,000	$ 4,349	$ 5,827	$ 16,000	$ 4,349	$ 7,741
2	13,598	7,341	7,199	13,598	7,341	10,796
3	11,962	6,179	8,756	11,962	8,566	11,433
4	10,881	6,354	9,483	10,877	7,614	12,240
5	10,114	6,634	9,449	10,109	7,981	12,108
6	9,401	6,831	8,752	9,395	8,241	11,158
7	8,737	6,949	7,485	8,730	8,403	9,505
8	8,120	7,050	5,678	8,112	8,542	7,188
9	7,546	7,289	3,201	7,537	8,853	4,041
10	7,011	7,585	-	7,001	9,233	-

The first three columns represent the assumptions updated as of the end of year 2 and demonstrate the projected reserves at that time, while the last three columns represent projections updated after year 3 experience. An increase in benefits in year 3 is reflected, and because the insurer updated future cash flow assumptions, the projected premiums and benefits for years 4 through 10 are also updated. The revised net premium ratio after updating for the actual benefits and updated future cash flow assumptions is calculated as 74.15% (present value of benefits and expenses of $68,766 divided by present value of gross premiums of $92,741).

The insurer applies this revised ratio to calculate a remeasured reserve as of the beginning of the reporting period (i.e., beginning of year 3 calculation).

Benefits and expenses (for years 3–10) discounted at 3%	(a)	$ 60,779
Net premiums (for years 3–10) discounted at 3%	(b)	49,983
Remeasured liability = (a) − (b)	(c)	10,796

The difference between the remeasured reserve balance as of the beginning of the current reporting period (using the revised net premium ratio) and the previously measured reserve balance at the beginning of the current reporting period of $3,597 ($10,796 less $7,199) is the remeasurement loss for the period. The same revised net premium ratio is used to measure the liability at the end of year 3 resulting in a change in reserves of $637 ($11,433 less $10,796).

Reserve calculations		Amount included in benefit expense
Original reserve, beginning of year 3	$ 7,199	
Remeasured reserve, beginning of year 3	10,796	$ 3,597 (remeasurement loss)
Reserve, end of year 3	11,433	637 (change in reserves)
		8,566 (benefits paid)
	Total benefit expense	$12,800

Note that in this instance, unfavorable experience is still mitigated by the cumulative catch-up mechanism, but the mitigation is overcome due to the insurer updating future cash flow assumptions based on the expectation of future unfavorable experience. As a result, a larger remeasurement loss is recorded.

How we see it

- Updating cash flow assumptions periodically throughout the life of the contract will result in periodic fluctuations in income that may have been deferred to future periods under today's model.
- A portion of the effect of current-period changes in assumptions will be reflected immediately in income (i.e., remeasurement gain or loss) and the remainder of the effect will be reflected in future periods as an adjustment to cash flows in the net premium model using the revised net premium ratio.
- The guidance does not specify whether the "beginning of the current reporting period" when determining a remeasurement gain or loss refers to the annual period or the current interim period. We believe it would be reasonable for an insurer to consider the remeasurement as a change in estimate (i.e., calculate as of the beginning of the current quarter if the entity prepares quarterly financial statements). For example, if the NPR is revised in the second quarter and again in the fourth quarter, the quarter-to-date remeasurement gain or loss for the fourth quarter would be calculated as of the beginning of the fourth quarter. However, the year-to-date remeasurement gain or loss would be the sum of both the remeasurement gain or loss calculated as of the beginning of the second quarter and the fourth quarter.
- The current period change in reserves (i.e., the difference between actual experience and expected experience) will continue to be reflected immediately in net income. However, the net effect of the change in net income will be mitigated if the actual experience does not affect the overall expectations for that assumption over the life of the contract due to the inclusion of the actual experience in the revised net premium ratio.

Adjustments to results of the net premium model

Consistent with current guidance and to prevent insurers from deferring losses to future periods, ASU 2018-12 will require insurers to recognize a loss in income (and a corresponding increase in the liability for future policyholder benefits) in the current period if the present value of future expected benefits and expenses exceeds the present value of future gross premiums (i.e., cap the net premium ratio at 100% so the net premiums may never exceed the gross premiums). If subsequent updates to cash flow assumptions result in the present value of future gross premiums exceeding the present value of future expected benefits and expenses (i.e., the net premium ratio is below 100%), the insurer should remeasure the liability for future policyholder benefits using the revised net premium ratio.

In addition, the Board decided that the liability for future policyholder benefits cannot be less than zero (nor can the insurer record an asset) at the level of aggregation at which reserves are calculated (i.e., unit of account or cohort).

Implementation questions

Questions LFPB 4.1 and 4.2 in Appendix C address common implementation questions about the 100% net premium ratio cap and negative reserves.

Discount rate assumptions

ASU 2018-12 will require insurers to discount the liability for future policyholder benefits for traditional long-duration and limited-payment contracts using upper-medium grade fixed-income instrument yields that reflect the duration characteristics of the liability and maximize the use of observable inputs. An upper-medium grade yield is generally interpreted as a single A or equivalent rating from a globally recognized statistical rating organization. An insurer will only substitute its own estimates for observable market data when market data reflects transactions that are not orderly.[4] Because the timing of expected future cash flows varies, insurers often calculate discount rates using a yield curve.

Insurers will discount the liability for future policyholder benefits using upper-medium grade fixed-income instrument yields.

Under the new guidance, this calculation will be based on single A rates for each expected cash flow duration. For points on the yield curve in which there are limited or no observable market prices, the insurer will need to apply a methodology similar to what is required for Level 3 fair value measurements in ASC 820.[5] That is, it will develop discount rate assumptions using the best information available to determine the upper-medium grade fixed-income instrument rate that reflects the duration characteristics of the liability. If the duration characteristics of the observable inputs differ from those of the liability, the discount rates will need to be adjusted to reflect this difference. Expected cash flows would be discounted at the rate on the yield curve matching the duration.

Determining the yield curve based on single A rates is a change from current guidance, where an insurer uses its expected investment yield to discount the liability for future policyholder benefits. In the Basis for Conclusions, the FASB noted that, under current guidance, duration risk and the spread between the return on investment and time value of the liability are not transparent to financial statement users.

The FASB also noted that an insurer is obligated to satisfy its benefit obligations regardless of its investment strategy and acknowledged that the proper rate to discount a guaranteed liability is a liability rate (i.e., a discount rate implicit in the insurance contract based on its contractual cash flows), rather than a rate linked to the insurer's investment experience. However, the FASB also noted that a liability rate is conceptually and practically challenging to calculate for long-duration contracts. Therefore, the FASB concluded that a fixed-income instrument yield would be operationally easier to determine, and an independent market observable rate allows for better comparability among insurers.

How we see it

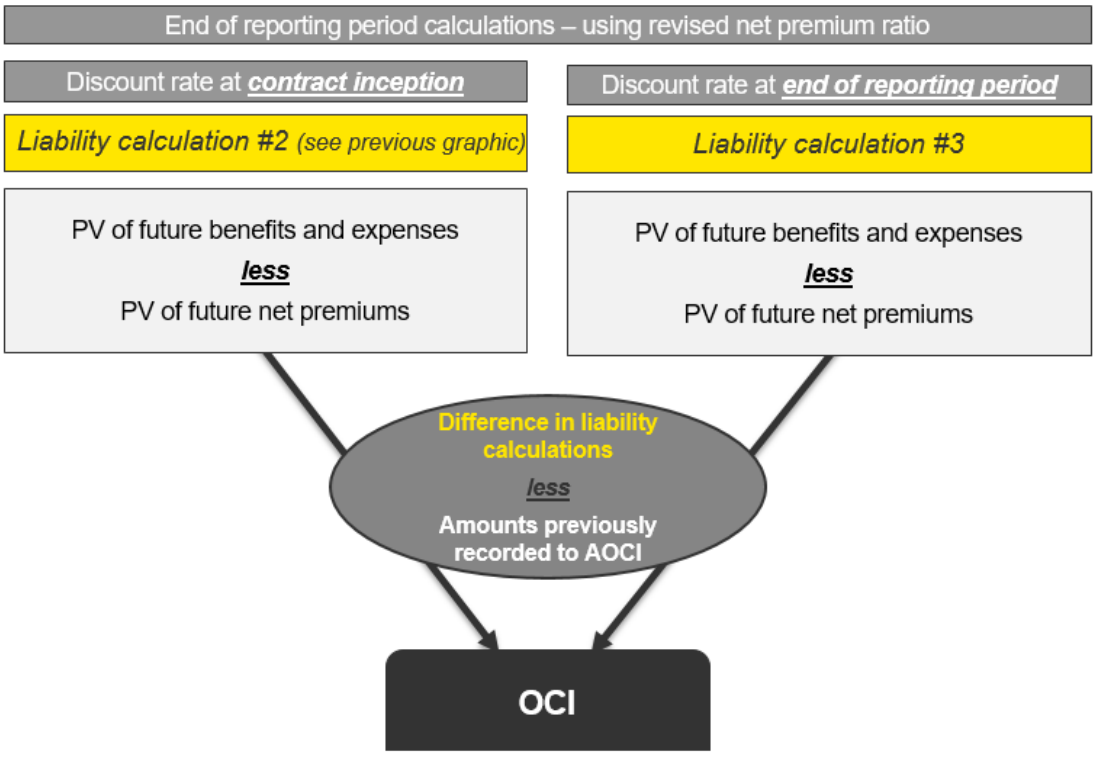
- An insurer will need to determine the expected duration of its benefit obligations and identify the upper-medium grade fixed-income instruments that will be of a similar duration to calculate the discount rate. Since the duration of many long-duration contracts may exceed the duration of available investment assets, the insurer will need to apply the principles of ASC 820 when observable inputs are not available for the duration of the liability.

- There could be diversity in how insurers determine the upper-medium grade fixed-income instrument yield used to discount cash flows when measuring the liability. However, the differences in rates are likely to be narrower than under today's accounting.
- Insurers that have pension liabilities may want to consider their process for determining the discount rate for their pension obligations, because the accounting requirements to determine the discount rate for long-duration contracts may have similarities.

Measuring and accounting for changes in discount rate assumptions

ASU 2018-12 will require insurers to update at each reporting date the discount rate used to measure the liability for future policyholder benefits for traditional long-duration and limited-payment contracts that is recorded in the statement of financial position. At each reporting date, insurers will compare the liability measured using the discount rate at contract inception to the liability measured using the updated discount rate. The difference is recorded in other comprehensive income (OCI), similar to recording unrealized gains and losses on securities categorized as available for sale. In subsequent periods, the insurer will also adjust the current period amount recorded to OCI for any amounts previously recorded in accumulated other comprehensive income (AOCI).

The following chart illustrates these steps:



While the measurement of the liability for future policyholder benefits is recorded using the current discount rate, the liability is accreted using the discount rate set at the contract issue date (referred to as the interest accretion). This will affect measurement of both the remeasurement gain or loss and the change in reserves, and therefore the effect of interest accretion will be recognized within benefit expense. The guidance does not explicitly address whether an insurer should base the interest accretion rate on a yield curve or a single effective yield (or weighted average yield) that produces the same net result at inception. One approach to accreting interest on the liability for policyholder benefits would be to derive the implied forward rates from the spot curve (sometimes referred to as "rolling forward on the curve"

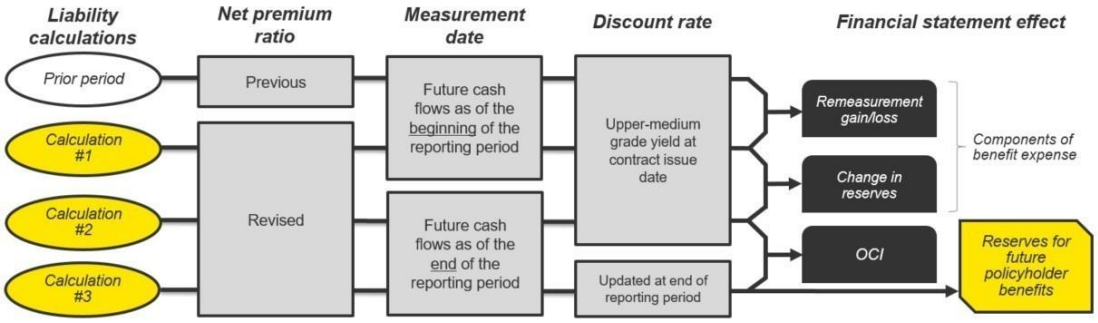
or "moving along the curve"). Another approach would be to use an effective yield method. There are other approaches that an insurer can apply, but it is important for the insurer to consistently apply the method it selects.

Implementation questions

Questions LFPB 3.1 through 3.4 in Appendix C address common implementation questions on how to determine the discount rate.

As discussed in the *Updating of cash flow assumptions and the net premium ratio under ASU 2018-12* section, before the final liability calculation of the reporting period, which uses the current net premium ratio and current discount rate, all present value calculations (both when determining the net premium ratio and when calculating the income statement effects) are performed using the discount rate set at the contract issue date. This isolates the effect of the changes in the discount rate and separately recognizes these changes in OCI as shown in the diagram below.

The effect of updating the discount rate used to measure the liability for future policyholder benefits each reporting period will be reported in OCI.



How we see it

- Insurers will need to develop processes and controls to perform multiple calculations to isolate various effects (i.e., remeasurement gain/loss, benefit expense and OCI impact) when measuring the liability for future policyholder benefits.
- Recognizing the effect of the current discount rate in OCI will align the presentation of the effect of interest rates on the insurer's liabilities with the portion of its investments classified as available for sale. However, this accounting alignment could highlight a mismatch in the duration of the liabilities and assets, which insurers should be prepared to explain to users of the financial statements.

Deferred profit liability for limited-payment contracts

Limited-payment policies are similar to traditional long-duration policies, except that policyholders pay premiums for a predetermined period while the benefit period extends for a longer duration. Consistent with current guidance, ASU 2018-12 will require any gross premiums received in excess of the net premiums to be deferred and recorded as a separate deferred profit liability. Any deferred profit liability will still be recognized in income in a constant relationship with the insurance in-force for life insurance contracts or with the amount of expected future benefit payments for annuity contracts.

Under ASU 2018-12, cash flow assumptions included in the measurement of the deferred profit liability will be reviewed at the same time as those in the net premium model (at least annually). Updates to the cash flow assumptions will be used to recalculate the contract issuance date deferred profit liability as if the updated assumptions were in place at the contract issuance date. The revised deferred profit liability as of the contract issuance date is then amortized

based on updated insurance in force for life contracts or expected future benefit payments for annuity contracts to derive the revised deferred profit liability as of the beginning of the reporting period. The difference between the revised deferred profit liability and the previously recorded liability will be recognized as a cumulative catch-up adjustment in net income.

Interest will accrue to the unamortized balance of the deferred profit liability using the contract issuance discount rate for the related policyholder liability.

Liability for unpaid claims (updated November 2020)

For traditional long-duration and limited-payment contracts, insurers generally recognize a liability for unpaid claims and claim adjustment expenses under the existing guidance in ASC 944-40-25-1 through 25-3 when a claim is incurred. These liabilities are often referred to as disabled life reserves and are measured using the insurer's best estimate of the duration and magnitude of future benefits for the claim. While the estimate of future benefits for reported claims is the most significant component, the disabled life reserve also includes an estimate for benefit expenses related to claims that have been incurred but have not been reported (i.e., IBNR). Under current practice, the best-estimate disabled life reserve is viewed as separate from the liability for future policyholder benefits (also referred to as active life reserves).

The FASB believes that under ASU 2018-12 the liability for future policyholder benefits represents the obligation of the insurer during the life of the contract, and, therefore, both the disabled life reserve and the active life reserve are components of the liability for future policyholder benefits. ASU 2018-12 modifies the guidance for the liability for future policyholder benefits to require that insurers group contracts and review the lifetime cash flow assumptions (i.e., actual historical cash flows and expectations of future cash flows) of that group of contracts used in the net premium model at least annually. Insurers are required to update the cash flow assumptions and to calculate a new net premium ratio if warranted based on the annual review.

This means that benefits paid and changes in expected future benefit payments will need to be included as an input into the lifetime cash flow assumptions in the net premium model. As a result, changes in cash flow assumptions related to incurred claims will need to be included in the calculation of the revised net premium ratio, which will be used in the calculation of the updated liability for future policyholder benefits. Any resulting change in the liability for future policyholder benefits is recognized on a cumulative catch-up basis in the period in which assumptions are updated.

As previously discussed, ASU 2018-12 modifies the guidance to require insurers to discount the liability for future policyholder benefits using upper-medium grade fixed-income instrument yields that reflect the duration characteristics of the liability. Thus, insurers should use upper-medium grade investment yields to discount all cash flows, including those related to incurred claims. The liability reported on the balance sheet is measured using the current discount rate, while accretion of the liability is measured using the discount rate set at contract issue date. The difference between the two calculations is recorded to OCI.

How we see it

- Because insurers will be required to reflect the best estimate of lifetime cash flows in the net premium model used to calculate the liability for policyholder benefits, they should develop a measurement approach that calculates a liability representing all future cash flows. This means that insurers will need to reflect cash flows related to incurred claims in their processes for updating the best estimate of cash flows.

- Depending on the needs of the users of the financial statements, insurers could develop a process to separately identify cash flows related to incurred claims (i.e., the disabled life reserve) that are included in the liability calculation for presentation or disclosure purposes. However, an insurer's measurement of the liability for future policyholder benefits should be consistent, regardless of whether incurred claims are separately presented or disclosed.

Liability for future policyholder benefits for participating life contracts

Participating contracts provide policyholders with certain guaranteed and discretionary benefits and dividends that are paid periodically and reflect the insurer's experience and investment performance, mortality and contract administration costs for each contract class. ASU 2018-12 does not change today's guidance for the liability for future policyholder benefits of participating contracts, other than the recognition pattern of terminal dividends.

Today's guidance acknowledges participation features and requires the future policyholder benefit liability to be recorded using the net premium model (with assumptions for the guaranteed mortality and dividend fund interest), which is a proxy for account balances (at the portfolio level). This model results in an expectation that profits will be recognized as a level percentage of margin over the entire life of the contracts. Only assumptions for mortality and discount rates are included in the net premium model. ASU 2018-12 does not require these assumptions to be updated.

Insurers will still have to determine which accounting model to apply to additional benefit features in insurance contracts.

Also, under today's guidance, there is no explicit policyholder dividend assumption included in the net premium model. However, insurers are required to record a separate liability for terminal dividends (i.e., dividends to policyholders calculated and paid upon termination of a contract). Terminal dividends are accrued over the life of the contract in proportion to the present value of the estimated gross margin expected to be realized. Interest accrues to the terminal dividend liability using the insurer's expected investment yield, net of related investment expenses.

ASU 2018-12 modifies the recognition pattern of terminal dividends, so they are accrued at a constant rate based on the present value of the basis used for the amortization of DAC. See the *Deferred acquisition costs* section for discussion regarding the basis to be used for DAC amortization.

How we see it

Because ASU 2018-12 retains the guidance for measuring the liability for future policyholder benefits of participating contracts, the measurement model for these types of contracts will continue to differ from that of traditional long-duration and limited-pay contracts.

Additional liabilities for benefit features

Certain long-duration products such as universal life-type or investment contracts may be sold with contract features that provide for benefits in addition to the account balance. The insurer's obligation to cover any shortfall between the guaranteed benefits and the account balance is the insurer's net amount at risk and exposes the insurer to capital market risk. These types of contract features often take the form of an annuitization, death or withdrawal benefit in excess of the policy's stated account value and are often offered through separate account products. However, they can also be offered through a general account product (e.g., fixed indexed annuities).

ASU 2018-12 creates a new category of benefit features called market risk benefits that will be measured using a fair value model similar to that currently used for embedded derivatives. Under current guidance, depending on the characteristics of the benefit feature, these features are accounted for as bifurcated embedded derivatives recorded at fair value under ASC 815[6] or as insurance liabilities under the benefit ratio model in ASC 944 (formerly known as the Statement of Position 03-1[7] liability), or they are not required to be recorded.

At contract inception, an insurer will be required to first evaluate whether benefit features meet the criteria of a market risk benefit. If they do not, the insurer will then evaluate whether the features meet the criteria of an embedded derivative that requires bifurcation under ASC 815. All other benefit features should be accounted for under today's insurance liability benefit ratio model, which has been retained (see *Annuitization, death or other insurance benefits — measurement* section).

Illustration 2 — Additional liability models for benefit features

The chart below identifies the three models that will be applied under the guidance for the recognition and measurement of benefit features.

Market risk benefits	▸ Any benefit features that protect the policyholder's account balance from and expose the insurer to capital market risk (e.g., guaranteed minimum death, accumulation, income, withdrawal and withdrawal-for-life benefits (GMXBs) commonly found in variable products) ▸ Measured at fair value applying ASC 944 ▸ Changes in the fair value related to instrument-specific credit risk recognized in OCI and remaining changes recognized in income
Bifurcated embedded derivatives	▸ Generally associated with benefit features offered in general account products (e.g., equity indexing features commonly found in indexed annuities and indexed universal life contracts) ▸ Measured at fair value applying ASC 815 ▸ All changes in the fair value recognized in income
Annuitization, death or other insurance benefits	▸ Applied to many benefit features that do not meet the above categories, such as those protecting the death benefit of a life contract (e.g., secondary guarantees under universal life insurance policies) ▸ Valued by applying the insurance liability benefit ratio model ▸ All changes in the liability recognized in benefit expense*

* If the assessments used in calculating the liability include investment margins, a portion of the change in the liability may be recognized in OCI (i.e., shadow adjustment).

The Board noted in the Basis for Conclusions that preparers had commented on the complexity in determining which accounting model should be applied to different benefit features. The Board decided to retain the guidance on embedded derivatives in ASC 815, and, as a result, some complexity in determining which accounting model to apply will still exist. However, the new guidance will prioritize the identification of market risk benefits within the scope hierarchy.

How we see it

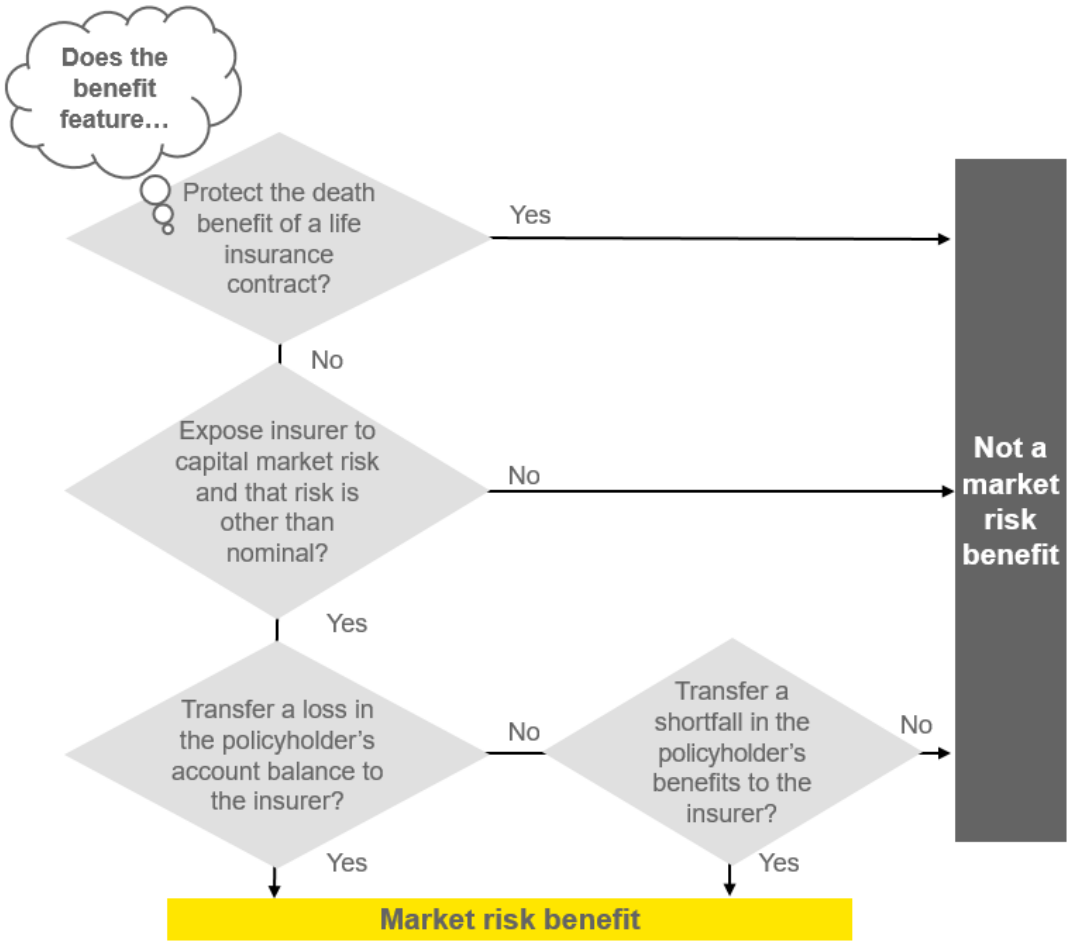
Introducing a new category of benefit features that will need to be assessed before any consideration of bifurcated embedded derivatives or additional insurance liabilities will reduce the diversity in practice in classifying and measuring certain benefit features and broaden the use of a fair value measurement model for benefit features commonly found in insurance products.

Market risk benefits — scoping

ASU 2018-12 will apply to benefit features included within either separate account products (i.e., the policyholder can direct the account funds to one or more separate account investment alternatives) or general account products (i.e., non-separate account products). In the Basis for Conclusions, the Board agreed with respondents that different measurement models for economically similar benefits, whether those benefits be offered in separate account products or general account products, would increase complexity and lead to user confusion.

ASU 2018-12 defines market risk benefits as contracts or contract features that both provide protection to the policyholder from capital market risk and expose the insurer to other-than-nominal capital market risk. Protection refers to either the transfer of a loss in, or shortfall of, the policyholder's account balance from the holder to the insurer but does not include the death benefit component of a life insurance contract.

In the Basis for Conclusions, the Board defined capital market risk to include equity, interest rate and foreign exchange risks. Other-than-nominal exposure to capital market risk would exist if the net amount at risk (that is, the guaranteed benefit in excess of the account balance, cash value or similar amount) varies by more than an insignificant amount in response to capital market volatility, and the exposure to market risk has more than a remote probability of occurring.



The definition focuses on features that expose the insurer to a loss or a shortfall in the policyholder's account balance that would otherwise have been borne by the policyholder. A loss in the policyholder's account balance generally occurs when negative investment performance is passed through to the policyholder, but the insurer is only exposed to this loss if the contract requires the insurer to compensate the policyholder for this loss. Since the shortfall of an account value is included in the definition, benefit features that are in addition to the insurance policy benefit but do not protect the policyholder from loss of an explicit account value will also be in the scope of the definition. Features that may meet the shortfall criteria are often structured as guaranteed benefits or specified account values in reference to a target amount.

If the investments backing the liability for any features are held in a general account where investment decisions are at the discretion of the insurer and the actual performance of the general account assets is not directly passed through to the policyholder, it would be difficult to assert the contractual transfer of a loss required to meet the definition. Similarly, contracts that include specific mechanisms for periodic crediting rates (e.g., returns based on an identified index, with or without a guaranteed floor) generally will not meet the definition solely due to the crediting rates fluctuating with the capital markets.

The guidance creates a new category of benefit features called market risk benefits that will be measured at fair value.

These features define the amount to be periodically credited to (or removed from) a policyholder's account but do not require the insurer to assume a loss otherwise borne by the policyholder, or otherwise provide a benefit due to a shortfall. While any shortfall of investment returns relative to guaranteed crediting rates exposes the insurer to capital market risk, because of the defined crediting rate, the policyholder is never exposed to that capital market risk and thus the guarantee is not providing protection to the policyholder.

The guidance will exclude features that protect the death benefit of life insurance contracts (i.e., instances where the death benefit of a life insurance policy exceeds the account value). Features such as secondary guarantees on universal life insurance contracts, which are primarily designed to protect the death benefit within the life insurance contract and do not change the amount of the death benefit, will generally meet this exception. The Board clarified that this exclusion should apply only to contracts that take the legal form of life insurance. However, additional benefits could be added to the life insurance policy (e.g., withdrawal benefits), which could meet the definition of a market risk benefit since the benefits would not be protecting the contractual death benefit.

The guidance also states this exclusion should not be analogized or applied to annuity or investment contracts. In the Basis for Conclusions, the Board noted that its decision on the scope of market risk benefits focused on variability in the benefit amount (or the net amount at risk) that is influenced by capital market performance. While mortality risk is one of the inputs used to value life-contingent benefits within annuity and investment contracts, capital market performance is also an input, and as a result, the Board deemed a fair value measurement model more appropriate for these types of features. In determining the fair value of the market risk benefit, the expected timing of mortality will be included in the valuation.

Implementation questions

Questions MRB 1.1 and 1.2 in Appendix C address common implementation questions on the scope of the market risk benefits guidance.

Illustration 3 — Applying the market risk benefit guidance to various benefit features

The chart below illustrates potential conclusions when analyzing various contracts or contract features to apply the definition of a market risk benefit. Any capital market risk within the benefit features analyzed in this illustration is assumed to be other than nominal. Analysis and conclusions reached will vary depending on the facts and circumstances of the contracts.

	Does the contract or benefit feature:				
Benefit feature	Protect the death benefit of a life insurance contract	Include capital market risk	Transfer a loss	Transfer a shortfall	Meet the definition of a market risk benefit
Guaranteed minimum benefits (GMXBs) — guaranteed benefits including death (GMDB), accumulation (GMAB), income (GMIB) and withdrawal (GMWB)	No	Yes	Yes	Yes	Yes
Interest credited — balance is credited based on discretion of insurer or subject to a floor (e.g., guaranteed minimum interest crediting rate)	No	Yes	No	No	No
Indexed crediting rate — balance is credited with investment returns based on the greater of a selected investment performance or a guaranteed floor return (which could include a loss of principal)	No	Yes	No	No	No
Indexed crediting rate with a GMXB — beneficiary receives the higher of the current account balance or another guaranteed amount	No	Yes	No	Yes	Yes
Death benefit in a variable life contract — account balance is credited with returns from designated investment funds and the beneficiary receives greater of account balance or death benefit	Yes	N/A	N/A	N/A	No
No lapse guarantee on an insurance contract (e.g., universal life) — insurance policy is kept in force even if the account balance is not sufficient to pay the cost of insurance	Yes	N/A	N/A	N/A	No
Annuity purchase guaranty — guarantees an interest rate or guaranteed amount at the annuitization date	No	Yes	No	Yes	Yes

How we see it

- Insurers will need to establish a process for determining which guarantees qualify as market risk benefits. For guarantees that do not qualify as market risk benefits, the new guidance will not reduce the number of measurement models that can be used.
- We expect less diversity in the accounting for certain benefit features, such as guaranteed minimum benefit features (i.e., GMXBs) commonly found in variable products, since these will generally qualify as market risk benefits. As a result, benefit features measured under the benefit ratio model will be significantly reduced.
- Most periodic crediting features that are not clearly and closely related to the host debt instrument (e.g., equity-indexed annuities) will not meet the criteria for market risk benefits and will continue to be accounted for as bifurcated embedded derivatives under ASC 815.
- We would not expect the accounting to change for crediting features (such as minimum interest guarantees) that currently do not require recording of a separate bifurcated embedded derivative liability at initiation due to the crediting features being clearly and closely related to the host contract.

Market risk benefits — measurement

As previously noted, market risk benefits are measured at fair value. In the Basis for Conclusions, the FASB noted that, given the significant effect of capital market risk on the benefit payment amounts, a fair value measurement better reflects the risks inherent in the economics of market risk benefits and will provide more meaningful information to users of the financial statements than a ratable insurance accrual measurement.

In addition, the Board said preparers and users expressed concern about the accounting mismatch that arises when a market risk benefit feature that is accounted for using the insurance liability benefit ratio model (i.e., a valuation method other than fair value) is economically hedged. That is because the hedging instrument is accounted for at fair value with changes in the fair value being recognized in net income while the hedged item is not. The new guidance reduces this accounting mismatch since the market risk benefit feature (i.e., the economically hedged item) will be carried at fair value, consistent with the hedging instrument. This better aligns accounting with many insurers' risk management practices.

When determining the terms of a market risk benefit feature, insurers will be required under ASU 2018-12 to consider the guidance in ASC 815-15[8] on determining the terms of an embedded derivative that must be accounted for separately. Insurers should use judgment at contract inception to determine the fees attributed to market risk benefits (e.g., rider fees, mortality and expense fees) that will be compared to expected benefits for measurement purposes. However, the total attributed fees used in measurement of the market risk benefit feature should not exceed the total contract fees or assessments collectible from the policyholder and should not be negative.

Throughout the life of the market risk benefit, the feature often will be in a liability position but may be in an asset position if the present value of expected attributed fees exceeds the present value of expected benefit payments. Insurers should establish accounting policies for determining the appropriate valuation approach (e.g., non-option or option-based) for various features.

Market risk benefits will be measured at fair value. Day 1 measurement should not result in recognition of a gain or loss, consistent with ASC 815-15. Under a non-option approach, the fair value of the feature at contract issuance is zero. Accordingly, insurers should determine the attributed fees to be charged to the policyholder so the present value of expected fees is equal to the present value of expected benefit payments.

Under an option-based approach, the insurer first determines the fair value of the feature at contract issuance using the present value of attributed fees and the present value of expected benefits. Although the feature can have an initial fair value measurement other than zero, any potential day 1 gains or losses associated with the feature should not be recognized immediately in net income, consistent with ASC 815-15. Instead, the insurer should adjust the value of the host contract so the initial measurement of the feature and the host contract do not exceed the total fair value (i.e., initial premium or initial deposit). The discount on the host contract (i.e., the initial adjustment to the value of the host contract) is subsequently amortized over the life of the host contract.

Multiple market risk benefits in a long-duration contract should be bundled together as a single, compound market risk benefit, consistent with ASC 815-15 requirements to combine all features that involve the same risk exposure. Previously, many benefit features were calculated separately, under different accounting models. This means the valuation model will need to utilize an integrated projection of cash flows for all applicable market benefits.

For accounting and valuation purposes, multiple market risk benefits will be bundled together as a single, compound market risk benefit.

During subsequent measurement, the portion of a change in the fair value of the benefit feature in a liability position attributable to a change in the instrument-specific credit risk (i.e., the entity's own credit risk) will be recognized in OCI with the remainder of the change in fair value recognized in income. This is similar to the guidance in ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*, which requires entities that adopt the fair value option for a financial instrument to separately present in OCI the portion of the total change in fair value that is caused by a change in the instrument-specific credit risk. This will result in different accounting for market risk benefit features accounted for in accordance with ASC 944 and bifurcated embedded derivatives accounted for in accordance with ASC 815-15, which does not separate the effect of a change in the instrument-specific credit risk (i.e., the entire change in the fair value of the bifurcated embedded derivative is recognized in income).

Implementation questions

Questions MRB 2.1 through 2.6 in Appendix C address common implementation questions on applying the new measurement guidance for market risk benefits.

How we see it

- Measuring market risk benefits at fair value will significantly increase income statement volatility if these benefits are not economically hedged.
- Some benefit features may be measured at fair value for the first time and other benefit features within the same contract that were previously individually measured may be measured together as a compound market risk benefit.
- Insurers will need to evaluate the financial statement impact of their risk management strategies as a result of the new guidance for market risk benefits.

Annuitization, death or other insurance benefits — measurement

For contract features that neither meet the definition of a market risk benefit or a bifurcated embedded derivative, ASU 2018-12 largely retains the existing insurance liability measurement models. Insurers will continue to perform an evaluation to determine whether an additional liability is needed for the contract feature. For death or other insurance benefits, this assessment continues to be done only at contract issuance.

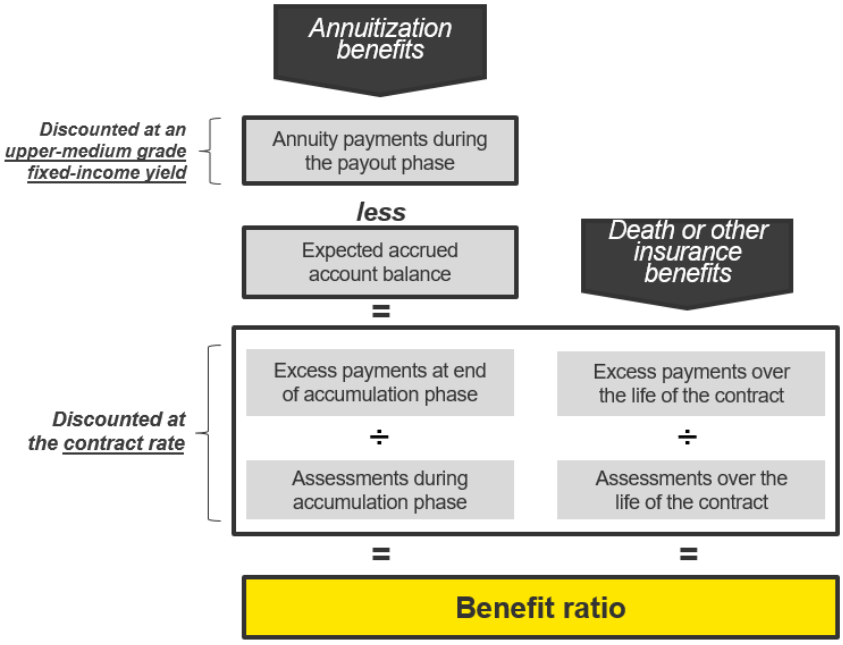
Insurers will continue to determine a benefit ratio and apply the ratio at each reporting period to cumulative assessments to measure any additional liability. However, ASU 2018-12 aligns the recognition and presentation of the remeasurement of the additional liability with that for traditional long-duration and limited-payment contracts so that the effect of changes to the benefit ratio is presented as a remeasurement gain or loss. ASU 2018-12 also changes the rate at which annuity payments expected during the payout phase are discounted to align with the upper-medium grade yield used for traditional long-duration and limited-payment contracts.

Consistent with current guidance, insurers will record an additional liability for death or other insurance benefits if amounts are assessed against a policyholder in a manner that is expected to result in profits in earlier years and subsequent losses from that insurance benefit. The liability is recognized for the portion of such assessments that, in effect, represents compensation to the insurer for services to be performed in future periods. An additional liability should be recorded for annuitization benefits if the present value of the expected annuity payments during the payout phase exceeds the expected account balance at the expected annuitization date. This provides a mechanism for establishing a liability during the accumulation phase of contracts to prevent the recognition of a loss during the payout phase as a result of the annuitization guarantee (charges for which presumably were assessed during the accumulation phase) and not to blend or smooth profits over the combination of the accumulation and payout phases.

Also consistent with today's guidance, when calculating the benefit ratio, the insurer discounts all components other than annuity payments expected during the payout phase (i.e., expected excess payments and assessments) at the contract rate. The contract rate is defined as the rate of interest that accrues to the policyholder balances, and the new guidance clarifies that the contract rate can be determined either at the contract issue date or the most recently updated date. Insurers should be consistent in applying the approach selected to determine the rate.

As previously noted, the new guidance modifies the treatment of annuity payments expected during the payout phase such that the upper-medium grade fixed-income instrument yield applicable to the payout phase of the contract (determined in the same manner as the discount rate for the liability for future policyholder benefits) will be used to calculate the present value of expected annuitization payments and related additional claim adjustment expenses. Under today's guidance, the discount rate used in these calculations is the expected investment yield. If the present value of the expected payments and expenses exceeds the expected accrued account balance at the annuitization date, the excess will be discounted at the contract rate.

To measure the additional liability, the insurer multiplies the total of the cumulative contract assessments by the benefit ratio. Contract assessments represent the compensation provided to the insurer in exchange for the insurance benefits and include all revenue expected from the contract holder from administration, mortality, expense and surrender charges, among others. For general account contracts (that is, for products in which the assets supporting the contract are reported in the general account), amounts expected to be earned from the investment of policyholder balances less amounts credited to the policyholder (i.e., expected investment margins) should be included with the total assessments considered in the calculation. For death or other insurance benefits, total assessments should also include any amortization of unearned revenue liabilities.



Because investment margins are included in an insurer's evaluation of contract assessments, the insurer will continue to measure and record the effect that unrealized gains and losses in the asset portfolio will have on the additional liability. These effects are commonly referred to as "shadow adjustments," and although the concept is no longer applicable to many other areas of the guidance (e.g., liability for future policyholder benefits and DAC) it remains applicable for additional liabilities that continue to consider the effect of an insurer's investment portfolio.

Consistent with today's guidance, for subsequent measurement insurers recalculate the benefit ratio periodically in light of emerging experience. To determine the additional liability, the insurer multiplies the cumulative assessments as they occur (i.e., actual assessments from contract inception through the balance sheet date) by the revised benefit ratio and adds accreted interest for the period. For death or other insurance benefits, cumulative excess payments are subtracted from this amount and the resulting balance is recorded as the additional liability.

As previously noted, the new guidance modifies the presentation requirements so that similar to traditional and limited-payment contracts, if the benefit ratio is subsequently revised for an additional liability, the insurer should remeasure the liability as of the beginning of the reporting period and record a remeasurement gain or loss. This remeasurement gain or loss should be reported as a separate component of benefit expense but can be included with the remeasurement gain or loss for traditional and limited-payment contracts.

How we see it

While the new guidance generally does not change the insurance liability models for the additional liabilities for annuitization, death or other benefits, it makes subtle changes that insurers should be aware of (i.e., discount rate used for excess annuity payments and presentation of a remeasurement gain or loss).

Implementation questions

Questions SOP 1.1 through 1.4 in Appendix C address common implementation questions on additional liabilities for annuitization, death or other benefits.

Deferred acquisition costs

ASU 2018-12 changes the amortization of DAC for traditional long-duration contracts, universal life-type insurance contracts, participating insurance contracts and investment contracts with significant surrender charges or other revenues. Investment contracts without significant surrender charges or other revenues will continue to be amortized under the effective interest method in ASC 310-20.

The new amortization approach is more consistent with how finite-lived intangible assets are amortized (i.e., if the pattern in which the economic benefits of the intangible asset are consumed cannot be reliably determined, a straight-line amortization method is used). In the Basis for Conclusions, the FASB noted that a long-duration contract is akin to a financing arrangement whereby a policyholder provides cash to an insurer that agrees to return cash to the policyholder or beneficiary at a future date. In this regard, DAC is similar to debt issuance costs, which are amortized over the borrowing term, regardless of how the borrower (i.e., the insurer) chooses to use the borrowing proceeds.

Under today's guidance, although the nature of the costs deferred is the same regardless of product type, there are different amortization models depending on product types (e.g., when the premium is recognized, or based on the pattern in which estimated gross profit (EGP) or estimated gross margin (EGM) is expected to be recognized over the life of a portfolio of contracts). Financial statement users have noted that the existing EGP and EGM amortization models are complex and require numerous inputs and assumptions that when updated result in adjustments that are challenging to understand and could result in the recovery of previously expensed DAC.

DAC will be amortized on a constant level basis over the expected term of the related contracts.

ASU 2018-12 will require insurers to amortize DAC for long-duration insurance contracts on a constant level basis over the expected life of the contracts, independent of profitability or revenue components. If DAC is grouped for measurement purposes, the unit of account (i.e., cohort) for the amortization of DAC should be the same unit of account used for the measurement of the related liability for future policyholder benefits.

Regardless of the unit of account used, the DAC amortization pattern should approximate straight-line amortization on an individual contract basis.

Insurers will need to identify attributes of the individual contracts or cohorts (independent of revenue or profitability) that provide a constant level criterion upon which the amortization may be based. The amount of insurance in force is one basis that would meet the constant level criterion. When considering various long-duration insurance product types, insurers may conclude that other attributes will accomplish the objective of ASU 2018-12. We expect insurers to consider, as applicable, insurance or benefits in force, policy count or net deposits.

Under ASU 2018-12, amortization will be required over the expected life of the contracts (i.e., all periods in which the contract is active) instead of the coverage period. In determining the expected life of the contracts, insurers will need to consider the attributes of the contracts, and in some cases, make judgments to estimate the expected life. Expected lapse rates, termination rates and mortality rates are all attributes that may be relevant to the determination, among others. Assumptions used in determining the expected life of the contract (e.g., mortality, lapse) should be consistent with those used in the measurement of the related liability for future policyholder benefits, account balance or additional liability.

In addition, for certain contracts, the determination of the expected life could include the claim payment period (e.g., disability, long-term care). However, for contracts that include accumulation and payout phases (e.g., deferred annuities), the payout phase will be considered a separate contract when determining the expected life of a contract. As a result, DAC will generally be amortized over the expected life of the accumulation phase.

Illustration 4 — Amortizing DAC using a constant level basis

Assume an insurer issues a block of five-year level term life insurance contracts in 2022 with increasing premiums and a high lapse rate at the end of the level term period. The insurer measures the reserves for future policyholder benefits at the issue year level (i.e., measures all the policies issued in 2022 together as a single cohort) and elects the amount of insurance in force as the constant level basis used to amortize deferred acquisition costs over the life of the contracts. At the beginning of 2022, the insurer defers costs totaling $80 and estimates the amount of insurance in force over the life of the contracts.

Year	Estimated amount of insurance in force at beginning of year	Lapse (at end of year)
2022	$ 10,000	2%
2023	9,800	2%
2024	9,604	2%
2025	9,412	2%
2026	9,224	80%
2027	1,845	10%
2028	1,660	10%
2029	1,494	10%
2030	1,345	100%
Total	$ 54,384	

Based on the amount of insurance expected to be in force in 2022, the amortization rate is initially determined to be 18.38% ($10,000 divided by total amount of estimated insurance in force of $54,384). At the end of 2022, lapses are consistent with the insurer's initial estimate. As a result, the insurer measures and records amortization expense of $14.71 for 2022 ($80 multiplied by the 18.38% amortization rate).

At the beginning of 2023, the insurer incurs an additional $10 of deferrable acquisition costs, resulting in a new balance of $75.29 ($65.29 of previous year's ending DAC balance plus $10 in additional deferred costs).

Year	Balance, beginning of year	Capitalization	Amortization	Balance, end of year
2022	$ -	$ 80.00	$ (14.71)	$ 65.29
2023	65.29	10.00	(16.62)	58.67

This amortization process is repeated in subsequent periods, and, in this example, it will result in a change to the amortization rate due to the expected change in the amount of insurance in force. The insurer calculates the amortization rate as the period's estimate of insurance in force divided by the total expected future in force. At the start of 2023, the amount of insurance in force is $9,800 and lapses during the year are 2%, consistent with the insurer's original estimate. As a result, the amortization rate to be applied to the unamortized DAC balance is determined to be 22.08% (the 2023 insurance in force of $9,800 divided by total expected insurance in force over the remaining life of $44,384). The amortization rate is then applied to the new DAC balance of $75.29, yielding amortization expense of $16.62 for 2023.

Changes in estimates of the selected constant level basis are reflected in the calculation of the amortization rate applied to future periods (i.e., prospective application of a change in accounting estimate). Actual experience relating to the constant level basis selected will likely differ from the experience previously estimated. Actual experience that reduces the constant level basis selected in excess of the expected reduction will result in additional expense through a write-off of DAC. Actual experience that results in the constant level basis selected being higher than expected will be recognized through a change in future amortization expense (i.e., prospective application).

Illustration 4.1 — Updates to the amortization rate

This illustration assumes the same fact pattern in Illustration 4 to demonstrate modifications to the amortization rate in periods subsequent to a contract's issuance.

At the end of 2024, the insurer experiences contract terminations of 10%, which is 8% higher than the initial expectations of 2%. The additional terminations result in the amount of in force at the end of 2024 (and beginning of 2025) being $8,644, rather than $9,412 as originally expected. As a result, after first recording the expected amortization, the insurer writes off deferred costs in proportion to the unexpected terminations.

Deferred costs, beginning of 2024	$ 58.67
2024 amortization (in accordance with original amortization schedule)	(16.29)
Deferred costs, prior to experience adjustment	42.38
Experience adjustment (deferred cost balance of $42.38 x 8.16%)	(3.46)
Deferred costs, end of 2024	$ 38.92

The insurer calculates the experience adjustment write-off as 8.16% of deferred costs after planned amortization because the in force amounts (after additional lapses at the end of 2024) were 8.16% less than expectations [(9,412-8,644)/9,412 = 8.16%].

The insurer next re-estimates its future terminations and adjusts its estimates of future amounts of insurance in force.

Year	Estimated amount of insurance in force at beginning of year	Lapse (at end of year)
2025	$ 8,644	10%
2026	7,780	90%
2027	778	10%
2028	700	10%
2029	630	10%
2030	567	100%
Total	$ 19,099	

As a result of the insurer's re-estimates, the amortization rate for 2025 is revised to 45.26% ($8,644 divided by the total amount of estimated insurance in force over the remaining duration of the life of the contracts of $19,099). This yields amortization expense of $17.62 (DAC balance of $38.92 multiplied by rate of 45.26%) in 2025. Throughout the remainder of the block's life, assuming the amount of insurance in force proves to be consistent with the insurer's revised estimates, DAC-related expense for 2024 and thereafter would be as follows:

Year	Balance, beginning of year	Amortization	Experience adjustments	Balance, end of year
2024	58.67	(16.29)	(3.46)	38.92
2025	38.92	(17.62)	-	21.30
2026	21.30	(15.85)	-	5.45
2027	5.45	(1.59)	-	3.86
2028	3.86	(1.43)	-	2.43
2029	2.43	(1.28)	-	1.15
2030	1.15	(1.15)	-	-
Total		$ (55.21)	$ (3.46)	

The DAC amortization model will also be applied to other balances that are amortized on a basis consistent with DAC.

The FASB noted in the Basis for Conclusions that the amortization model applied using current guidance introduced uncertainty (and income variability) since it is based on long-dated and market-based (e.g., investment performance) assumptions. While the new approach under ASU 2018-12 eliminates this variability, as noted above, actual experience when compared with estimated experience is expected to affect the amortization pattern prospectively, and in some cases result in DAC write-offs.

ASU 2018-12 also clarifies or modifies guidance relating to DAC in a few areas as follows:

- Interest will not be accrued on the undiscounted balance of DAC. Because the amortization methods do not employ present value techniques and DAC is not a monetary asset, the FASB concluded interest accrual would be inappropriate.
- DAC should only include costs that have been incurred and capitalized as of the reporting date. Therefore, costs such as future contract renewal acquisition costs are not included in the amortization model until incurred.
- Assessing DAC for recoverability or impairment is not required because the FASB views DAC in a manner similar to debt issuance costs in a financing arrangement (for which there is no impairment assessment).
- The requirement to adjust DAC (e.g., when amortized using EGP or EGM) for the effect unrealized gains and losses on available-for-sale securities would have on cash flows generated by the related policies as if those gains and losses had been realized (the shadow DAC adjustment) is eliminated.

Implementation questions

Questions DAC 1.1 through 1.7 in Appendix C address common implementation questions on the measurement of DAC.

Other balances required to be amortized on a basis consistent with DAC

The simplified DAC amortization model will also affect the amortization of other balances that are amortized on a basis consistent with DAC, whether due to existing requirements in ASC 944 (e.g., deferred sales inducements or unearned revenue liabilities) or to an existing accounting policy election. Examples of balances amortized consistent with DAC as a result of an existing accounting policy election could include value of business acquired (VOBA) in a business combination or the cost of reinsurance.

The new guidance does not change the requirement to perform recoverability testing on these non-DAC balances. Examples of such balances include:

- Unearned revenue liabilities are related to universal life-type contracts and are therefore included in the loss recognition testing of the liabilities of universal life policies (which is retained under the new guidance).
- VOBA, which is an intangible resulting from the difference between the fair value of future cash flows from contracts acquired in a business combination and the liability for policyholder benefits as of the acquisition date, is subject to impairment testing in accordance with ASC 944-30-35-63.

How we see it

- The guidance introduces a single DAC amortization model for all long-duration contract types, with the exception of certain investment contracts, based on the concept of a constant level basis.
- Insurers will need to determine the constant level basis to be used for each type of contract, which will be independent of revenue or profit emergence. This means, under the new guidance, the amortization of acquisition expenses will no longer be aligned with the recognition of revenues, as it was previously for both traditional long-duration and nontraditional contracts.
- Eliminating the EGP and EGM DAC amortization models for universal life-type insurance contracts and investment contracts will simplify the accounting for financial statement users and reduce effort for financial statement preparers. However, this will affect the amortization pattern, which could increase income statement volatility since DAC amortization will no longer serve as an offset to movements in other liabilities such as market risk benefits or other insurance benefits.

Presentation

ASU 2018-12 will make limited changes to the current financial statement presentation, as illustrated in the following table:

	Income statement	Other comprehensive income	Statement of financial position
Reserve for future policyholder benefits	Separately present the remeasurement gain or loss (effect of updating experience and cash flow assumptions) as a component of benefit expense	Separately present the effect of updating discount rates	No change in presentation
Market risk benefits	Separately present changes in fair value other than changes attributable to instrument-specific credit risk	Separately present the portion of changes in fair value attributable to instrument-specific credit risk	Separately present the carrying amount of market risk benefit liabilities (or assets)

For the reserve for future policyholder benefits, insurers will be required to present a remeasurement gain or loss as a separate component of benefit expense during any period in which they update the net premium ratio. In the Basis for Conclusions, the FASB observed that a separate remeasurement gain or loss reflects an intuitive relationship between the remeasurement of the liability and expected future profitability. Consistent with current practice, the change in reserves during the reporting period measured using the revised net premium ratio is also reported as a component of benefit expense. Additionally, insurers will be required to separately present in OCI the effect of updating discount rates used to measure the reserve for future policyholder benefits.

The new concept of market risk benefits will require insurers to separately present the carrying amount of market risk benefit liabilities (or assets) in the statement of financial position. Similarly, the guidance will require that changes in the fair value related to the market risk benefits, other than the portion of the change attributable to a change in an instrument-specific credit risk, be presented separately in the income statement. The portion of the change in fair value attributable to instrument-specific credit risk is presented separately in OCI.

The guidance modifies the method to amortize DAC, but there are no changes to the presentation of DAC in the financial statements.

How we see it

The inclusion of a remeasurement gain or loss as a separate component of benefit expense will be a significant change from the current guidance and will result in greater transparency into the changes in reserves for future policyholder benefits. Insurers should be prepared to explain the effect of changes in assumptions to users of the financial statements.

Disclosure

The guidance will significantly expand the disclosure requirements for long-duration contracts in the annual and interim financial statements. Insurers will be required to make additional disaggregated disclosures for the insurance liabilities and DAC, including rollforwards of opening and closing balances and quantitative and qualitative information about significant inputs, judgments and assumptions used in the measurement of the liabilities and DAC.

New disclosures

The new disclosures that insurers will have to make include disaggregated tabular rollforwards of opening to closing balances of the liability for future policyholder benefits, policyholder account balances, market risk benefits, separate account assets and liabilities, DAC, and balances amortized on a basis consistent with DAC (e.g., deferred sales inducements, unearned revenue, terminal dividends). In the Basis for Conclusions, the Board stated that it made this decision because the rollforwards will provide users with information about changes in the asset or liability balances that otherwise could not be discerned solely by the fluctuation in the balances.

Insurers will also be required to provide qualitative and quantitative information about the inputs and assumptions they used to measure the balances and changes to those inputs and assumptions, among other disclosure items. The new disclosures are intended to provide financial statement users with more meaningful information to evaluate the amount, timing and uncertainty of cash flows arising from long-duration contracts. These disclosures will provide significantly more information than is currently required to be disclosed under ASC 944. Refer to Appendix B for a summary of these new disclosures.

Insurers will need to disclose disaggregated tabular rollforwards of insurance liabilities, DAC and market risk benefits in their interim and annual financial statements.

Implementation questions

Questions LFPB 5.1 through 5.3, MRB 3.2 through 3.3, MRB 4.3, and DISC 1.1 through 1.2 in Appendix C address common implementation questions on applying the new disclosure guidance.

Disaggregation principle for new disclosures

The disaggregation principle for disclosures in the guidance follows the same approach in the recent standards on short-duration insurance contract disclosures, revenue recognition, leases and credit losses. This principle provides insurers with guidelines for determining how to disaggregate the new disclosures to give users meaningful information without requiring the inclusion of a large amount of insignificant detail or the aggregation of items with significantly different characteristics. In the Basis for Conclusions, the Board observed that useful disaggregation of information depends on the characteristics of the contracts that an insurer writes and on various entity-specific factors.

While the guidance does not specify how the insurer will disaggregate the information, the implementation guidance provides examples of categories an insurer might use, such as type of coverage or geography. An insurer should consider how information about its insurance liabilities or DAC has been disaggregated for other purposes when determining which categories would be the most relevant and useful. Some examples would include investor presentations, earnings releases, annual reports (including MD&A), statutory filings or other information used by the insurer or the users of its financial statements.

The implementation guidance clarifies that the disaggregation of the disclosures should at a minimum be consistent with segment-related disclosures. That is, if an insurer provides segment-related disclosures in its audited financial statements under ASC 280, the disaggregated categories should not include amounts of the insurance balances or DAC from different reportable segments.

After the adoption of ASU 2015-09, *Disclosures about Short-Duration Contracts*, the Securities and Exchange Commission (SEC) staff issued numerous comment letters regarding the level of disaggregation with specific emphasis on disaggregating contracts with different characteristics. The staff commented that the disaggregated categories should be dynamic to mirror changes

within the insurer. These lessons learned from the implementation of ASU 2015-09 could be useful as insurers implement the new disclosures required for long-duration contracts, regardless of whether the insurer is an SEC registrant.

See Appendix B for details on the disclosures that will have to be disaggregated.

How we see it

- Insurers will have to capture, accumulate and evaluate on a timely basis significantly more data to comply with the additional disaggregated annual and interim disclosure requirements. An insurer may need to change its processes, systems and controls to prepare these disclosures.
- The additional disclosures will provide users of the financial statements greater transparency into the risks embedded in policies insurers underwrite and the resulting risks assumed, as well as the drivers of changes in the measurement of the liability. Because of this increased transparency, insurers should be prepared to explain their business (e.g., liability for future policyholder benefits, market risk benefits) at a more granular level.
- Insurers will need to determine the appropriate level of disaggregation for most of the new required disclosures. At a minimum, they will need to disaggregate disclosures by reportable segments, if applicable. When making this determination, management should consider whether the level at which the information is being disclosed is meaningful based on the characteristics of the insurance balance.
- Insurers should consider leveraging SEC staff observations and comments on recently issued standards when determining the appropriate level of disaggregation for the new disclosures.

Transition and effective date

Effective date (updated December 2023)

In November 2020, the FASB issued ASU 2020-11 to defer the effective dates of the new guidance in response to implementation disruptions due to COVID-19. An SEC filer that is not a smaller reporting company (SRC) is now required to adopt the guidance for fiscal years beginning after 15 December 2022 (i.e., 2023 for calendar-year insurers) and for interim periods therein. All other entities (i.e., SRCs and private insurers) are required to adopt the guidance for annual periods beginning after 15 December 2024 (i.e., 2025 for calendar-year insurers) and interim periods within fiscal years beginning a year later.

An entity meets the definition of an SEC filer if its financial statements are required to be filed with or furnished to the SEC. It does not meet the definition if the financial statements are only filed with or furnished to the SEC through the submission of another SEC filer. SRCs are subject to the same required effective date as private insurers. The one-time determination of whether an entity is eligible to be an SRC is based on the entity's most recent determination as of 15 November 2019. An SRC is, in part, identified based on the significance of public float and annual revenues, and is defined in Part 230.405 of the SEC's general rules and regulations, per the Securities Act of 1933.

If insurers adopt the guidance at the required effective date, the transition date will be the beginning of the earliest period presented in the financial statements. This means the transition date will be 1 January 2021 for calendar year-end SEC filers (that are not SRCs) that adopt the guidance at the required effective date of 1 January 2023 and present three years of certain financial statements (i.e., statements of income, comprehensive income and shareholders' equity).

Early adoption continues to be permitted for all insurers; however, ASU 2020-11 provides early adopters with the ability to elect a transition date as either the beginning of the earliest period presented or the beginning of the prior period. Insurers will want to determine a planned transition date so they can begin the process to measure the effect of adopting the new guidance as of that transition date.

In December 2022, the FASB issued ASU 2022-05 to allow an insurer to make an accounting policy election to not apply the new guidance on long-duration insurance contracts to contracts or legal entities sold and derecognized before the effective date (i.e., 1 January 2023 for calendar-year SEC filers that are not SRCs). Ceded reinsurance transactions do not qualify as contracts or legal entities sold and derecognized under the guidance.

The accounting policy election would be limited to each contract in which the insurer does not have certain forms of significant continuing involvement. Arrangements for investment management, policy servicing or other administrative services would not be deemed significant continuing involvement. However, arrangements that allow for significant participation in the derecognized contracts, such as assumed reinsurance of the sold business, could be considered significant continuing involvement. An investment accounted for under the equity method could be considered significant continuing involvement if certain criteria in ASC 323-10-15-6 through 15-11 are met.

Generally, a company with a 2% to 5% interest in a limited partnership that does not have significant influence, but has more than virtually no influence, would not violate the continuing involvement principle and could apply the policy election under the guidance. If this guidance is applied, insurers need to disclose the accounting policy and provide a qualitative description of each sale or disposal transaction to which the insurer applied the accounting policy election.

How we see it

- ASU 2020-11 provides all insurers with additional time to implement the new guidance. Although some insurers may be dealing with business disruptions related to COVID-19, all insurers should look to strengthen back-end testing procedures, such as parallel processing of financial statements under the new guidance.
- We expect that most SEC filers (that are not SRCs) will plan for a transition date of 1 January 2021. This would allow these insurers to begin calculating and analyzing transition adjustments with certainty, while still maintaining the option to early adopt the guidance in 2022, if implementation of the guidance progresses.
- Subsidiaries of SEC filers (that are not SRCs and adopt the guidance on the required effective date) may conclude it is advantageous to early adopt and gain operational efficiencies by aligning the transition dates of its standalone financial statements and the consolidated financial statements of the SEC filer parent. However, this means these insurers will need to present three years of certain financial statements, consistent with the parent.
- Many private insurance company sponsors of separate accounts that are considered PBEs generally do not meet the definition of an SEC filer; therefore, they can adopt the standard on the effective date for all other entities (i.e., 1 January 2025).

Transition approaches

The guidance prescribes the following transition approaches:

- Measurement of the liability for future policyholder benefits and DAC is required to be applied on a modified retrospective basis, with the option to elect a retrospective application.
- Measurement of market risk benefits is required to be applied retrospectively.

ASU 2018-12 does not provide specific transition guidance related to additional liabilities for annuitization benefits, where ASU 2018-12 modifies the discount rate used when determining the present value of expected annuitization payments for measurement purposes (see the *Annuitization, death or other insurance benefits — measurement* section earlier in the publication). In the absence of specific transition guidance, insurers should apply the principles of the initial adoption of an accounting principle within ASC 250.[9]

Liability for future policyholder benefits

Determining the transition method

Insurers should apply the new guidance for the liability for future policyholder benefits on a modified retrospective basis but can elect to apply it retrospectively.

The determination of whether to apply the modified retrospective transition or elect the retrospective transition approach for the liability for future policyholder benefits should be made at the issue year level and applied entity-wide.

Insurers can elect to apply the retrospective transition method to issue years for which actual historical experience is available for all contracts throughout the entity. The earliest issue year for which actual historical experience is available for all contracts throughout the entity determines the potential retrospective adoption date. The guidance will be applied to all issue years after the retrospective adoption date. For any issue years preceding the retrospective adoption date, the insurer will apply the guidance to those contracts on a modified retrospective basis at the transition date.

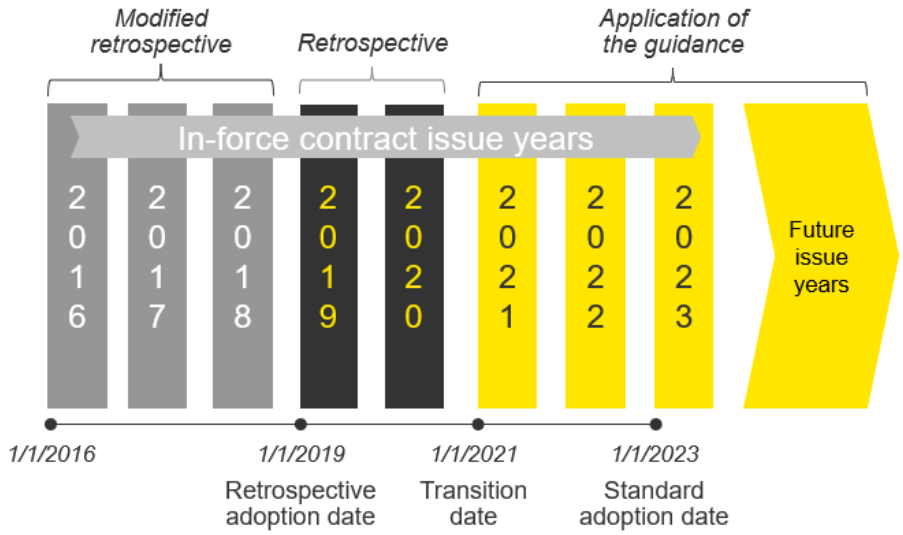
In the Basis for Conclusions, the FASB recognized that actual historical information and estimates of historical experience may be unavailable (or not readily accessible), limited or insufficient because of the age of many in force contracts. As a result, the FASB recognized that requiring full retrospective application of the guidance could be costly and impracticable and therefore decided to require a modified retrospective transition approach.

Such approach allows insurers to elect the retrospective transition method only when they have access to actual historical information from their books and records, which may include, among other things, general and subsidiary ledgers, actuarial reports, regulatory filings or other data maintained in system warehouses. Estimates of historical information may not be used.

Illustration 5 — Determining the transition method

This illustration demonstrates how insurers can evaluate their options for transitioning the measurement of the reserve for future policyholder benefits under the new guidance.

Assume an insurer is a calendar year-end entity and is adopting the guidance as of 1 January 2023. The insurer began writing business for three different groups of contracts in 2016 and presents three years in the income statement. Assume the insurer determines it has actual historical information back to issue year 2016 for two of the three contract groups, and only has actual historical information back to issue year 2019 for the third contract group. In this instance, the insurer can elect to apply the retrospective transition method back to issue-year 2019 (retrospective adoption date) since it is the first issue year for which actual historical information is available for all contract groups.



Under this scenario, if the insurer elects the retrospective measurement transition option, issue years 2019 and 2020 will be transitioned retrospectively. That is, the insurer will apply the guidance for the measurement of the liability for future policyholder benefits to all contracts issued in 2019 and subsequently. The insurer will then apply the guidance for issue years 2016 through 2018 on a modified retrospective basis.

How we see it

- Insurers need to establish a process to accumulate available information and determine whether that information meets the requirement for actual historical information at the level of disaggregation required. They also need to determine the extent to which this information is available on an entity-wide basis for all contract groups.
- Identifying and gathering historical information could be more challenging for insurers that operate in multiple jurisdictions, have numerous product types and in force contracts written many years ago, and use various systems, some of which may have been changed during the life of contracts resulting in data not being retained. These and other factors may restrict an insurer's ability to elect the retrospective transition method.

Modified retrospective transition — determining the revised net premium ratio at transition

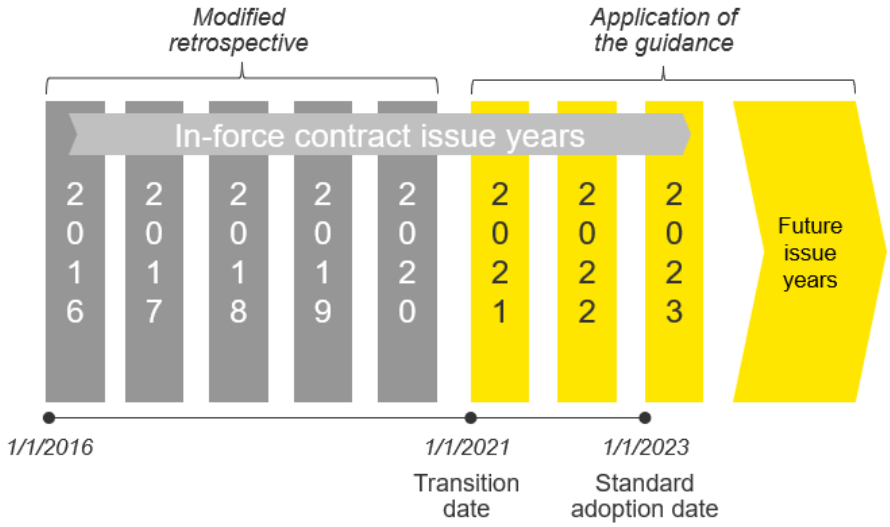
Under the modified retrospective transition method, an insurer will apply the guidance to contracts on the basis of existing carrying values as of the transition date. That is, the opening balance at the transition date would generally be the same as the closing balance before transition, updated for the removal of any related amounts previously recorded in AOCI for items such as shadow loss reserves. The opening balance at the transition date will then be updated for the cumulative effect of changes in the discount rate between the rates applied in the measurement of the liability immediately before the transition date and the upper-medium grade fixed-income instrument yield at the transition date. This difference will be recorded in AOCI.

The modified retrospective transition approach allows insurers to apply the guidance to contracts on the basis of their existing carrying values.

Illustration 5.1 — Determining the transition method: identifying modified retrospective issue years

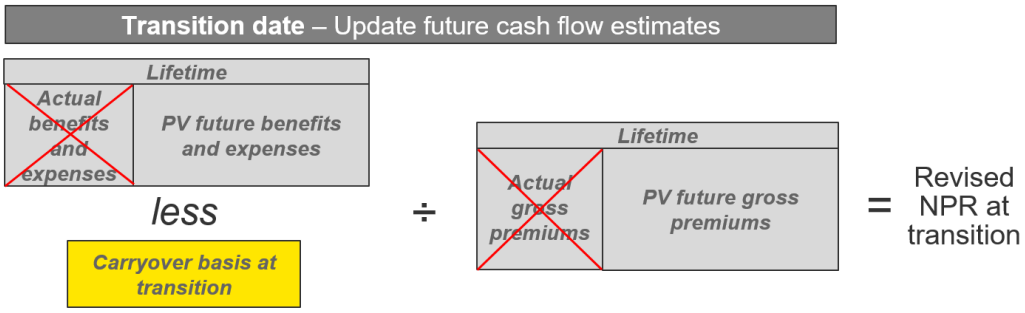
Assume the same fact pattern as in Illustration 5, with the exception that the insurer determines not to elect the retrospective transition approach. Recall that the insurer is a calendar year-end entity and is adopting the guidance as of 1 January 2023. The insurer began writing business for three different groups of contracts in 2016 and presents three years in the income statement.

Because the insurer did not elect retrospective transition, it applies the guidance on a modified retrospective basis, under which it fully applies the guidance as of the transition date. As a result, the guidance for the measurement of the liability for future policyholder benefits is applied to all contracts issued in 2021 and thereafter.



The measurement of the liability for future policyholder benefits for contracts issued in 2016 through 2020 will be based on their existing carrying value as of the transition date, adjusted for the cumulative effect of changes in the discount rate between the rates applied in the measurement of the liability immediately before the transition date and the upper-medium grade fixed-income instrument yield at the transition date.

For contracts measured under the modified retrospective transition, insurers will calculate a revised net premium ratio at the cohort level using updated expected future cash flow assumptions as of the transition date less the existing carrying amount of the cohort at transition adjusted for the removal of any related amounts in AOCI at transition (cumulatively referred to as the carryover basis). The expected future cash flow assumptions should be discounted using the discount rate used in the measurement of the liability immediately before the transition date (i.e., applying the existing guidance).



The diagram above demonstrates how the net premium ratio calculation is adjusted under a modified retrospective transition. At the transition date, an insurer only considers updated expected cash flows for future periods, adjusted for the cohort's carryover basis at transition. The cohort's carryover basis is the reserve balance of all contracts in the cohort at transition, adjusted for the removal of any related amounts previously recorded in AOCI.

In subsequent periods, the revised net premium ratio calculation will be based on the present value of cash flows (both actual historical cash flows and expected future cash flows) after the transition date, and the carryover basis at the transition date, which will continue to be an adjustment to the calculation for the remaining life of all contracts transitioned under the modified retrospective basis. See the *Updating of cash flow assumptions and the net premium ratio under ASU 2018-12* section for more details about the net premium ratio calculation.

Modified retrospective transition — revised net premium ratio less than 100%

When the revised net premium ratio does not exceed 100%, there is no transition adjustment other than the removal of adjustments previously recorded to AOCI and recording the effect of the upper-medium grade fixed-income instrument yield in AOCI. Any effect from updating the net premium ratio will be recognized in future periods.

Illustration 6 — Modified retrospective transition

Assume an insurer is a calendar year-end entity that adopts the guidance as of 1 January 2023 and presents three years in the income statement. The insurer applies the new guidance beginning 1 January 2021, which is considered the transition date.

The insurer applies the modified retrospective transition approach to the liability for future policyholder benefits for contracts issued in 2019 with a 20-year term. As of 31 December 2020, the recorded liability for future policyholder benefits is $275,000, with $25,000 of the reserve balance being attributed to AOCI shadow reserve adjustments previously recorded.

To apply the modified retrospective measurement guidance, the insurer would first record the following journal entry at the transition date to remove the amounts previously recorded in AOCI for shadow reserves:

Dr. Liability for future policyholder benefits	$ 25,000	
Cr. Accumulated other comprehensive income		$ 25,000

The carryover basis at transition is now $250,000 after the adjustment for amounts previously recorded in AOCI. The insurer then updates its cash flow assumptions as of the transition date (i.e., 1 January 2021) to determine the expected future cash flows for benefits, policy expenses and gross premiums, resulting in the following:

Undiscounted benefits and policy expenses (for years 2021–2038)	$ 4,925,000
Undiscounted gross premiums (for years 2021–2038)	$ 5,364,000

All cash flows are discounted with the rate used in the measurement of the liability immediately before the transition date (in accordance with the guidance existing at that time) to determine a revised net premium ratio. In this example, that discount rate was 5.5%.

Benefits and expenses (for years 2021–2038) discounted at 5.5%	(a)	$ 3,076,000
Less: Carryover basis (liability at transition after adjusting for amounts in AOCI)		250,000
Present value of benefits and policy expenses, less carryover basis	(b)	2,826,000
Gross premiums (for years 2021–2038) discounted at 5.5%	(c)	3,604,000
Revised net premium ratio at transition = (b) / (c)	(d)	78.4%

Because the revised net premium ratio is less than 100%, no cumulative catch-up adjustment is recorded.

The insurer also will remeasure the liability using the current upper-medium grade fixed-income instrument yield and record the difference between the remeasured liability and the carrying amount before transition to AOCI. The upper-medium grade fixed-income instrument yield at the transition date is determined to be 4%.

Benefits and expenses (for years 2021–2038) discounted at 4%	(e)	$ 3,464,000
Net premiums (for years 2021–2038) discounted at 4%	(f)	3,122,000
Remeasured liability = (e) – (f)	(g)	342,000
Carryover basis (liability at transition after adjusting for amounts in AOCI)	(h)	250,000
Difference = (g) – (h)		$ 92,000

The insurer would record the following journal entry at the transition date to record the effect of the upper-medium grade fixed-income instrument yield at the transition date:

Dr. Accumulated other comprehensive income	$ 92,000	
Cr. Liability for future policyholder benefits		$ 92,000

Modified retrospective transition — revised net premium ratio exceeding 100%

If the revised net premium ratio at the transition date exceeds 100%, the insurer will cap the net premium ratio at 100% and increase the liability by recording a transition adjustment to the opening balance of retained earnings. To prevent a deferral of expected future losses, the liability will be remeasured as the present value of remaining expected benefits and expense amounts less the present value of remaining expected net premiums (capped at 100%). The transition adjustment is the difference between this remeasured liability and the carryover basis (i.e., existing liability excluding amounts in AOCI).

Illustration 7 — Modified retrospective transition: Revised net premium ratio exceeds 100%

Assume the same fact pattern as Illustration 6, except at the transition date the insurer's updated future cash flow expectations resulted in a revised net premium ratio of 102.2%, which means the present value of expected benefits and expenses (adjusted for the carryover basis) exceeds the present value of expected gross premiums. Thus, to prevent the deferral of expected losses to future periods, the insurer will measure the liability using the present value of expected future gross premiums (i.e., cap the net premium ratio at 100%) and determine a transition adjustment as follows:

Benefits and expenses (for years 2021–2038) discounted at 5.5%	(a)	$ 3,933,000
Net premiums capped at 100% (for years 2021–2038) discounted at 5.5%	(b)	3,604,000
Remeasured liability = (a) – (b)	(c)	329,000
Less: Carryover basis (liability at transition after adjusting for amounts in AOCI)	(d)	250,000
Transition adjustment = (c) – (d)		$ 79,000

The insurer would record the following journal entry at the transition date:

Dr. Retained earnings	$ 79,000	
Cr. Liability for future policyholder benefits		$ 79,000

The insurer would then also determine the same entries shown in Illustration 6 to adjust AOCI for the updated discount rate.

Modified retrospective transition — limited-payment contracts

The modified retrospective transition for limited-payment contracts is slightly different due to the separate deferred profit liability that is recorded at contract issuance.

Consistent with the modified retrospective transition guidance for traditional long-duration contracts, the revised net premium ratio is determined at transition using the cohort's carryover basis and updated estimates of future cash flows. To the extent the liability for future policyholder benefits using the revised net premium ratio differs from the existing carrying amounts at transition, adjusted for the removal of any related amounts in AOCI at transition, the liability for future policyholder benefits should be adjusted to reflect the revised liability calculation.

This adjustment to the liability for future policyholder benefits is offset with a corresponding adjustment to the separate deferred profit liability. If the increase to the liability for future policyholder benefits exceeds the recorded deferred profit liability at transition, an immediate loss is recorded to retained earnings.

Consistent with the guidance for traditional long-duration contracts, the cumulative effect of changes in the discount rate will be recorded to the reserve for future policyholder benefits (not the deferred profit liability), with a corresponding adjustment to AOCI. The adjustment will be calculated as the difference between the rates applied in the measurement of the liability for future policyholder benefits determined immediately before the transition date and the upper-medium grade fixed-income instrument yield determined at the transition date.

Retrospective transition (all contracts)

For any issue years transitioned under the retrospective method, insurers will use actual historical information, updated expected future cash flow assumptions and an upper-medium grade fixed-income instrument yield as of the contract issue date to calculate a revised net premium ratio. The transition adjustment will equal the difference between the carrying value of the liability immediately preceding the transition date and the measurement of the liability as of that date using the revised net premium ratio.

The cumulative effect of changes in the upper-medium grade discount rates from the contract issue date to the transition date will be recorded in AOCI. To isolate and measure the discount rate effect, the insurer will perform present value calculations of projected future cash flows at the transition date using (1) the discount rate at the contract issue date and (2) the discount rate at the transition date. The difference in the two calculations will be recorded in AOCI.

Grouping of contracts at transition

When determining the level of measurement (i.e., unit of account, sometimes referred to as cohort) for the liability for future policyholder benefits, the guidance requires insurers to group contracts in force as of the transition date using the same principles as contracts issued subsequent to the transition date. That is, for contracts in force as of the transition date, insurers should group contracts into quarterly or annual groups on the basis of the original contract issue date.

This guidance is applicable regardless of the transition method (i.e., modified retrospective or retrospective).

How we see it

- The requirement to group all contracts into quarterly or annual groups may be a change in the level of measurement used by many insurers for contracts in force as of the transition date. This could add complexity for an insurer transitioning under the modified retrospective method, which requires the guidance to be applied to existing carrying values as of the transition date.
- Insurers transitioning under the modified retrospective method may need to establish a process to allocate recorded reserves as of the transition date among groups of contracts (i.e., cohorts) to determine the carrying values at the new level of measurement as of the transition date.
- If insurers previously aggregated contracts across issue years, at transition these contracts will need to be disaggregated at a level that is not beyond the contract issue year. The revised net premium ratios for some of the new cohorts may exceed 100% resulting in transition adjustments to retained earnings.

Earnings after the adoption of ASU 2018-12 for contracts transitioned using the modified retrospective approach

For any cohorts transitioned on a retrospective basis and for all contracts issued after the transition date, the reserve for future policyholder benefits and the profit emergence for these cohorts will be in accordance with ASU 2018-12.

In contrast, cohorts transitioned on a modified retrospective basis will realize a different profit emergence pattern over the life of cohorts due to:

- The discount rate used in the calculation of the revised net premium ratios (i.e., the interest accretion rate embedded in the net premium model that remains unchanged throughout the life of the cohort)
- The existence of a carryover basis for some cohorts, which adjusts the calculation of the revised net premium ratio

If the modified retrospective transition is applied, that rate at which interest accretes throughout the expected lifetime of the cohorts will be the rate used in the measurement of the liability immediately preceding transition, which is generally the expected investment yield at the time the contracts were issued. Under a retrospective transition and for all contracts issued subsequent to transition, that rate would be the upper-medium grade fixed-income instrument yield at the date the contracts were issued. Therefore, for many insurers the effect on the interest accretion and thus the profit emergence stemming from the variety of discount rates used in the net premium ratio calculation will continue to exist many years following the transition date.

When the modified retrospective transition approach is applied, the revised net premium ratio calculation as of the transition date and all subsequent measurement periods will include a carryover basis adjustment. Accordingly, profit emergence for those cohorts will be a blend of the recorded liability at transition and updated expectations of future cash flows over the remaining life of the cohorts.

Implementation questions

Questions TRAN 1.2 through 1.7 in Appendix C address common implementation questions about applying the modified retrospective transition guidance for the liability for future policyholder benefits.

How we see it

- Profit emergence patterns will differ for cohorts transitioned under the modified retrospective transition method and those transitioned under the retrospective transition method, as well as all cohorts issued after transition. This is due to the different interest rates used in the net premium calculation and the carryover basis effect. Insurers should consider the effect on profit emergence when determining whether to elect the retrospective transition approach.
- The significance of the effect on profit emergence to cohorts transitioned under the modified retrospective method will depend on where a contract is in its expected life as of the transition date. Generally, the interest rate used in the net premium calculation will have a greater effect on cohorts in the earlier durations (i.e., earlier in the life of the contract), whereas any carryover basis will have a greater effect on cohorts in the later durations.

Insurers will use the same transition approach for DAC and the liability for future policyholder benefits.

Deferred acquisition costs

The guidance will require insurers to align the DAC transition approach with the transition approach for the liability for future policyholder benefits. That is, for those contracts for which the insurer elects to apply a retrospective transition approach for the liability for future policyholder benefits, the insurer will apply a retrospective transition approach for the determination of the related DAC at transition. For all remaining DAC, a modified retrospective transition approach will be applied.

Consistent with the modified retrospective transition approach for the liability for future policyholder benefits, the opening DAC balance at the transition date will be the same as the closing balance before transition, only updated for the removal of any related amounts previously recorded in AOCI for items such as shadow DAC adjustments. That is, DAC balances measured using current guidance will generally remain the same at transition and an insurer will only adjust its amortization methods for purposes of subsequent measurement. For example, an insurer would not adjust the opening DAC balance at the transition date for accreted interest included in the balance or a balance that was determined using EGPs before transition.

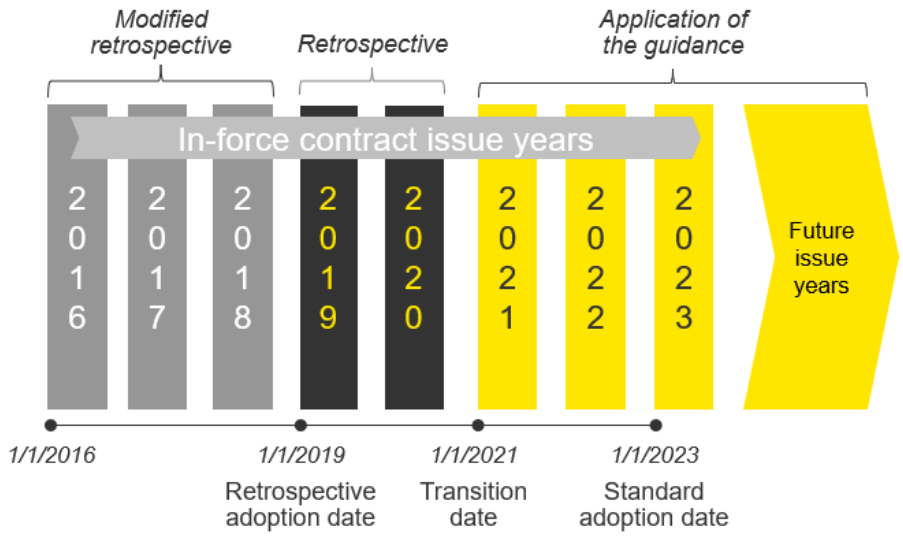
Consistent with the retrospective transition approach for the liability for future policyholder benefits, insurers will apply the DAC guidance beginning at the contract issuance date and through the transition date. Similar to the modified retrospective transition method, a transition adjustment will need to be recorded to remove any related amounts in AOCI for items such as shadow DAC. The difference between the previously recorded closing balance (after the AOCI adjustments) and the revised balance as of the transition date will be recorded as a cumulative catch-up adjustment to the opening balance of retained earnings.

Implementation questions

Question TRAN 1.8 in Appendix C addresses a common implementation question about applying the modified retrospective transition guidance for DAC.

The new guidance on DAC is applicable to all insurance contracts, not only those types of contracts affected by the revised liability measurement guidance in the new guidance. Therefore, DAC related to participating and nontraditional insurance contracts (i.e., universal life-type contracts) will also be subject to the transition guidance. The transition approach would follow the insurer's elected transition approach at the contract aggregation level, which may be contract issue year. That is, the modified retrospective or retrospective approach would be applied.

Illustration 8 — Aligning DAC transition with the liability for future policyholder benefits



Consider the circumstances in Illustration 5, in which the insurer elected to apply the guidance for measuring the liability for future policyholder benefits on a retrospective basis for issue years 2019 and 2020, while applying the guidance on a modified retrospective basis for issue years 2016 through 2018.

In this instance, the new guidance for measuring DAC will be applied beginning with contracts issued in 2019. A cumulative catch-up transition adjustment equal to the difference between the carrying value of the DAC balances for issue years 2019 and 2020 as of 31 December 2020 and the measurement of DAC for those issue years as of 1 January 2021 applying the new guidance will be recorded to the opening balance of retained earnings as of the transition date. The carrying value of the DAC balances for issue years 2016 through 2018 as of 31 December 2020, adjusted for the removal of any previously recorded balances in AOCI, will be the DAC balances as of 1 January 2021.

This transition method for DAC will apply to all other balances that are amortized on a basis consistent with DAC, whether due to the existing requirements in ASC 944 (e.g., deferred sales inducements or unearned revenue liabilities) or an existing accounting policy election. Examples of balances amortized consistent with DAC as a result of an existing accounting policy election may include value of business acquired in a business combination or the cost of reinsurance.

How we see it

The effect of DAC amortization on profit emergence patterns will vary, depending on whether contracts were transitioned under the modified retrospective or retrospective transition methods. This effect will be driven by the inclusion of certain components (e.g., interest) in the DAC balance under today's guidance that will be excluded under the new guidance.

Market risk benefits

The guidance will require market risk benefits to be measured at fair value at the transition date under a full retrospective approach. This means that insurers will need to determine the valuation model (i.e., option or non-option) and the amount of attributed fees associated to the market risk benefit at contract inception as the initial steps required to measure the market risk benefit at fair value at the transition date.

In determining the fair value, insurers should maximize the use of relevant observable information for each applicable assumption as of the contract inception date. Insurers can use hindsight at transition to determine an assumption if information relevant for determining the assumption as of the contract inception date is unobservable or unavailable and cannot be independently substantiated.

In the Basis for Conclusions, the FASB noted that preparers commented that retrospective transition would be difficult due to the need to calibrate the attributed fees on an objective basis at contract inception dates under the non-option model. Therefore, the use of hindsight was provided as a practical expedient to give insurers the ability to determine attributed fees at the contract inception date, which may be many years prior to the transition date.

Insurers should apply the new guidance for market risk benefits on a retrospective basis.

Implementation questions

Questions MRB 5.1 through 5.7 in Appendix C address common implementation questions about applying the transition guidance for market risk benefits.

Changes in the instrument-specific credit risk (i.e., own credit risk) between the contract issue date and the transition date will be recognized as a cumulative effect adjustment in AOCI. All other changes between the fair value and carrying value from the contract issue date to the transition date will be recognized as an adjustment to the opening balance of retained earnings.

How we see it

- Insurers will need to apply significant judgment to assess the applicability and availability of observable data to support assumptions used in the fair value measurement of market risk benefits. We believe that insurers that previously used the fair value approach for bifurcated embedded derivatives will be less likely to use hindsight.
- We believe that an insurer's retrospective transition of market risk benefits does not affect DAC balances. That is, any change to the lifetime gross profits of a contract as a result of the guidance for market risk benefits does not affect the carrying amount of DAC at the transition date.

Transition-related disclosures

The guidance will require insurers to disclose in the year of adoption disaggregated rollforwards for the following balances:

- Liability for future policyholder benefits
- DAC
- Balances amortized on a basis consistent with DAC that are impacted by the adoption of the new guidance
- Market risk benefits

The rollforwards should begin with the ending balance of the reporting period before the transition date and end with the opening balance at the transition date. The insurer should further disaggregate the rollforwards for any liability for future policyholder benefits and DAC balances for which it elects to apply the guidance retrospectively. Insurers are also required to disclose qualitative and quantitative information about the effect of the transition adjustments related to the opening balance of retained earnings and AOCI.

In addition, the guidance will require insurers to disclose quantitative and qualitative information regarding transition adjustments related to contracts for which the net premium ratio has been capped at 100% (i.e., when net premiums would have exceeded gross premiums)

Other matters

ASU 2018-12 retains the guidance in ASC 944 on the classification of product types (e.g., determining whether the contract is an insurance contract or an investment contract) and the classification of insurance contract types (i.e., whether an insurance contract is long duration or short duration).

The new guidance on the liability for future policyholder benefits will apply to all long-duration products measured using the net premium model, which includes products such as term life, whole life, long-term care and individual disability. It also could include group life, group disability, certain medical supplemental and certain critical illness guaranteed renewable contracts, depending on the insurer's classification of these contracts. ASU 2018-12 also retains the following aspects of current guidance:

- Measurement of liabilities carried at account balance (e.g., fixed deferred annuity, universal life, variable annuity and variable universal life)
- Performance of loss recognition testing on liabilities for universal life-type insurance contracts
- Measurement of the liability for future policyholder benefits for participating contracts
- Identification and capitalization of costs that meet the criteria to be considered acquisition costs (i.e., DAC)
- Accounting for DAC in connection with internal replacements (i.e., contract modifications or exchanges)
- Amortization of DAC for certain investment contracts that use the interest method
- Methods to recognize revenue (i.e., premiums due and amounts assessed against policyholders)
- Initial accounting for a business combination under ASC 944

However, ASU 2018-12 will indirectly change aspects of an insurer's accounting in areas where the FASB has not changed current guidance. For example, the measurement of reinsurance recoverables will change based on the modified framework for the measurement of the underlying direct liabilities. In addition, the measurement of deferred tax assets and/or liabilities will reflect the difference between the liability and DAC balances measured under the new guidance and the tax-basis balances of those accounts.

Implementation questions

Questions LFPB 6.1 through 6.5, MRB 4.1 through 4.2, and TRAN 1.9 in Appendix C address common implementation questions about how to apply the new guidance when accounting for reinsurance activity.

Endnotes:

1 ASU 2018-12, *Targeted Improvements to the Accounting for Long-Duration Contracts*.

2 ASU 2015-09, *Disclosures about Short-Duration Contracts*.

3 IFRS 17, *Insurance Contracts*.

4 An orderly transaction is defined in the ASC Master Glossary as "a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale)."

5 ASC 820, *Fair Value Measurement*.

6 ASC 815, *Derivatives and Hedging*.

7 Statement of Position 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*.

8 ASC 815-15, *Embedded Derivatives*.

9 ASC 250, *Accounting Changes and Error Corrections*.

Appendix A: How the new guidance compares with existing guidance

The following table compares key aspects of ASU 2018-12 with existing recognition and measurement guidance for long-duration contracts in ASC 944.

	ASU 2018-12	Existing guidance in ASC 944
	Liability for future policyholder benefits: traditional and limited-payment contracts	

Cash flow assumptions	▸ Reviewed at least annually in the same period
	▸ Updated through the net premium model on a cumulative catch-up basis:
	  ▸ Cumulative catch-up adjustment recorded in net income
	  ▸ Revised net premium ratio applied subsequently
	▸ No provision for adverse deviation in the assumptions
	▸ Option to lock in expense assumptions at contract initiation
		▸ Locked in at contract initiation and held constant over the contract term, except when unlocked to recognize a premium deficiency
		▸ Assumptions include a provision for adverse deviation

Liability for unpaid claims	▸ Included as a component of the liability for future policyholder benefits
	  ▸ Revised net premium ratio includes development on incurred claims
	  ▸ Discounted using the same upper-medium grade fixed-income yield determined at contract issuance
		▸ At the time the claim is incurred:
		  ▸ Separate and distinct liability recorded
		  ▸ Discounted using updated rate (generally an expected investment yield)

Discount rate assumptions	▸ Based on a portfolio of upper-medium grade fixed-income instrument yields
	  ▸ Reflect duration characteristics of the liability
	  ▸ Maximize the use of observable inputs
	▸ Updated every reporting period with the effect of changes recorded in OCI
		▸ Based on expected investment yield at the contract issue date for most contracts
		▸ Assumptions include a provision for adverse deviation

Other considerations	▸ Loss recognition/premium deficiency test is eliminated ▸ Net premium ratio is capped at 100%, resulting in recognition of a loss when the cap is reached ▸ Contracts can be grouped to measure the liability but cannot include contracts from different issue years ▸ Liability at the unit of account should never be less than zero	▸ Loss recognition/premium deficiency test ▸ Measure liability at the contract level
	Participating contracts	
Terminal dividend liability	▸ Accrued at a constant rate based on the present value of the basis used for the amortization of DAC	▸ Accrued over the life of the contract in proportion to the present value of the estimated gross margin expected to be realized over the life of the contract

	ASU 2018-12	Existing guidance in ASC 944
	Additional liabilities for benefit features	
Scoping	▸ Benefit features meeting certain criteria are classified as market risk benefits ▸ If the benefit feature is not classified as a market risk benefit, it is first assessed to determine whether it is accounted for as an embedded derivative that requires bifurcation, and if it is not a bifurcated embedded derivative, it is accounted for under the benefit ratio model as an annuitization benefit, death benefit or other insurance benefit	▸ Benefit features may be accounted for as an embedded derivative that requires bifurcation or under the benefit ratio model, depending on the insurer's evaluation of the factors in the guidance
Market risk benefit	▸ Measured at fair value ▸ May be an asset or a liability position ▸ Change in fair value attributed to instrument-specific credit risk recognized in OCI; remainder of change recognized in net income	▸ Concept of market risk benefit does not exist in today's guidance
Annuitization, death or other insurance benefits applying the insurance liability benefit ratio model	▸ Expected annuitization payments discounted at upper-medium grade fixed-income instrument yields applicable to payout phase	▸ Expected annuitization payments discounted at estimated yields applicable to payout phase
	Deferred acquisition costs	
Amortization methods for all long-duration contracts (except certain investment contracts applying the interest method)	▸ On a straight-line basis for individual contracts, or over the expected life of a group of contracts using a constant level basis that approximates straight-line ▸ Update amortization rate for changes in expected assumptions; apply prospectively	▸ Method varies by product (e.g., when premium is recognized or based on the pattern in which estimated gross profits or estimated gross margins are expected to be recognized over the life of a portfolio of contracts) ▸ Update amortization rate for changes in expected assumptions retrospectively for certain products or locked-in assumptions for other products
Interest	▸ No interest accretion	▸ Accrued on the unamortized DAC
Impairment	▸ Unexpected deviations from constant level basis result in a proportionate write-down of DAC ▸ No initial recoverability test at contract inception ▸ No impairment test	▸ Recoverability test performed at contract inception to make sure gross premiums are sufficient to cover deferred costs ▸ Assessed as part of loss recognition in subsequent periods for any potential impairment

Appendix B: New disclosures

Insurers will need to apply the disaggregation principle to many of the new required disclosures and include the new required disclosures in annual and interim financial statements.

Disaggregation principles	
▸ Disclose information in a manner that allows users to understand the amount, timing and uncertainty of future cash flows arising from the liabilities ▸ Do not obscure useful information by including a large amount of insignificant detail or aggregating items that have significantly different characteristics ▸ Consider how information has been presented for other purposes ▸ Do not aggregate amounts from different reportable segments ▸ Do not make disclosures for insignificant categories except in the reconciliation	
Disclosures	

Liability for future policyholder benefits and the additional liability for annuitization, death and other insurance benefits	▸ Disaggregated rollforward of the liability balance with separate rollforwards of expected future gross premiums, expected future net premiums and expected future benefits
	  ▸ Components of the rollforward may include issuances, interest accrual, net premiums collected, benefit payments, derecognition (lapses), experience adjustments, changes in cash flow assumptions and changes in discount rate assumptions
	▸ For each rollforward presented:
	  ▸ Undiscounted ending balance for the expected future gross premiums, expected future net premiums and expected future benefits
	  ▸ Amount of gross premiums recognized in the statement of operations
	  ▸ Amount of any related reinsurance recoverable
	  ▸ Weighted average duration of the liability and discount rate, and information about technique(s) used to determine unobservable rates
	▸ Reconciliation of the disaggregated rollforwards to the aggregate ending carrying amount of the liability, and total interest and gross premiums recognized for the period
	▸ Qualitative and quantitative information about adverse developments resulting from when net premiums would have exceeded gross premiums in the current period
	▸ On an annual basis, qualitative and quantitative information about the significant inputs, judgments and assumptions used in measuring the liability, including how they changed and the effects of the changes on the measurement of the liability

Liability for policyholder's account balances (e.g., liabilities measured at an account balance not tied to a separate account, such as universal life-type contracts)	▸ Disaggregated rollforward of the liability balance
	  ▸ Components of the rollforward may include issuances, premiums received, policy charges, surrenders or withdrawals, benefit payments, transfers from or to separate accounts and interest credited
	▸ For each rollforward presented:
	  ▸ Weighted average crediting rate
	  ▸ Guaranteed benefit amounts in excess of the current account balances (i.e., net amount at risk)
	  ▸ Cash surrender value
	▸ Reconciliation of the disaggregated rollforwards to the aggregate ending carrying amount of the liability
	▸ Tabular presentation of policyholder's account balances by range of guaranteed minimum crediting rates, and the related range of the difference between rates being credited to policyholders and the respective guaranteed minimums
	▸ Qualitative and quantitative information about adverse development that resulted in a charge to current-period benefit expense as a result of premium deficiency

Disclosures	

Additional liability for market risk benefits	▸ Disaggregated rollforward of the liability balance
	  ▸ Components of the rollforward may include issuances, interest accrual, net assessments collected, benefit payments, derecognition (lapses), experience adjustments, changes in cash flow assumptions, changes in discount rate assumptions and changes in the instrument-specific credit risk
	  ▸ If this rollforward achieves the fair value disclosure requirements, an insurer would not duplicate the related fair value disclosure
	▸ For each rollforward presented, guaranteed benefit amounts in excess of the current account balances
	▸ Reconciliation of the disaggregated rollforwards to the aggregate ending carrying amount of the liability, disaggregated between positions that are in an asset position and those that are in a liability position
	▸ On an annual basis, qualitative and quantitative information about the significant inputs, judgments and assumptions used in measuring the liability, including how they changed and the effects of the changes on the measurement of the liability

Separate account liabilities	▸ Disaggregated rollforward of the liability balance ▸ Components of the rollforward may include premiums and deposits, policy charges, surrenders or withdrawals, benefit payments, investment performance, net transfers from or to separate accounts and other charges ▸ For each rollforward presented, disclose the related cash surrender values ▸ Reconciliation of the disaggregated rollforwards to the aggregate ending carrying amount of the liability
Deferred acquisition costs (for all long-duration contracts) and other balances amortized on a basis consistent with deferred acquisition costs	▸ Separate disaggregated rollforward of the DAC and other balances ▸ Components of the rollforward may include capitalization, amortization expense and termination ▸ On an annual basis, qualitative and quantitative information about inputs, judgments and assumptions, and methods used to determine amortization amounts for DAC and other balances amortized on a basis consistent with DAC

Appendix C: Implementation questions and answers

This section provides answers to questions that insurers may have when applying the new guidance on long-duration contracts. Interpretations are subject to change as industry representatives continue discussing how to apply the guidance.

Contents

Liability for future policyholder benefits — unit of account

LFPB 1.1 What guidelines should insurers follow when determining the grouping of contracts (i.e., the cohort or unit of account) for purposes of measuring the liability for future policyholder benefits?

Current guidance in ASC 944 does not address the unit of account used to measure the liability for future policyholder benefits of traditional insurance contracts. Under current practice, insurers generally aggregate insurance contracts with homogenous characteristics into groups for purposes of determining assumptions and measure the liability on an individual contract (i.e., seriatim) basis. When identifying groups for purposes of determining assumptions, many insurers analogize to ASC 944-60-25-3, which indicates that, when determining whether a premium deficiency exists and the subsequent measurement of that block, insurers should group contracts "consistent with the entity's manner of acquiring, servicing, and measuring the profitability" of its insurance contracts. However, the level at which insurers group contracts for determining assumptions is generally more granular than grouping for purposes of determining whether a premium deficiency exists.

The new guidance in ASC 944-40-30-7 addresses when insurers are "determining the level of aggregation at which reserves are calculated," which suggests that grouping is expected to measure the liability for future policyholder benefits. The new guidance requires insurers to record any resulting change to the liability for future policyholder benefits from updating assumptions on a cumulative catch-up basis. Because historical information for both in force and terminated contracts will be needed to determine a lifetime net premium ratio to determine the cumulative catch-up, some degree of aggregation will likely be required.

However, when aggregating (i.e., grouping) contracts into cohorts for measurement purposes, insurers are prohibited from grouping contracts from different issue years within a single cohort. Instead, the guidance allows them to use quarterly or annual cohorts. For contracts acquired in a business combination, the acquisition date is considered the contract issuance date (i.e., a cohort of acquired contracts could include contracts from different issue years).

ASU 2018-12 does not provide further guidance on how insurers should determine cohorts, but insurers should use judgment to group contracts that exhibit similar characteristics, such as product type, date of issuance, accounting method (i.e., traditional long-duration or limited-payment), types of benefit features included, functional currency and expected life (i.e., term or duration). For example, insurers generally should not combine contracts from different types of products with dissimilar characteristics within the same cohort, such as whole life and term life contracts, but depending on the facts and circumstances, they may group contracts with similar characteristics and different durations (e.g., 10-year and 15-year term life contracts). Ultimately, an insurer's grouping of contracts should result in cohorts that faithfully represent the underlying economics of the business being measured.

LFPB 1.2 Can insurers group contracts at a level other than quarterly or annual cohorts?

ASU 2018-12 prohibits insurers from grouping contracts from different issue years within a single cohort and instead requires them to group contracts on a quarterly or annual basis. However, we believe this guidance does not prohibit grouping contracts at a different level. We do not believe this is an entity-wide evaluation and conclusion. Based on facts and circumstances, an insurer could group contracts on a semiannual, monthly, weekly or daily basis. In addition, grouping may be different in the same entity based on the characteristics of the contracts written.

LFPB 1.3 Can an issue year be different from an insurer's fiscal year?

ASU 2018-12 states that contracts must be grouped on quarterly or annual basis, provided that contracts from different issue years are not included within the same cohort. However, the guidance does not prohibit insurers from defining the issue year as something other than their fiscal year. We do not believe this is an entity-wide evaluation and conclusion. For example, an insurer could define the issue year for new products as the 12 months ending 30 September and the issue year for existing products as the 12 months ending 31 December, both consistent with when the insurer updates pricing for new and existing products.

LFPB 1.4 **How does ASU 2018-12 affect the unit of account for group contracts?**

For many long-duration group contracts, such as group life, disability, long-term care, dental and health contracts, the insurance contract is between the insurer and the group being insured (e.g., an employer). However, certificates of insurance are issued to individuals through their association with the insured group (e.g., individual employees of the group). Depending on the nature of the contractual relationship and the provisions of the group contract, the insurer, under its existing accounting policy, will either account for the contract at the group level or "look through" the group relationship to account for the contract at the individual certificate level (i.e., the relationship between the insurer and the certificate holders).

An insurer may have concluded that accounting for the contract at the group level is appropriate if the group contract is "guaranteed renewable" or contains limited ability to reprice at the level of the group contract. Furthermore, under certain group contracts, the insurer may be compelled to issue new certificates to individuals within the group. When accounting for the contract at the group level, it would generally be appropriate to include estimates of cash flows from all expected individual certificates issued under the group contract, whether written or expected to be written.

Alternatively, an insurer could have concluded that it is appropriate to "look through" the group relationship and separately account for each individual certificate holder. An insurer may have concluded this is appropriate if the insurer can reprice the contract at the level of the group contract or for new individual certificate holders, or if the insurer can stop issuance of new certificates.

The insurer should consider its existing accounting policies to determine the issuance date for purposes of grouping contracts into cohorts. If the insurer is accounting for the contract at the group level, the contract issuance date would be the point in time the group contract is issued. Alternatively, if the insurer "looks through" the group contract, the contract issuance date would vary for each individual certificate holder, based on when the certificates are issued. Once the issuance date of the contract is identified, the insurer should apply the guidance for grouping contracts in ASU 2018-12 (see LFPB 1.1) consistent with the specific facts and circumstances.

Liability for future policyholder benefits — cash flow assumptions and the cumulative catch-up adjustment

LFPB 2.1 **If an insurer makes the entity-wide election not to update its expense assumptions when measuring liabilities for future policyholder benefits, is it required to update actual history for expenses when determining the net premium ratio?**

If an insurer has elected to lock in the expense assumption at policy issuance, it should not update actual expense experience. Any difference between actual and expected expenses will be recognized in the income statement as the cash activity occurs. We believe this is consistent with the Board's intent to simplify the process for estimating related expenses included in the liability for future policyholder benefits.

LFPB 2.2 **When an insurer updates actual experience information within the calculation of the net premium ratio, is it required to also update future cash flow assumptions in the same reporting period?**

ASU 2018-12 requires that insurers revise the net premium ratio for actual experience (e.g., lapses, mortality) and updated future cash flow assumptions on at least an annual basis, or more frequently if evidence suggests it is needed. Although insurers are not required to perform full experience studies outside of the regular annual process, if an insurer updates actual experience at an interim period to determine a revised net premium ratio, the insurer should validate that all available information regarding future cash flow assumptions is reflected in the revised calculation, so that the resulting liability represents the insurer's best estimate at that point in time.

Updating the actual experience in the net premium ratio calculation results in an update to the liability for future policyholder benefits. We believe insurers should incorporate all available information that affects the calculation at the date when the liability is updated (i.e., it would be inappropriate to only update a component of the calculation of the liability).

LFPB 2.3 When an insurer updates a cash flow assumption within the calculation of the net premium ratio, is it required to also update actual experience and all other applicable cash flow assumptions?

When an insurer updates any cash flow assumption within the calculation of the premium ratio, ASC 944-40-35-6 requires the insurer to also update actual experience. Consistent with LFPB 2.2, we also believe insurers should incorporate all available information that affects the calculation at the date when the liability is updated (i.e., it would be inappropriate to only update a single assumption in the calculation of the liability for future policyholder benefits). Thus, if an insurer updates any cash flow assumption in the calculation of the net premium ratio, the insurer should also validate that all other cash flow assumptions represent the insurer's best estimate at that point in time.

LFPB 2.4 When an insurer updates the information about insurance in force, is it required to revise the net premium ratio (i.e., update actual experience and future cash flow assumptions) as well?

We believe insurers should update information about insurance in force (i.e., the actual number and demographic information of active policies) each reporting period regardless of whether the net premium ratio is revised in the same period. When insurers update information about insurance in force, they only record a liability for future policyholder benefits for active policies.

Changes in such information from period to period will occur due to lapses, mortality and other terminations, and this information reflects an aspect of the insurer's actual historical information. The calculation of the net premium ratio (and the inclusion of actual experience in that calculation) is a component of the calculation of the liability for future policyholder benefits. An additional component of that calculation involves the determination of future policyholder benefits and premiums, which should be based on information about insurance in force at the date of the calculation.

Insurers should evaluate whether updated information about insurance in force affects their assumptions regarding emerging experience. An insurer would not be required to revise the net premium ratio for actual experience and updated future assumptions if it concludes that the assumptions of ultimate cash flows included in the previous calculation remain reasonable. In this scenario, the insurer would maintain the existing net premium ratio and apply it to actual information about insurance in force to calculate the liability.

LFPB 2.5 Can an insurer change the period in which it performs the annual cash flow assumption review?

ASU 2018-12 revises the guidance in ASC 944-40-35-5 and requires cash flow assumptions (e.g., mortality, morbidity, termination) used for measuring the liability for future policyholder benefits to be reviewed on an annual basis "at the same time every year." The guidance does not require insurers to elect an annual review period at an entity-wide basis, and insurers can elect different periods to perform reviews for different products or cohorts. For example, an insurer could elect to perform the annual review for term life insurance cohorts each year in the third quarter and perform the review for whole life insurance cohorts each year in the fourth quarter.

We believe the period an annual assumption review is conducted would be considered part of an insurer's accounting policy. Therefore, when contemplating a change in the period an assumption review is performed for the entire entity or a given product or cohort, insurers should follow the guidance on a voluntary change in accounting principle in ASC 250, *Accounting Changes and Error Corrections*.

Liability for future policyholder benefits — discount rate

LFPB 3.1 When using a yield curve, how should insurers determine interest accretion in subsequent reporting periods?

ASU 2018-12 does not provide guidance on the method an insurer should use to lock in an interest accretion rate assumption. Insurers may use a variety of methods, such as locking in spot rates, weighted average rates or forward rates.

Under the spot rate method, an insurer considers the timing of individual cash flows and locks in the spot rates of an upper-medium grade (low-credit-risk or single A rated) fixed-income yield curve at contract inception. In subsequent reporting periods, the insurer applies the same rates for each cash flow throughout the life of the contract (i.e., cash flows of a particular period will always be discounted at the same rate within the net premium ratio calculation).

Under the weighted average method, an insurer uses the individual yields that match the expected durations of the individual cash flows to calculate a present value at contract inception and then determines a single, effective yield that, when applied to these same cash flows at contract inception, results in the same present value. This single effective yield is then locked in over the life of the contract.

Under the forward rate method, an insurer locks in the vector of one-year forward rates that define the yield curve at contract inception. In subsequent reporting periods, the insurer discounts the remaining cash flows using the predetermined rates for that period (i.e., the forward rates).

LFPB 3.2 **When locking in a yield curve, should insurers use the same method for all cohorts and all contracts within a cohort? (updated December 2023)**

We believe that, depending on the facts and circumstances, it may be reasonable for an insurer to use different methods to lock in the yield curve for different cohorts based on their characteristics. An insurer may also elect to consider expected profit emergence patterns for the cohort when locking in interest accretion.

We believe the same method to determine the discount rate should be used within a cohort. However, a cohort may have multiple locked-in yield curves based on the observable market yields at the time the contracts within the cohort were issued.

LFPB 3.3 **How should insurers determine the yield curve at contract issuance (i.e., interest accretion rate) for a cohort that groups policies issued at various points throughout the cohort period?**

ASU 2018-12 does not address how insurers should determine the upper-medium grade fixed-income instrument yield at contract issuance for a cohort that aggregates policies issued throughout a given period (e.g., quarter, year). We believe that, depending on the facts and circumstances, determining the yield using a weighted average for the period, a simple average for the period or at a point in time during the period (e.g., the beginning of the period) could all be reasonable methodologies.

Insurers should use judgment to determine a methodology that is representative of the entire cohort. Among the factors they could consider are the expected timing of policy issuance and whether the policy characteristics are expected to be homogeneous (i.e., similar levels of cash flow significance). New information may affect the insurer's conclusion regarding how to determine the yield curve at contract issuance for new cohorts. For example, in periods of changing interest rates, insurers may determine that a weighted average yield curve would produce a better estimate of the liability by locking in an interest accretion rate that is more consistent with the period in which the contracts are issued.

Depending on the methodology elected by the insurer, the contract issuance yield curve may require periodic updates until the cohort is finalized. For example, if an insurer prepares quarterly financial statements but is developing a weighted average yield curve for an annual cohort, the weighted average yield curve for the cohort in the year of issuance will change throughout the year. Once finalized, the contract issuance yield curve for a cohort should remain unchanged for the duration of the cohort.

LFPB 3.4 How should insurers determine an upper-medium grade fixed-income instrument (i.e., single-A rated) yield for contracts issued in foreign countries or jurisdictions?

We believe the cash flows related to insurance contracts issued in foreign countries or jurisdictions (i.e., locations outside the US) should be discounted at yields denominated in the currency at which those contracts are transacted. Such yields reflect where those cash flows occur. However, some foreign jurisdictions may not have observable upper-medium grade fixed-income instrument yields (i.e., single-A rated securities) due to a lack of liquidity.

In these situations, insurers should first consider observable inputs available in the applicable jurisdiction to determine a yield that is equivalent to a single-A rate. If observable information is unavailable, insurers should use the fair value principles in ASC 820, *Fair Value Measurements,* to determine an estimate.

Liability for future policyholder benefits — recognition and measurement

LFPB 4.1 Does the prohibition of negative reserves apply to reserves measured using the locked-in interest accretion rate or reserves measured using a current discount rate?

Both. ASC 944-40-30-7A states that "in no event shall the liability for future policyholder benefits be less than zero." We believe this prohibition should be applied to the liability recorded in the balance sheet at each reporting period. That is, if the liability for future policyholder benefits becomes negative, either based on updated cash flow or discount rate assumptions, the insurer should record the liability at zero.

LFPB 4.2 Does ASU 2018-12 eliminate premium deficiency testing?

ASU 2018-12 eliminates the requirement to perform premium deficiency testing for nonparticipating traditional long-duration and limited-payment contracts. However, this testing is still required under ASC 944 for nontraditional (i.e., universal life-type) long-duration, short-duration and participating contracts.

Additionally, ASU 2018-12 modifies how premium deficiencies are measured for nontraditional long-duration and participating contracts. Insurers should no longer include maintenance costs or unamortized acquisition costs in the premium deficiency analysis. They will recognize a premium deficiency if the recorded liability, together with the insurer's best estimate of the present value of future gross premiums, is not sufficient to cover the insurer's best estimate of future benefits and settlement costs and recover the unamortized present value of future profits related to a business acquisition (i.e., VOBA), if applicable.

Any unearned revenue liabilities related to universal life-type contracts should be included with the recorded liability balance when determining whether a premium deficiency exists and the additional amount to be recorded. However, unamortized deferred sales inducement assets should be excluded from the calculation, similar to how unamortized acquisition costs are excluded.

LFPB 4.3 Should the cohort to which a traditional or limited-payment contract is associated change if the contract is deemed to be substantially changed? (updated December 2023)

When a contract is determined to be substantially changed in accordance with ASC 944-30-35-37, the insurer should follow the guidance in paragraphs ASC 944-30-40-1 through 40-4 and account for the substantially changed contract as an extinguishment of the replaced contract and the recognition of a newly established contract. For further guidance on internal replacements, refer to our Financial reporting developments (FRD) publication, ***Insurance contract modifications or exchanges***.

Because the original contract is extinguished, the insurer would terminate that contract, similar to lapse or surrender, its related LFPB would no longer be required, and the new contract would be included in a new cohort as if it were written that day.

Liability for future policyholder benefits — presentation and disclosure

LFPB 5.1 Are insurers required to provide rollforward disclosures for liabilities on contracts that are 100% ceded?

Under ASC 944-40-50-6, rollforward disclosures are required on a gross basis for both the liability for future policyholder benefits related to traditional and limited-payment contracts and the additional liability for annuitization, death or other insurance benefits. Insurers are also required to include the amount of any related reinsurance recoverable in each rollforward disclosure. Therefore, insurers should provide the rollforward disclosures for the liability for all contracts, regardless of whether the contracts are reinsured.

LFPB 5.2 How should insurers determine the effect of assumption changes in actuarial models for disclosure purposes?

ASC 944-40-50-7(b) requires insurers to disclose information about changes in significant inputs, judgments and assumptions related to both the measurement of the liability for future policyholder benefits and the additional liability for annuitization, death or other insurance benefits. Furthermore, the guidance requires insurers to disclose the quantitative effect of those changes on the liabilities but does not specify how insurers should quantify the effect.

For many actuarial inputs, judgments and assumptions, the order in which changes are made could influence the quantification of the effect of each change (i.e., attribution analysis). Therefore, we believe for each product or cohort insurers should establish a consistent policy for the order in which changes are made for purposes of quantification.

LFPB 5.3 Within the rollforward disclosures, are insurers required to separately disclose actual and expected experience for each relevant cash flow assumption?

ASC 944-40-50-6(b) requires insurers to disclose within the rollforwards (or as accompanying information) quantitative information related to actual experience compared to expectations related to mortality, morbidity and lapses. The guidance does not specify whether this information should be separately disclosed for each relevant cash flow assumption.

We believe insurers could elect to separately disclose this information for each individual cash flow assumption. Alternatively, insurers could aggregate actual experience compared to expectations for all relevant cash flow assumptions and present it as a single line within the rollforwards, which would be consistent with the example in ASC 944-40-55-29E.

Liability for future policyholder benefits — assumed and ceded reinsurance

LFPB 6.1 How does ASU 2018-12 affect the unit of account for assumed reinsurance arrangements? (updated December 2023)

ASU 2018-12 modifies ASC 944-40-30-7 to allow insurers to group contracts issued in the same quarter or year (i.e., establish cohorts), but it prohibits grouping of contracts across multiple issue years. Assumed reinsurance arrangements are often structured such that a single reinsurance arrangement includes underlying policies issued by the direct writer after initiation of the arrangement. Such arrangements are often priced with the expectation that underlying policies will be added for several years.

Currently, many reinsurers account for such transferred policies on a seriatim basis (i.e., individually) and "look through" the reinsurance contract to the underlying contracts, with assumptions locked in as the contracts are issued. After adopting ASU 2018-12, reinsurers should continue to account for the underlying direct contracts as they are issued (and transferred under the reinsurance arrangement), but they will have to apply the cohorting guidance to the underlying policies, which may require the reinsurer to obtain additional information from the ceding insurer. That is, the reinsurer could group the underlying direct contracts into cohorts, as long as the underlying direct contracts are not written across multiple issue years (see LFPB 1.1). Reinsurers will adjust cohorts as additional underlying contracts that meet the criteria of the cohort are assumed until the contract issue year is completed.

In some circumstances, the reinsurer may conclude that the unit of account for an assumed reinsurance arrangement is the legal reinsurance contract. Under this approach, insurers would consider all cash flows related to the arrangement as part of a single contract. Specifically, all estimated future cash flows for both existing underlying contracts and those expected to be written in the future would be included in the measurement of the single contract. This approach adds additional complexities related to discount rates, DAC and other aspects of the accounting.

LFPB 6.2 How should insurers measure the reinsurance recoverable balances resulting from ceded reinsurance arrangements?

ASC 944 provides limited guidance on the measurement of reinsurance recoverable balances resulting from ceded reinsurance arrangements. ASC 944-40-25-34 requires the recoverable balances be recognized in "a manner consistent with the liabilities," and ASC 944-605-35-15 states, "The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts." This guidance has resulted in diversity in practice under current GAAP.

Currently, some insurers use a direct mirroring approach, in which the recoverable balance is recorded at an amount equal to the liability for future policyholder benefits related to the underlying insurance contracts. Other insurers consider all cash flows related to the reinsurance arrangement (i.e., ceded premiums and ceded or reimbursed benefits) to determine a separate net premium ratio for measurement of the estimated reinsurance recoverable balance. When arrangements are contemporaneous (i.e., reinsurance arrangements are entered into in the same period the direct contracts are written), each of these approaches will result in a similar measurement.

ASU 2018-12 does not directly modify the guidance in ASC 944 on the measurement of reinsurance recoverable balances, but we believe insurers should determine a separate net premium ratio for the reinsurance contract. That is, insurers should evaluate the contractual terms and use a current discount rate as of the date of the arrangement and estimated cash flows to measure reinsurance recoverable balances under a net premium model.

When ceded reinsurance arrangements are non-contemporaneous (i.e., arrangements cede existing blocks of in force contracts), using a current discount rate as of the date of the reinsurance arrangement will generally result in measurement differences between the reinsurance recoverable and the liability for future policyholder benefits of the underlying insurance contracts. As a result, only the effect of subsequent discount rate changes (i.e., changes after the date of the reinsurance arrangement) will be directly offset in the financial statements. That is, the ceding insurer will not cede AOCI balances that represent the effect of discount rate changes from the issuance date of the underlying contracts to the effective date of the reinsurance arrangement.

LFPB 6.3 How should cash flows from recaptured reinsurance contracts be considered in the model?

When measuring the liability for future policyholder benefits, insurers should consider all lifetime cash flows (actual and expected future cash flows for a group of contracts). Similarly, when measuring the reinsurance recoverable, the direct insurer should consider all lifetime cash flows related to the ceding arrangement. For reinsurance arrangements, actual cash flows often include cash flows related to recapture provisions. Recapture provisions allow the ceding insurer to "recapture" the rights and obligations of contracts previously ceded to the assuming insurer. At times, such recaptures might only include a portion of the reinsured contracts, which will require the ceding and assuming insurers to continue measuring the ceding arrangement that the recaptured contracts were part of for the remaining contracts.

Consistent with the requirements for a cumulative catch-up adjustment, if the recaptured contracts are grouped with other contracts that continue to be reinsured under the ceding arrangement, the ceding and assuming insurers should generally include actual experience from recaptured contracts when determining the lifetime net premium ratio for the ceding arrangement.

One way to update cash flows when including experience from recaptured contracts could be similar to how a direct writer considers experience from terminated contracts (whether due to death or lapse). In addition to premium and claim experience of the recaptured contracts, insurers could also include any recapture fees paid or received within the lifetime cash flows used to determine the net premium ratio. Ceding insurers could also consider such recapture fees when measuring the cost of reinsurance.

LFPB 6.4 What discount rate should insurers use when determining the cost of reinsurance for a block of ceded in force contracts?

Under current guidance, when recognizing a reinsurance arrangement of long-duration insurance contracts, ceding insurers are required to determine an initial "cost of reinsurance" and amortize that cost over the entire period that the underlying reinsured policies are in force. Although not explicitly defined in ASC 944, the cost of reinsurance balance represents the expected value of all cash flows between the ceding and assuming entities (e.g., reinsurance premiums, claim reimbursements, commissions, experience allowances). ASU 2018-12 does not change the guidance on the recognition and measurement of the cost of reinsurance.

For arrangements that reinsure a group of existing (i.e., in force) contracts, the ceding insurer is required under existing guidance in ASC 944-605-30-4 to include any difference between amounts paid for the reinsurance coverage and the "amount of the liabilities for policy benefits" related to the underlying contracts in the estimated cost of reinsurance. After adopting ASU 2018-12, we believe insurers should consider the liabilities recorded on the balance sheet, which are measured using a current discount rate, when applying this guidance. This will result in an estimated cost of reinsurance balance that represents the economics of the reinsurance arrangement when it is entered into.

LFPB 6.5 Is a cost of reinsurance in a net asset position subject to premium deficiency testing?

Existing guidance requires ceding insurers to determine a cost of reinsurance balance, which is amortized over the life of the reinsurance arrangement and represents an adjustment to the ceded insurance contracts to reflect the net cash flows that occur between the ceding and assuming insurers. Existing guidance does not require insurers to test cost of reinsurance balances for impairment, but under current practice some insurers include both the cost of reinsurance and deferred acquisition costs in premium deficiency analysis under ASC Subtopic 944-60.

ASU 2018-12 eliminates the requirement to evaluate nonparticipating traditional long-duration and limited-payment contracts for premium deficiencies. Insurers must continue to evaluate short-duration, universal life-type long-duration and participating contracts for premium deficiencies, but the ASU eliminates the guidance that requires DAC to be included in this analysis.

ASU 2018-12 does not address cost of reinsurance balances. As a result, if an insurer includes the cost of reinsurance for purposes of premium deficiency testing for universal life-type or participating contracts before adopting ASU 2018-12, it should continue the current practice upon adoption of the guidance.

LFPB 6.6 Are there situations when the constraints of the NPR model (e.g., constant profit margin) would not be applicable when accounting for reinsurance? (updated December 2023)

The application of the constraints in ASC 944-40-35-6A through 35-7B, which prohibit the net premium ratio used to measure the liability for future policyholder benefits from exceeding 100% and the resulting liability from being less than zero, could inhibit the constant profit margin concept as outlined in the FASB's Basis for Conclusions of ASU 2018-12 when used in accounting for reinsurance. Paragraph BC50 in the Basis for Conclusions says that the net premium ratio is used to derive a constant profit margin over the life of the insurance contract. As noted in LFPB 6.2, to satisfy the requirement to recognize the reinsurance recoverable in a manner consistent with the liabilities relating to the underlying reinsured contract, a separate net premium ratio should be determined to measure the estimated reinsurance recoverable balance.

For the reinsurance recoverables to be recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts as required by ASC 944-40-25-34, the ceding insurer should consider the impact that the constraints in ASC 944-40-35-6A through 35-7B have on the direct liabilities that are reinsured. Generally, an immediate gain should be recognized on reinsurance only to the extent an immediate loss was recognized on the direct underlying reinsured contracts in the same period.

For example, if the direct net premium ratio is capped at 100% for a cohort of contracts and the insurer purchases coinsurance for the entire cohort with all terms matching the direct contracts, the reinsurance net premium ratio will generally be consistently capped at 100%, resulting in a gain on the reinsurance contract equal to the loss on the direct contracts. However, where the terms are not proportional (e.g., yearly renewable term insurance agreements), it may not be appropriate to cap the ceded net premium ratio at 100% and recognize an immediate gain, because this could violate the constant profit margin concept.

Additionally, if the insurer calculates a direct liability of less than zero and thus floors the direct liability at zero in accordance with ASC 944-40-25-7B, and coinsures the entire cohort with all terms matching the direct contracts, the related reinsurance recoverable asset should be floored at zero as well. This results in a gain on the reinsurance contract equal to the loss on the direct contract. However, when the cash flows of a reinsurance contract are not proportional, it may be appropriate to recognize a reinsurance liability (e.g., a noncancellable yearly renewable increasing premium term contract or excess of loss contract).

The above guidance would not apply when a ceding insurer enters into a reinsurance arrangement for a cohort in which the ceding insurer had recognized a loss in a preceding period. That is, the recognition of a gain in a subsequent period would result in a net gain for that period, which would violate the provision in ASC 944-40-25-33 that reinsurance contracts do not result in immediate recognition of gains.

Additional liability for death or other insurance and annuitization benefit features (SOP 03-1 reserves)

SOP 1.1 Did ASU 2018-12 change the guidance addressing when an insurer includes an investment margin assumption in expected assessments when measuring benefit feature liabilities?

ASU 2018-12 did not change the guidance requiring investment margins to be included in expected assessments for product features falling under the category of either death or other insurance benefits (ASC 944-40-30-22) or annuitization benefits (ASC 944-40-30-27). However, the guidance clarifies that the expected investment margins should only include amounts expected to be earned from the investment of policyholder balances less amounts credited to policyholder balances and not expected investment margins on the entire asset balances backing the liabilities.

SOP 1.2 If an insurer previously included expected investment margins on the entire assets backing the additional liability (see SOP 1.1), how should it account for the effect of adopting the new guidance?

ASU 2018-12 does not provide transition guidance on additional liabilities related to death or other insurance benefit or annuitization benefit features. Therefore, entities should apply the principles of ASC 250, *Accounting Changes and Error Corrections*, which require entities to report a change in accounting through retrospective application of the new principle to all previous periods unless it is impracticable to do so.

We believe insurers should determine a cumulative effect adjustment for the effect of the change in the expected investment margin, if applicable, and record the adjustment to the opening balance of retained earnings as of the transition date.

SOP 1.3 Does the modified amortization pattern for unearned revenue liabilities (URLs) affect the additional liability for death or other insurance benefits at transition? (updated December 2023)

Existing guidance requires insurers to include the amortization of URLs in the assessments used to measure the additional liability for death or other insurance benefits. ASU 2018-12 modifies the guidance for amortizing URLs to align the model with the revised DAC amortization guidance.

ASU 2018-12 provides transition guidance in ASC 944-40-65-2c for DAC and balances amortized on a basis consistent with DAC (such as URLs). The nature and extent of changes to the opening balance of URLs will depend on whether an insurer adopts the guidance on a modified retrospective or retrospective basis.

For insurers adopting the guidance on a modified retrospective basis, the only change to the opening balance of URLs at the transition date will be an adjustment for the removal of any related amounts previously recorded in AOCI as shadow adjustments, if applicable. These insurers should not retrospectively measure amortization of URLs.

For insurers adopting the guidance on a retrospective basis, the opening balance of URLs at the transition date should be adjusted for both the removal of any related amounts previously recorded in AOCI as shadow adjustments and the insurer's retrospective amortization of URL balances on a basis consistent with the revised DAC framework.

However, there is diversity in practice in the accounting for the effect on the additional liability for death or other insurance benefits resulting from a change in the balance of URLs as a result of adopting ASU 2018-12. If an insurer considers the change to be a direct effect of adopting the new accounting principle, the effect of the change on the measurement of the additional liability should be recognized consistent with the recognition of the change in the URL.

That is, if the guidance is adopted on a modified retrospective basis, the additional liability for death or other insurance benefits will not be adjusted at transition. If the guidance is adopted on a retrospective basis, the transition adjustment will include the effects of the change in the amortization of the URL balance on the additional liability for death or other insurance benefits. If an insurer determines the effect on the assessments used to measure the additional liability for death or other insurance benefits resulting from a change in the amortization of URLs due to an insurer's adoption of the new guidance to be an indirect effect, these changes are recognized in the income statement and recorded as a change in estimate of the additional liability in the period of adoption of ASU 2018-12 (e.g., 1 January 2023 for an SEC filer that is not an SRC).

Refer to TRAN 1.11 for additional information on accounting for direct or indirect effects of the adoption of ASU 2018-12.

SOP 1.4 How should additional liabilities for death or other insurance benefits and liabilities for annuitization benefits be incorporated into rollforward disclosures? (updated December 2023)

ASC 944-40-50-6 indicates that the disaggregated rollforward disclosure requirements apply to additional liabilities for annuitization, death or other insurance benefits. However, ASC 944-40-50-5A clarifies that an insurer does not have to provide disclosures about liabilities for insignificant categories. Therefore, if additional liabilities are significant, an insurer should disclose a disaggregated rollforward of those liabilities.

Generally, we believe that when the additional liabilities are significant, an insurer should present a separate rollforward for the additional liabilities. That is, the components of the rollforward of the additional liability should be presented separately from the components of the rollforward for the liability of the base contract (i.e., the liability for future policyholder benefits for a traditional or limited-payment contract or the policyholder account balance for a nontraditional long-duration contract). This could be accomplished by presenting each of the disaggregated rollforwards of the additional liabilities on their own or by including a separate column in the rollforward presentation for the liability of the related host contract. An insurer should use judgment in tailoring individual line items to more accurately reflect the nature of the changes in the additional liabilities for death or other insurance benefits and liabilities for annuitization benefits.

Market risk benefits — scoping

MRB 1.1 When determining whether a contract feature meets the criteria of a market risk benefit, can insurers consider the expected usage of contract features?

No, the evaluation of whether a contract feature contains significant capital market risk is made based on the substance of the contract feature. This evaluation should be made independently from any probability of usage, which can take a number of forms depending on the nature of the contract feature (e.g., conversion to a payout annuity, withdrawal of account balance, death of the contract holder).

MRB 1.2 How should insurers determine whether a benefit feature contains other-than-nominal capital market risk? (updated December 2023)

Among other criteria, ASU 2018-12 requires an insurer to categorize a benefit feature that exposes it to other-than-nominal capital market risk (defined as equity, interest rate or foreign exchange risk) as a market risk benefit feature. ASC 944-40-25-25D(c) indicates benefit features are presumed to contain other-than-nominal exposure to capital market risk if the contract's guaranteed benefits (i.e., net amount at risk) vary by more than an insignificant amount in response to capital market volatility. In contrast, the guidance defines a nominal risk as a risk of an insignificant amount or remote probability.

There is no quantitative threshold when evaluating the significance of capital market exposure and the related variance in guaranteed benefits. An insurer should use judgment to evaluate the facts and circumstances of the guaranteed benefits to conclude whether capital market volatility would cause the insurer's exposure to vary by more than an insignificant amount. In performing this analysis, the insurer should consider a range of capital market risk scenarios without considering the likelihood of the contract holder using the market risk benefit. If the only exposure to other-than-nominal capital market variance is in scenarios where the exposure has a remote probability of occurring, an insurer may conclude that the exposure to capital market risk for the benefit feature is nominal and, as such, the contract or contract feature does not meet the conditions to be accounted for as a market risk benefit.

We believe an insurer should also consider current accounting policies before adopting ASU 2018-12. For example, if an insurer currently records an additional liability under SOP 03-1 for a certain type of return-of-premium benefit feature, we believe concluding that the same feature does not expose the insurer to other-than-nominal capital market risk under ASU 2018-12 would generally be inconsistent with that earlier conclusion. Similarly, if an insurer concludes that a contract or contract feature is not a market risk benefit under ASC 944-40-25-25D because it does not expose the insurer to other-than-nominal capital market risk, the capital market risk for that same contract or contract feature will also be considered nominal under ASC 944-20-15-21 and, therefore, the additional benefit guidance in ASC 944-40-25-26 through 25-27A would not apply either.

MRB 1.3 Should insurers consider disability and health insurance benefit features that are similar to a universal life-type contract to be in the scope of the MRB guidance? (updated December 2023)

No. We believe that the exception in ASC 944-40-25-25D(b), which excludes the death benefit component of life insurance contracts from the scope of market risk benefits, also applies to disability and health insurance benefit features, whether designed as a universal disability or health contract or as a rider to a universal life-type contract. ASC 944-20-15-12 states, "Universal disability contracts that have many of the same characteristics as universal life-type contracts, with the exception of providing disability benefits instead of life insurance benefits, shall be accounted for in a manner consistent with universal life-type contracts." As such, the scope exception generally applies to features that are primarily designed to protect the disability and health insurance benefits of an insurance contract that is accounted for consistent with universal-life type contracts (i.e., instances where the disability and health benefit of an insurance policy exceeds the account value).

Market risk benefits — recognition and measurement

MRB 2.1 What is the unit of account used to measure market risk benefit features?

ASU 2018-12 does not prescribe the unit of account to be used when measuring market risk benefit features, other than requiring multiple benefit features within the same contract (that are individually determined to meet the criteria of market risk benefits) to be bundled together as a single compound market risk benefit feature in a manner consistent with ASC 815, *Derivatives and Hedging,* and measured at fair value. Therefore, we believe an insurer should determine the fair value of market risk benefits at the contract level.

Additionally, under the fair value framework of ASC 820, *Fair Value Measurement*, financial assets and liabilities are generally measured using the unit of account prescribed by the guidance that requires (or permits) the fair value measurement. While ASC 820 provides a limited exception that allows for the grouping of financial instruments with offsetting risks for measurement purposes, we believe market risk benefits generally would not meet the requirements for the exception. See our FRD publication, ***Fair value measurement*** **(SCORE No. BB1462)**, for further discussion.

Although we believe market risk benefits should be measured at the contract level, we do not believe ASU 2018-12 prohibits insurers from determining assumptions for a homogeneous group of contracts.

MRB 2.2 When determining the amount of attributed fees to be used in the measurement of market risk benefit features, can insurers include shared mutual fund service fees, investment margins earned on a contract holder's account balance or surrender charges? (previously MRB 2.3 — renumbered December 2023)

Under ASC 944-40-30-19C, attributed fees must not exceed total contract fees and assessments collectible from the contract holder when an insurer measures market risk benefits. Shared mutual fund service fees (e.g., 12b-1 fees or sub-transfer agent fees) and investment margins earned on a contract holder's account balance are not collectible from the contract holder. Therefore, it would not be appropriate to include either type of fees among the attributed fees used to measure market risk benefits.

Although surrender charges are explicit assessments collectible from the contract holder, their nature and timing generally are not intended to support market risk benefit features, and surrender charges from one contract holder should not be used in valuing the feature of another contract holder. That is, surrender charges are collected by the insurer upon termination or partial termination of a contract, which would generally result in the policyholder forfeiting any related market risk benefits.

Furthermore, the American Institute of Certified Public Accountants' *Life and Health Insurance Entities — Audit and Accounting Guide* states that surrender charges are intended to help an insurer recoup the initial costs of selling and issuing the terminated contracts. Thus, we generally believe that surrender charges are not fees that are charged to support the market risk benefit feature, and therefore, they should not be included among attributed fees.

MRB 2.3 Is an insurer required to include attributed fees in measuring the market risk benefit? (updated December 2023)

No. Insurance and annuity contracts that are issued with market risk benefit features generally have a variety of fee structures. Separate account products (e.g., variable annuities) generally include explicit rider fees related to the benefit features and other explicit fees assessed while the host insurance or annuity contract is in force (e.g., mortality and expense fees). In contrast, many general account (i.e., non-separate account) products, such as fixed-indexed annuities, do not contain explicit rider or mortality and expense fees and are instead priced for insurers to earn investment margins on policyholders' account balances.

Some insurers offer insurance contracts with and without benefit features that meet the definition of a market risk benefit within the contract. If the only difference between two identical contracts is the existence of a market risk benefit and the fee charged for the benefit, the fees can be directly attributed to a market risk benefit.

However, many times the insurance contract is priced to achieve a rate of return on the overall contract, inclusive of any features that meet the definition of a market risk benefit within the contract. Therefore, attributing fees to specific components could be considered arbitrary.

MRB 2.4 Does the standard require a specific valuation approach? (replaced MRB 2.2 — December 2023)

The standard does not prescribe a specific valuation approach for determining the fair value of a market risk benefit. While ASC 944-40-30-19D requires insurers to consider the guidance in ASC 815-15, *Derivatives and Hedging — Embedded Derivatives*, on determining the terms of an embedded derivative that is required to be bifurcated, specifically the option-based and non-option valuation approaches used for determining the fair value of embedded derivatives, the standard does not require insurers to apply these approaches. The Board acknowledged in BC 76 that it will allow insurers to use existing measurement models and practices to determine the valuation of market risk benefits, thereby mitigating any incremental costs of adopting the amendments. Therefore, an insurer should use judgement to determine the appropriate valuation approach based on the facts and circumstances of each market risk benefit and apply that approach for the life of the market risk benefit.

MRB 2.5 How should an insurer measure a market risk benefit when fees are considered an attribute of the market risk benefit and are insufficient to result in fair value being equal to zero at the inception of the contract? (replaced previous MRB 2.4 — December 2023)

Many general account (i.e., non-separate account) products, such as fixed-indexed annuities, do not contain mortality and expense fees and may not include an explicit rider fee or the rider fee is insufficient to cover the related cost of the market risk benefit. Instead, these products are priced for insurers to earn investment margins on policyholders' account balances.

Insurance products structured as separate accounts require the contract liability (i.e., the policy account balance) to be accounted for at an amount equal to the assets in the separate account. The explicit rider and mortality and expense fees for these contracts are generally sufficient to cover the present value of projected future expected benefits. However, in rare instances the rider and mortality and expense fees are insufficient to cover the full present value of estimated future benefit payments.

Other contracts may combine investment features of both general accounts and separate accounts.

Consistent with the guidance in ASC 815-15-30-2 regarding a Day 1 gain or loss on a bifurcated derivative, we believe any potential Day 1 gains or losses associated with the market risk benefit should not be recognized immediately in earnings. Instead, insurers should recognize a host adjustment or establish a separate asset when the separate account contract liability cannot be adjusted.

When a separate asset is recognized at the initial recognition of a market risk benefit, that asset should be considered a component of the market risk benefit. As such, we believe subsequent measurement of the initially recognized separate asset should be charged to expense over the life of the contract consistent with other recognition approaches in ASC 944, such as host adjustment amortization, deferred acquisition cost or deferred sales inducement amortization.

MRB 2.6 How should an insurer account for instrument-specific credit risk in a market risk benefit feature? (previously MRB 2.5 — renumbered December 2023)

ASU 2018-12 indicates that the effect of the change in instrument-specific credit risk for a market risk benefit feature in a liability position is measured and presented in OCI. We believe the standard specifically references instrument-specific credit risk for market risk benefits *in a liability position* to clarify that only the effects of changes in the insurer's own nonperformance risk (i.e., default by the insurer) are separately measured and recorded in OCI. This is consistent with the measurement of liabilities under the fair value option in ASC 825, *Financial Instruments*, as referenced to in the Basis for Conclusions of ASU 2018-12.

Nonperformance risk broadly refers to the risk that an obligation will not be fulfilled. The estimation of this risk often consists of analyzing the insurer's own-credit risk as a mechanism to measure the effect. Thus, nonperformance risk is often simply referred to as own-credit risk. The effect of own-credit risk on fair value should not be assumed to be zero, and ASC 825-10 provides several methodologies for determining own-credit risk and estimating the effect on fair value. For example, an insurer may use the current credit spread associated with the insurer's debt rating as an initial indication and estimate the insurer's ultimate own-credit risk related to the benefits.

Regardless of the method selected by the insurer, only the effect of a *change* in the own-credit risk is measured and presented in OCI. Insurers will need to track certain information to effectively measure the change in own-credit risk, such as retaining the base risk-free or benchmark interest rate or the insurer's own credit spread at the date of contract issuance.

There is diversity in practice related to how insurers consider the effect of own-credit risk on fair value measurements for existing embedded derivatives in insurance contracts under ASC 815. Insurance contracts and benefit features generally contain two distinct sets of cash flows: those collected from the contract holder (i.e., fees and other assessments) and benefits paid. Some insurers elect to evaluate the cash flows on a net basis and apply an estimate of own-credit risk to contracts in a net liability position (i.e., expected benefits exceed expected cash flows collected from the contract holder). Others elect to apply an estimate of own-credit risk on the "pay leg" (i.e., the expected benefits to be paid by the insurer) of all contracts. There may be other acceptable approaches to calculate the effect of own-credit risk on the fair value of the market risk benefit.

See our FRD publication, ***Fair value measurement*** **(SCORE No. BB1462)**, for further discussion about existing practice related to credit valuation adjustments to derivative fair value measurements.

MRB 2.7 Is counterparty risk a component of own-credit risk? (previously MRB 2.6 — renumbered December 2023)

Counterparty risk does not relate to the nonperformance risk of the insurer; therefore, it is not a component of own-credit risk that is estimated and recorded in OCI. Counterparty risk should be considered as a component of the fair value measurement, but the effect of changes in counterparty risk should be recorded in earnings in accordance with ASC 820, *Fair Value Measurement*.

MRB 2.8 How are market risk benefits accounted for upon derecognition? (previously MRB 2.7 — updated December 2023)

Under certain circumstances, an insurer is required to derecognize market risk benefit features. ASC 944-40-35-8B indicates that upon annuitization (for annuitization benefits) or extinguishment of the account balance (for withdrawal benefits), the balance related to the market risk benefit must be derecognized. This means that when the account value reaches zero on a host variable annuity contract that includes a guaranteed minimum withdrawal benefit (GMWB) rider, the insurer should treat the future GMWB payment(s) as an immediate annuitization. Likewise, when a policyholder elects to annuitize, the insurer should derecognize the market risk benefit related to the annuitization benefit.

Upon derecognition of a market risk benefit, the insurer first derecognizes any related amount in AOCI related to own-credit risk by adjusting the market risk benefit. A gain or loss is recognized in net income only for the effect of the insurer's nonperformance. An insurer then derecognizes the market risk benefit balance for the settlement of the obligation or the establishment of a new contract liability under a different accounting model, depending on the nature of the benefit feature. In practice, the portion recognized in AOCI is derecognized through AOCI, and the portion recognized in net income is derecognized through net income.

Using the GMWB example above, upon derecognition of the market risk benefit, the insurer records a liability for future policyholder benefits for the resulting payout annuity using the net premium model, with the amount of the derecognized market risk benefit considered in the premium paid for the payout annuity. ASC 944-40-35-8B further clarifies that if the derecognized market risk balance is insufficient to fund the liability for future policyholder benefits, the insurer would record an immediate loss through earnings. However, if the derecognized market risk balance plus any derecognized contract holder account balance

exceeds the expected future policyholder benefits, the insurer should apply the guidance for limited-payment contracts and establish a deferred profit liability at the initiation of the new contract (i.e., recording of a deferred profit liability for a single-premium payout annuity).

The accounting for a derecognition event for a market risk benefit related to a withdrawal benefit, such as a guaranteed minimum accumulation benefit on a variable annuity contract, is similar in that the insurer would first derecognize any related amount in AOCI. However, because the contract is terminating, if the cash withdrawal amount differs from the market risk benefit balance plus any derecognized contract holder account balance, the insurer would record an immediate gain or loss through earnings.

Many annuity contracts are issued with both withdrawal and accumulation benefit features, which are required to be measured as a single compound market risk benefit in accordance with ASC 944-40-30-19D(c). Insurers should account for the derecognition of a compound market risk benefit at the point in which one of the benefit features is elected or triggered.

MRB 2.9 **How is the initial measurement of the market risk benefit affected when a contract holder has the option to allocate funds across multiple investment options, in the general account and the separate account? (updated December 2023)**

If a contract allows a contract holder to allocate funds across multiple investment options in the separate account and the general account, the cash flows used to calculate the initial present value of projected benefits and expected fees (if applicable) would reflect the consideration of policyholder behavior.

MRB 2.10 **How would an insurer account for a market risk benefit that is acquired in a business combination? (updated December 2023)**

The acquiring insurer should carry forward the acquiree's classification of a market risk benefit and measure the market risk benefit at fair value at the date of acquisition.

We believe that the guidance in ASC 805-20-25-8 and ASC 944-805-25-2 could apply to the classification of market risk benefits in a business combination, given that the guidance for market risk benefits is included in the additional liability section of ASC 944.

Under this guidance, insurance and reinsurance contracts retain the acquiree's classification as an insurance or reinsurance contract or a deposit contract. That is, the acquirer is required to carry forward the acquiree's classification of an acquired contract as an insurance or reinsurance contract or a deposit contract based on an understanding of the terms of the acquired contract and any related contracts or agreements at the inception of the contract or, if the terms of those contracts or agreements were later modified in a manner that would change the classification, at the date of that modification (which may be the acquisition date).

The acquired market risk benefit is recognized at fair value at the acquisition date in accordance with ASC 944-805-30-1, which requires assets and liabilities arising from the rights and obligations of insurance and reinsurance contracts to be accounted for at fair value and presented in two components: (1) assets and liabilities measured in accordance with the acquirer's accounting policies for insurance and reinsurance contracts that it issues or holds and (2) an intangible asset or liability for the difference between the fair value of the contractual insurance and reinsurance assets acquired and liabilities assumed and the amount in (1).

Market risk benefits — presentation and disclosure

MRB 3.1 **If an insurer holds some market risk benefits measured as liabilities and others measured as assets, can the two be netted together into one amount, or should liabilities and assets be presented separately?**

As previously discussed, we believe insurers should recognize market risk benefits at the contract level. Consistent with the presentation of derivatives, the fair value of contracts in a liability position should not be offset (i.e., netted) on the statement of financial position by the fair value of contracts in an asset position,

unless the "right of offset" conditions set forth in ASC 210-20 exist. Because each market risk benefit represents a contract between an insurer and a variety of individual policyholders, the "right of offset" is generally not present.

MRB 3.2 **Is a separate, disaggregated rollforward disclosure required for each type of market risk benefit offered by an insurer? How would the level of disaggregation for market risk benefit rollforward disclosure change for multiple benefits in a contract that are bundled together and measured as a single compound market risk benefit?**

The aggregation principle in ASC 944-40-50-5A applies to all disclosures for long-duration insurance contracts. This principle provides insurers with guidelines for aggregating or disaggregating the disclosures to give users meaningful information without having to include a large amount of insignificant detail or aggregate items with significantly different characteristics. ASU 2018-12 does not provide further guidance on how insurers should aggregate market risk benefit features for disclosure, beyond ASC 944-40-55-13H, which prohibits insurers from aggregating contracts from different reportable segments for rollforward disclosure purposes.

For market risk benefits, ASU 2018-12 provides an example rollforward disclosure (ASC 944-40-55-29G) that illustrates separate and distinct rollforwards for GMWB features based on the respective base contract (i.e., separate disclosure of features within variable annuity contracts and those within indexed annuity contracts). This manner of aggregation based on the combination of the single benefit feature and base contract is one way to meet the objective of the guidance, which requires a detailed rollforward of balances for the effects of various activity, such as accrual of interest, payments of benefits and changes in specific assumptions (e.g., interest rates, equity markets).

Many products often include multiple benefit features within a single contract. ASU 2018-12 requires insurers to bundle multiple market risk benefit features from the same contract together and measure the features as a single compound market risk benefit. For example, many policies are structured with both guaranteed death and withdrawal benefits, and insurers may issue a variety of policies with this type of arrangement. We believe it would be reasonable for an insurer to aggregate benefits with similar features (or a similar combination of features).

MRB 3.3 **Do insurers need to separately disclose fair value information for market risk benefits under ASC 820?**

ASC 944-40-55-13K clarifies that if the market risk benefits tabular rollforward disclosures meet the "fair value disclosure requirements described in ASC Section 820-10-50, an insurer need not duplicate [the disclosures]." Due to the significance of unobservable inputs, most market risk benefits will be classified as Level 3 fair value measurements. ASC 944-40-55-13K provides various line items of activity that insurers could consider including in the rollforwards that would be consistent with much of the activity in the Level 3 rollforward requirements in ASC 820. Such activity within the market risk benefits rollforwards could include issuances, attributed fees collected and benefit payments.

However, if any disclosures required by ASC 820-10-50 are not included within the market risk benefits rollforwards (e.g., qualitative disclosures regarding recurring Level 3 fair value measurements), the insurer should make additional fair value disclosures either in the market risk benefits footnote or the fair value footnote.

Market risk benefits — reinsurance

MRB 4.1 **How should an insurer/reinsurer recognize arrangements that cede market risk benefits?**

The current guidance in ASC 944-20-15-20 requires insurers to evaluate at contract inception whether a contract should be classified as an insurance contract based on whether it contains significant morbidity or mortality risk. Regardless of the specifics of any reinsurance arrangement, this analysis is the first step that must be completed when insurers enter into an arrangement (i.e., inception of the contract).

ASU 2018-12 provides further guidance when considering the nature of arrangements that cede market risk benefits. ASC 944-40-25-40 requires that the ceding and assuming insurers evaluate the terms of any arrangements that cede other insurance benefits (i.e., annuitization, death or other insurance benefits) in accordance with the defined scope of market risk benefits outlined in ASC 944-40-25-25C through 25-25D. The guidance further clarifies that when performing an analysis related to the transfer of a loss or shortfall in

the account balance as defined in ASC 944-40-25-25D(a), the "account balance" continues to refer to the underlying contract between the direct writer (i.e., ceding insurer) and the contract holder. That is, if the ceding insurer is protected from capital market risk by transferring a loss or shortfall in the contract holder's account balance or benefit amount to the assuming insurer, the arrangement between the ceding and assuming insurers may qualify as a market risk benefit.

If each of the market risk benefit criteria are met, we believe the ceding insurer should treat the arrangement as the purchase of a separate market risk benefit (i.e., a purchased market risk benefit), and the assuming insurer should treat it as the issuance of a market risk benefit. If the arrangement does not meet the criteria of a market risk benefit, ASC 944-40-25-40 and 25-41 require the ceding and assuming insurers to evaluate whether the arrangement meets the criteria of embedded derivatives.

If the arrangement is neither a market risk benefit nor an embedded derivative, insurers would then proceed to evaluate the arrangement in accordance with the ASC 944 provisions for annuitization, death or other insurance benefits.

MRB 4.2 When measuring an arrangement that only cedes or assumes market risk benefit features, how should an insurer consider the attributed fee guidance?

Arrangements that cede or assume market risk benefits will often meet the criteria for recognition as separate market risk benefits (see MRB 4.1). ASC 944-40-30-19C prohibits attributed fees from exceeding total contract fees or assessments collectible from the contract holder but does not specify how to apply the guidance when determining fees used in measuring a separate market risk benefit created through a reinsurance arrangement.

In an arrangement that cedes market risk benefits from an insurer to a reinsurer, we believe the "contract holder" in paragraph 944-40-30-19C is the ceding insurer and all cash flows between the ceding insurer and assuming reinsurer could be considered by either party in determining the attributed fees for purposes of measuring the fair values of the new market risk benefits. That is, cash flows available for attribution include all collectible cash flows between the ceding insurer and assuming reinsurer (i.e., they are not limited to those derived as passthroughs of rider fees and maintenance and expense fees from the underlying contract holders).

MRB 4.3 What are the presentation and disclosure implications for ceded market risk benefits?

We believe ceded market risk benefits will often meet the criteria for recognition as separate market risk benefits (i.e., purchased market risk benefits). See MRB 4.1 and MRB 4.2 for further discussion regarding the recognition and measurement of arrangements that cede market risk benefits.

As discussed in MRB 3.1, we believe insurers should present market risk benefits in a liability position separately from those in an asset position. Ceded market risk benefits will often be in an asset position and must be presented separately from direct market risk benefits in a liability position, but insurers should also evaluate how the presentation of the activity will provide decision-useful information. For example, an insurer may conclude that purchased (i.e., ceded) market risk benefits present risks that are different than those for written (i.e., direct) market risk benefits. As a result, the insurer could consider presenting purchased market risk benefits separately from written market risk benefits in the balance sheet (i.e., similar to separate presentation of reinsurance recoverables), regardless of whether the written or purchased market risk benefits are in an asset or liability position.

ASC 944-40-45-3 requires insurers to present the change in fair value related to market risk benefits separately in net income (with the exception of changes in fair value attributable to changes in own-credit risk, which are presented separately in OCI). The guidance does not specifically require income statement activity related to market risk benefits in a liability position to be presented separately from those in an asset position, but insurers should evaluate what constitutes decision-useful information. For example, an insurer may conclude that expanded disclosures provide more decision-useful information than the separate presentation of the change in fair value of market risk benefits in a liability and asset position.

We believe ceded market risk benefits are subject to the disclosure requirements in ASC 944-40-50-7B and 50-7C. Insurers could consider including these amounts as a separate disaggregated rollforward or consider providing an additional column in the rollforward disclosure for direct market risk benefits.

MRB 4.4 Are market risk benefits in an asset position in the scope of ASC 326? (updated December 2023)

No. ASC 326 requires entities to estimate an expected lifetime credit loss on financial assets that are not measured at fair value through net income. Although the scope of ASC 326 includes premiums receivable and reinsurance recoverables, ASC 326-20-15-3 explicitly excludes financial assets measured at fair value through net income. Therefore, market risk benefits, which are recorded at fair value through net income, are excluded from the scope of ASC 326.

Market risk benefits — transition

MRB 5.1 How should insurers interpret the ability to use hindsight when retrospectively applying the guidance for market risk benefits?

ASU 2018-12 requires the guidance for market risk benefits to be applied retrospectively and in certain circumstances allows insurers to use hindsight when determining assumptions. We believe the use of hindsight provides insurers with the ability to determine attributed fees as of contract inception when actual assumptions as of the contract issuance date (which may be many years before the transition date) are impracticable to obtain. Hindsight should only be used to determine an insurer's estimate of assumptions that would have been used at contract inception.

In addition, the fair value hierarchy in ASC 820 requires insurers to prioritize observable Level 1 and Level 2 inputs and give the lowest priority to unobservable Level 3 inputs. In maximizing observable inputs, actual historical experience can be used to inform an insurer's determination of assumptions that would have been used at contract inception, but actual historical experience cannot be used as a direct replacement for such assumptions.

That is, the use of hindsight is not equivalent to a single-scenario measurement (i.e., a deterministic measurement). Instead, insurers should maximize observable inputs to estimate assumptions that would have been used at contract inception in a manner consistent with the principles of fair value measurement.

MRB 5.2 When retrospectively applying the measurement guidance for market risk benefits, insurers can use hindsight when prior-period assumptions are "unobservable or otherwise unavailable and cannot be independently substantiated." How should insurers interpret that language?

US GAAP does not define the terms "otherwise unavailable" and "independently substantiated," but it defines "unobservable inputs" as those for which there is no market data available and that are instead developed using the best information about the assumptions that market participants would use when pricing an asset or liability. The interpretation and application of this guidance will vary based on facts and circumstances, but insurers should make reasonable efforts to determine whether information needed for prior-period contract issue date assumptions is available from other sources. Although not "observable" in the sense of a fair value measurement model, information that is available internally can meet the description of "available." These internal sources could include pricing information, other models (e.g., previous embedded derivative or enterprise risk management) or other projections (e.g., regulatory capital calculations).

For many insurers, previous fair value calculations of benefit features accounted for as bifurcated embedded derivatives will be a likely source of available information. The assumptions used in the fair value measurement of those embedded derivatives in many cases will be similar to assumptions needed to measure market risk benefits at contract inception. In addition, mortality rates, lapses, annuitization election rates or other policyholder behaviors may also be obtained from actuarial models, experience studies and pricing models. Yield curves, implied volatilities and own-credit spreads may be obtained from market data platforms (i.e., Bloomberg), brokers or valuation specialists.

The determination of the level of effort required to obtain prior-period assumptions before using hindsight will depend on the insurer's facts and circumstances, but we believe the use of hindsight may be necessary for certain assumptions in prior periods. However, similar to the impracticability guidance in ASC 250, *Accounting Changes and Error Corrections*, insurers should make every reasonable effort to determine assumptions without the use of hindsight. That is, if insurers are unable to obtain the necessary information through reasonable efforts, or information would require assumptions about management's intent, insurers can use hindsight in determining the assumptions.

MRB 5.3 At what level should insurers determine whether the use of hindsight should be applied?

Consistent with ASC 944-40-65-2F, we believe the determination of whether hindsight is required should be made for each individual assumption.

MRB 5.4 Does retrospective measurement of market risk benefits at transition include recording the effects of changes in instrument-specific credit risk?

ASU 2018-12 requires changes in the instrument-specific credit risk (i.e., own credit risk) between the contract issue date and the transition date to be recorded as a cumulative effect adjustment in AOCI. If information related to instrument-specific credit risk in prior periods is unavailable, insurers should use hindsight to estimate the change in fair value attributable to changes in instrument-specific credit risk for all contracts back to inception.

See our FRD publication, *Fair value measurement* (SCORE No. BB1462), for further discussion regarding fair value measurement considerations specific to the insurance industry, including evaluations of instrument-specific credit risk.

MRB 5.5 Do market risk benefits that are derecognized as of the transition date affect an insurer's retrospective application of the guidance?

No. Market risk benefits that are derecognized as of the transition date should not affect an insurer's retrospective application of the guidance to market risk benefits that are active as of the transition date. In current practice, when measuring embedded derivative features related to insurance contracts, insurers often group contracts with similar features for purposes of setting attributed fees at contract issuance. Insurers may follow a similar practice when measuring market risk benefits after adopting ASU 2018-12, but they should not consider derecognized market risk benefits when applying this practice to the retrospective transition requirements.

For example, consider an insurer that issues variable annuities that include GMWB riders. MRB 2.7 discusses ASC 944-40-35-8B, which requires that insurers derecognize the balance related to withdrawal benefits upon extinguishment of the account balance. Thus, the insurer should treat the future GMWB payment(s) as an immediate annuitization once the variable annuity account value reaches zero.

Further assume the insurer groups variable annuities with similar characteristics for purposes of setting attributed fees. When adopting ASU 2018-12, we believe the insurer should only consider GMWB riders active as of the transition date and should exclude GMWBs related to variable annuities where the account value was extinguished before the transition date. In a period before the transition date, the balances related to such GMWBs would have been derecognized with the amount considered the premium paid for recognizing a subsequent payout annuity under the net premium model.

After grouping active contracts with similar characteristics, the insurer should then evaluate whether needed information is available, using hindsight when information is "unobservable or otherwise unavailable and cannot be independently substantiated." See MRB 5.1 through 5.3 for further discussion regarding the use of hindsight.

MRB 5.6 When retrospectively applying the measurement guidance for market risk benefits in periods preceding the transition date, can insurers use improved fair value models?

The transition guidance in ASU 2018-12 requires insurers to maximize the use of relevant and observable information when determining prior period assumptions. This does not preclude insurers from using improved fair value models when applying the measurement guidance for market risk benefits retrospectively to periods preceding the transition date. That is, when adopting the guidance, insurers should generally use current fair value models. Any improvement to such models compared to those used in prior periods (e.g., updated software) would be considered part of the insurer's retrospective application of fair value.

MRB 5.7 For contracts issued before the effective date of FAS 157, should insurers use the current fair value framework for the retrospective adoption of market risk benefits?

ASU 2018-12 requires retrospective application of the guidance for market risk benefits. As defined in the ASC Master Glossary, retrospective application requires entities to apply the accounting principle "as if that principle had always been used." Therefore, insurers will be required to apply the current fair value framework to re-determine the present value of expected benefit payments at the contract issue date and the resulting attributed fees. They will have to consider conditions and assumptions that existed at the contract issue date, adjusted for the inclusion of nonperformance risk and a risk margin. They will then remeasure the market risk benefit on the transition date based on the re-determined attributed fees.

Certain contracts written by insurers, such as variable annuities with guarantees, include benefit features that, prior to adoption of ASU 2018-12, are classified as bifurcated embedded derivatives and measured at fair value under current guidance at ASC 815-15. Upon adoption of ASU 2018-12, many of these benefit features will be classified as market risk benefits and measured at fair value under ASC 944, under a retrospective approach.

FAS 157, *Fair Value Measurements,* became effective in 2007 with the objective of enhancing the fair value measurement model and was subsequently codified as ASC 820, *Fair Value Measurements and Disclosures*. The enhanced fair value framework clarified the requirements for the measurement of liabilities to include consideration of nonperformance risk and an explicit "risk premium" (i.e., risk margin) to reflect the risk of uncertainty in expected cash flows. FAS 157 was adopted on a prospective basis, and insurers incorporated the concepts of nonperformance risk and risk premiums in subsequent fair value measurements.

Because the guidance was adopted prospectively, insurers did not re-determine the present value of expected benefit payments resulting from additional considerations of nonperformance risk and risk margins as of the date of contract issuance. As a result, insurers did not recalibrate the attributed fees that were needed to cover the present value of expected benefit payments for those contracts issued before the effective date of the standard. However, because ASU 2018-12 requires retrospective application of the guidance for market risk benefits, insurers will be required to apply the current fair value framework to re-determine the present value of expected benefit payments at the contract issue date and the resulting attributed fees for all contracts in effect at the transition date.

Deferred acquisition costs

DAC 1.1 Does ASU 2018-12 change the nature of acquisition costs that can be capitalized?

Generally, no. Insurers should continue to capitalize acquisition costs related directly to the successful acquisition of new or renewal insurance contracts if the costs are incremental direct costs of contract acquisition, a portion of an employee's total compensation related directly to time spent performing acquisition activities and advertising costs that meet the criteria for capitalization.

In addition, ASC 944-30-25-3 through 25-5 describe the costs that are not eligible for capitalization. These paragraphs indicate incurred costs are ineligible for capitalization if the costs have a constant relationship to premiums or insurance in force, are recurring in nature, are incurred in a level amount from period to period or vary with premium revenue (e.g., premium taxes or level commissions). Costs exhibiting any of these attributes should be considered maintenance or other period costs and charged to expense in the period incurred.

Prior to ASU 2018-12, these paragraphs only applied to universal life-type contracts. However, after the adoption of ASU 2018-12, these paragraphs will apply to all long-duration contracts (i.e., the guidance will no longer just apply to universal life-type contracts). Therefore, insurers will need to determine that the costs being capitalized do not meet any of the conditions in these paragraphs, and if they do, insurers will need to change their accounting policies to expense such costs. If the insurer prospectively adopts the new DAC guidance, any such costs previously capitalized would be included in the DAC carryover basis at transition. If the insurer retrospectively adopts the new DAC guidance, the insurer would need to measure the unamortized balance of such costs and record a cumulative effect adjustment at transition.

We believe it would be reasonable for an insurer to consider the expected coverage period of the insurance contract (i.e., period during which claims may be incurred) when evaluating this guidance. That is, insurers could consider whether the costs are incurred over the entire coverage period of the insurance contract or just a portion of the coverage period. Insurers should use judgment to consider the facts and circumstances of the costs incurred related to the issuance of new contracts when concluding whether costs are eligible for capitalization.

DAC 1.2 How should insurers determine the expected term of an insurance contract?

ASC 944-30-35-3A requires insurers to amortize DAC "over the expected term of the related contract." Insurers will need to use judgment to estimate their assumptions of the attributes relevant to a contract's expected life, such as expected lapse, termination and mortality rates, which should be consistent with those used in estimating the liability for future policyholder benefits.

An insurer's consideration of a contract's expected term may vary depending on the contract type. For example, ASC 944-30-35-3 makes it clear that for fixed annuities with separate and distinct accumulation and payout phases, the expected term should be limited to the accumulation phase, which is defined in ASC 944 as "the period during an annuity contract before annuitization." ASC 944-30-35-3 continues to clarify that the expected term for fixed annuities should not extend to the payout phase. However, there is no such explicit guidance for a variable annuity contract that contains a GMWB feature. We believe the extended income phase of the GMWB should be considered the payout phase, based on the contract no longer being in an accumulation phase and paragraph 944-40-35-8B analogizing this contract type to a fixed annuity. That is, when the account value of the base contract reaches zero it is considered the extinguishment of the original contract and the beginning of a new contract.

Additionally, there is no explicit guidance on certain non-annuity contract types that have extended claim payment periods, such as disability or long-term care insurance. For these contracts, we believe insurers should include the claim payment period in the expected term of the contract, since the nature of the contract remains constant (i.e., there are no distinct accumulation and payout phases), and the insurer continues to account for and perform on the contract.

DAC 1.3 How should insurers determine the constant level basis to use in amortizing DAC?

ASU 2018-12 requires insurers to amortize DAC on a constant level basis that achieves a straight-line basis for individual contracts or an approximation of a straight-line basis for grouped contracts. ASC 944-30-35-3A prohibits insurers from using a function of revenue or profit emergence as an amortization basis, but otherwise the guidance does not further prescribe how insurers should determine the appropriate basis.

As the FASB staff noted during a November 2018 webcast, a constant level basis is not synonymous with a constant dollar amount. The FASB staff indicated when analyzing whether the amortization of grouped contracts approximates straight-line amortization on an individual contract basis, insurers should focus on the pattern of amortization rather than a quantitative materiality analysis. These views alleviate any pressure for insurers to demonstrate that amortization using the constant level basis selected for a group of contracts is equivalent to a straight-line basis for each individual contract.

The FASB staff also noted that the illustrative example in ASC 944-30-55-7 uses the amount of insurance in force as the amortization basis because insurance in force stays level over the contractual term of an individual contract. However, in the Basis for Conclusions, the FASB noted that insurance in force cannot be applied to all product types (e.g., flexible premium life contracts, annuity contracts). Therefore, when grouping contracts for amortization, insurers should consider the characteristics of each product to identify a basis that will stay level over the contractual term of an individual contract.

The identified basis should achieve proportionate amortization based on the size of each policy. Once the expected life of the group of contracts is layered into the identified basis, consistent with the example at ASC 944-30-55-7, the insurer will calculate a fixed amortization rate.

Once a basis is selected, insurers should use mortality and lapse assumptions consistent with those used in estimating the liability for future policyholder benefits to estimate an expected life. The guidance requires insurers to reduce unamortized acquisition costs in response to unexpected contract terminations such that the amount of cumulative amortization reflects the fixed amortization rate for expected and unexpected terminations. That is, consistent with the principle of a level basis over the contractual term, any changes to the total grouped basis in subsequent periods should be a direct result of contract terminations.

When grouping contracts for purposes of amortization, we believe it may be reasonable for insurers to consider the following constant level bases for common products, depending on the facts and circumstances of the products issued.

Amortization basis	Products for consideration	Additional considerations of facts and circumstances
Policy counts	▸ Term and whole life ▸ Universal life ▸ Annuities ▸ Disability	Policy counts may be appropriate for a wide variety of product types. All products have policy counts that are level over the contractual life of individual contracts. Insurers may want to consider whether the grouped contracts contain homogeneous characteristics such that this basis would achieve an amortization pattern proportionate to the size of contracts.
Insurance in force (face amount)	▸ Term and whole life ▸ Universal life	Insurance in force (often referred to as face amount) will generally be appropriate for term and whole life products, since the amount is level over the contractual life of individual contracts and is proportionate to the size of contracts. Insurers could also consider whether certain universal life products contain a fixed amount of insurance in force, which may be reflected in the face amounts of secondary guarantee features.
Deposits	▸ Annuities ▸ Universal life	Deposits will generally be appropriate for annuities (whether fixed or variable) and may be appropriate for universal life contracts under certain circumstances. These amounts are proportionate to the size of contracts, but insurers may need to track deposit information for the first time. This information must be tracked to maintain a level basis over the contractual life.
Fixed benefits	▸ Disability	The amount of fixed benefits (e.g., maximum lifetime benefits or guaranteed daily or monthly benefit amounts) will generally be appropriate for various types of disability products such as long-term care insurance. These amounts are proportionate to the size of contracts, and the amount should be level over the contractual life of individual contracts. In certain circumstances, other metrics (such as annualized in force premiums) may be a proxy for determining the proportionate size of contracts.

We believe the use of premiums (unless akin to deposits), estimated profits or estimated margins as an amortization basis would violate the prohibition against using a function of revenue or profit emergence as an amortization basis. Other bases may be inconsistent with the guidance for certain product types or circumstances because the bases do not produce a constant-level pattern of amortization.

For example, using net amount at risk for many universal life contracts (the guaranteed benefit in excess of the account value) would not achieve a constant-level pattern of amortization because the net amount at risk is often unpredictable due to cash inflows/outflows and variability in the value of separate account assets (for variable contracts). Similarly, using reported account value for variable annuities generally would not achieve a constant-level pattern of amortization because it is subject to market variability and policyholder withdrawals.

DAC 1.4 In assumed reinsurance arrangements, should the insurer consider the reinsurance contract or the underlying insurance contracts when determining a constant-level basis?

We believe assuming insurers should consider the underlying insurance contracts when determining a constant-level basis for amortizing DAC of assumed reinsurance arrangements. That is, insurers should use judgment to estimate the reinsurance contract's expected life based on estimated lapses, mortality and other terminations of the underlying insurance contracts. The insurer should then consider attributes of the underlying insurance contracts to determine an appropriate constant-level basis.

DAC 1.5 Is there a prescribed method for updating the DAC amortization models to reflect the effect of actual experience deviating from expectations? Should the model include actual experience that deviates from expected experience within the current reporting period?

ASU 2018-12 does not specify whether the model used to amortize DAC (i.e., the amortization rate) should be updated for experience deviations (activity during the period that varies from that which was previously expected) within the current reporting period. Illustration 4.1 in the body of this publication demonstrates a calculation where the insurer measures regular amortization expense for the period based on information known at the beginning of the period and then measures an experience adjustment based on information known as of the end of the period. ASC 944-30-55-7 through 55-7B illustrate this same method.

However, insurers could elect to calculate amortization expense for the entire period based on information known at of the end of the period. In this case, an insurer would not reflect experience adjustments in the financial statements. Instead, deviations from expected experience would be reflected within a revised amortization expense determined on a prospective basis from the beginning of the period in which the deviations occur, over the remaining expected life of the contracts, consistent with changes in assumptions of future expectations.

The table below illustrates how this alternate methodology would result in measurement differences when applied to the fact pattern in Illustration 4.1. The illustration considers a situation where an insurer experiences higher lapses at the end of 2024 than originally expected (i.e., insurance in force decreases from $9,604 to $8,644 instead of the original expectation of a decrease from $9,604 to $9,412). The illustration continues to demonstrate how the insurer calculates $16.29 of amortization expense using the original assumptions, followed by calculating an additional $3.46 experience adjustment (not shown in the table below) to reflect the higher-than-expected lapses.

In contrast, if an insurer calculates amortization expense using information known at the end of the period, the insurer would use updated assumptions to calculate $19.63 of amortization expense as shown in the table below. Under this method, because the updated assumptions already consider higher than expected lapses occurring at the end of 2024, the insurer would not calculate a separate experience adjustment.

Year	DAC beginning of year	Original assumptions (Illustration 4.1)		Updated assumptions	
		Insurance in force	Amortization	Insurance in force	Amortization
2024	$58.67	$ 9,604	$(16.29)[1]	$ 9,604	$(19.63)[2]
2025		9,412		8,644	
2026		9,224		7,780	
2027		1,845		778	
2028		1,660		700	
2029		1,494		630	
2030		1,345		567	
Total		$ 34,584		$ 28,703	

[1] 58.67 x (9,604 / 34,584) = 16.29

[2] 58.67 x (9,604 / 28,703) = 19.63

Insurers should determine an entity-wide accounting policy for how they will recalibrate the DAC models so that experience adjustments and amortization expense are consistently measured each reporting period and provide meaningful information to the users of the financial statements.

DAC 1.6 Are insurers required to revise future assumptions affecting DAC amortization on a quarterly basis or should the revision of future assumptions be aligned with the insurer's annual, or more frequent, assumption review of the cash flow assumptions related to the liability for future policyholder benefits?

Unlike the guidance regarding the review of cash flow assumptions related to the liability for future policyholder benefits, the guidance does not explicitly indicate that a review of assumptions affecting DAC amortization should be performed on an annual basis. However, ASC 944-30-35-3 indicates DAC should be amortized using assumptions consistent with those used in estimating the liability for future policyholder benefits (or any other related balance) for the corresponding contracts. Based on this guidance, we believe it would be reasonable for an insurer to align its processes for determining assumptions related to DAC and the liability for future policyholder benefits.

However, ASC 944-30-35-3B states that the balance of capitalized acquisition costs should be reduced to reflect actual experience in excess of expected experience (e.g., unexpected contract terminations). That is, outside of the pre-determined annual review, insurers should perform an analysis each reporting period to determine whether experience deviates from expectations. The insurer will need to use judgment, and if the deviation between experience and expectations is deemed significant, the insurer should revise assumptions as necessary. Depending on how the insurer has designed the DAC model, this could result in writing off a portion of DAC if actual terminations exceed expectations (see DAC 1.5).

DAC 1.7 If an insurer makes prospective changes to the DAC amortization pattern to reflect actual experience in accordance with ASC 944-30-35-3B, is the insurer also required to revise the net premium ratio used to measure the liability for future policyholder benefits for the corresponding contracts?

The guidance does not explicitly require an immediate update of the net premium ratio for the liability of the related insurance contract in periods in which DAC estimates are revised. However, the FASB has been clear that assumptions of expected life, the constant level basis and expected cash flows should be consistent between DAC and the related liability for future policyholder benefits. Specifically, ASC 944-30-35-3 requires DAC amortization assumptions to be consistent with those used in estimating the liability for future policyholder benefits (or any other related balance) for the corresponding contracts.

If actual experience results in a write-off of DAC (e.g., due to excess lapses) that is significant, the insurer should consider whether this experience suggests that an interim update to cash flow assumptions used to measure the liability for future policyholder benefits is required to meet the objective of ASC 944-40-35-5a(1). This does not preclude the insurer from concluding that a revision to the net premium ratio is unnecessary. That is, the insurer may continue using the existing net premium ratio if it concludes that updated experience and revised future cash flow assumptions in the net premium ratio would not result in a significant change in the liability for future policyholder benefits.

Transition — liability for future policyholder benefits and DAC

TRAN 1.1 Can an insurer elect to adopt the revised guidance for DAC on participating and nontraditional long-duration contracts retrospectively if it does not write traditional long-duration or limited payment contracts?

ASU 2018-12 aligns an insurer's transition election related to the adoption of the revised guidance for the liability for future policyholder benefits with the transition election related to the adoption of the revised guidance for DAC, at the entity level. However, there is no revised guidance for the liability for future policyholder benefits to adopt if the insurer does not write traditional long-duration or limited-payment contracts (i.e., the insurer only writes participating or universal life-type contracts as defined in ASC 944-20-05-20). This could be the case for insurers that primarily issue universal life-type and annuity contracts. However, insurers should evaluate whether any contracts include life-contingent payout options, which would be recognized in accordance with the traditional long-duration model once in payout status.

In this situation (i.e., the insurer only writes participating or universal life-type contracts and has no life-contingent benefits in payout status), we believe the insurer can make an entity-wide election to adopt the revised DAC guidance using either the modified retrospective or retrospective method, based on the issuance dates of contracts that the DAC relates to.

An insurer that stopped writing traditional long-duration contracts before adopting the guidance in ASU 2018-12 could be in a similar situation, where the entity's election to adopt the guidance on a retrospective method for certain periods would only affect DAC. For example, consider an insurer that has a 1 January 2021 transition date but stopped writing traditional long-duration contracts in 2015. In this instance, the insurer can make an entity-wide election to adopt the revised guidance on DAC and the liability for future policyholder benefit using a retrospective method, but any such adoption for the 2016 issue year or later would only affect DAC balances.

TRAN 1.2 If an insurer makes the election to not update expense assumptions, at transition can the insurer "lock in" the expense assumption used before adopting ASU 2018-12?

At transition, insurers need to re-determine assumptions for each cohort concerning the expected future expenses that are included within the measurement of the liability for future policyholder benefits. If an insurer makes the election provided in ASC 944-40-35-5 to not update the expense assumptions, those assumptions are "locked in" for purposes of subsequent measurement.

Before the adoption of ASU 2018-12, there is diversity in practice over which policy maintenance expenses are included in measurement of the liability for future policyholder benefits. ASU 2018-12 clarifies the types of expenses that should not be included when estimating the liability for future policyholder benefits and specifically identifies acquisition costs and costs that are required to be expensed as incurred, such as those relating to investments, general administration, policy maintenance, product development, market research and general overhead. However, if an insurer is applying the guidance on a modified retrospective basis, it should not reconsider expenses included in the liability as of the transition date. That is, the expense assumptions that are included in the liability for future policyholder benefits at the transition date (i.e., the carryover basis) will be the same as those before the transition date. However, the expense assumptions included in the liability for future policyholder benefits for contracts written after the transition date will need to comply with the clarified guidance.

TRAN 1.3 When applying the modified retrospective transition approach, should insurers adjust the liability at transition for the effect of removing the provision for adverse deviation (PAD)?

When measuring the liability for future policyholder benefits for traditional long-duration and limited-payment contracts, insurers will have to use best estimate assumptions and will no longer be required to include a PAD in the assumptions.

Under the modified retrospective transition approach, the opening balance of the liability for policyholder benefits at the transition date would generally be the same as the closing balance before transition, updated for the removal of any related amounts previously recorded in AOCI. Therefore, at transition, insurers should not adjust the liability (i.e., the carryover basis) to remove the effects related to the provision for adverse deviation.

TRAN 1.4 When applying the modified retrospective transition approach, should an insurer adjust the liability at transition if the closing balance of the liability for policyholder benefits before transition exceeds the calculation of the present value of future benefits and expenses, using current assumptions, as of the transition date?

ASC 944-40-65-2d(3) requires insurers that apply the modified retrospective transition approach to the liability for future policyholder benefits to adjust the opening balance of retained earnings only to the extent that the net premiums exceed gross premiums. Therefore, under the modified retrospective transition approach, the opening balance of the liability for policyholder benefits at the transition date would generally be the same as the closing balance before transition, updated for the removal of any related amounts previously recorded in AOCI.

The ASU provides transition implementation guidance in ASC 944-40-65-2k through 2p but does not address when the closing balance of the liability for future policyholder benefits before transition (i.e., the carryover basis) exceeds the calculation of the present value of future benefits and expenses. Although this scenario would result in a negative net premium ratio at transition, the insurer should follow the ASU's modified retrospective transition principles, which requires the guidance to be applied based on "existing carrying amounts at the transition date" and clarifies that the insurer should only record a transition adjustment to retained earnings in the event net premiums exceed gross premiums (i.e., a net premium ratio greater than 100%).

Therefore, the insurer should not make any adjustments to the transition framework (i.e., the calculation of net premiums for a transition block) provided and should continue to determine the net premium ratio using the carryover basis and estimates of future cash flows at transition and in any subsequent reporting periods. Consistent with the concepts of a modified retrospective transition, such a framework results in a liability measurement that is proportionately responsive to both components (i.e., the carryover basis and estimates of future cash flows).

TRAN 1.5 When applying the modified retrospective transition approach, how should insurers determine the interest accretion rate at transition for a cohort that is newly defined under ASU 2018-12?

ASU 2018-12 clarifies that insurers are required to measure the liability for future policyholder benefits for contracts in-force as of the transition date using the updated guidance for grouping contracts, which requires a certain level of aggregation and prohibits grouping contracts from different issue years.

Current practice varies with respect to how insurers determine the discount rates. Some insurers may aggregate policies and determine the discount rate to be applied to that block of policies, and others may determine the discount rate for individual policies.

ASU 2018-12 requires that, for purposes of the interest accretion rate (i.e., the rate set at contract inception and used to present value cash flows when determining the net premium ratio), insurers should retain the discount rate assumption that was used before their adoption of the ASU. If the new unit of account for measuring the liability for future policyholder benefits differs from the previous unit of account, which results in contracts that were discounted at various rates being aggregated, we believe it would be reasonable for an insurer to determine a discount rate to apply to the cohort in its entirety rather than maintaining multiple

discount rates. The resulting discounted liability for the cohort should be equal to the cumulative discounted liabilities before the change in aggregation. As such, a weighted average rate may be the most appropriate, although, other methods may also achieve the objective.

TRAN 1.6 When applying the modified retrospective transition approach, how should insurers determine the carryover basis at transition on a cohort that was part of a block of business that was in loss recognition (e.g., a block where a premium deficiency had been previously recognized)?

In accordance with ASC 944-60-25-9, most insurers define the deficient line of business as the loss recognition cohort and the unit of account for purposes of evaluating potential premium deficiencies. This evaluation is generally performed for a block of business, which often spans multiple issue years and may include various product types. ASU 2018-12 clarifies that insurers are required to measure the liability for future policyholder benefits for contracts in-force as of the transition date using the updated guidance for grouping contracts, which prohibits grouping contracts from different issue years.

Because of the difference in how the unit of account is determined under current US GAAP (i.e., entire loss recognition cohort) and under ASU 2018-12 (i.e., prohibition of grouping different issue years), insurers with loss recognition blocks will likely need to disaggregate the blocks to measure the liability at the separate annual (or lower level) cohorts. We believe insurers should develop a reasonable and appropriate allocation process so that the total existing carrying amount of the liability before the transition date (that is, for all the contracts included in the loss recognition block) is apportioned to the cohorts such that the cohort can be measured as required by paragraph 944-40-65-2d(6).

In determining whether an allocation method is reasonable and appropriate, insurers should consider the following: (1) whether the allocation methodology is designed such that the sum of the parts equals the whole (i.e., the carrying amount of the liability for the loss recognition block prior to the transition date should equal the sum of the ASU 2018-12 cohorts' carryover basis) and (2) the allocation methodology should result in a revised net premium ratio and subsequent profit emergence that are consistent with the economics of the cohorts. For example, the allocation methodology should be designed to avoid scenarios, such as losses recorded at transition, that will be mitigated by future profits.

Allocation of the reserve carryover basis does not guarantee that an insurer will not be required to record an adjustment to retained earnings at transition, since an adjustment will be required if the net premium ratio exceeds 100% for any cohort determined under the grouping requirements of ASU 2018-12.

TRAN 1.7 When applying the modified retrospective transition method, how should insurers account for changes in ceded reinsurance recoverable balances resulting from transition adjustments to the liability for future policyholder benefits to reflect updated discount rates?

The modified retrospective transition method of ASU 2018-12 requires that insurers remeasure the opening balance of the liability for future policyholder benefits using the current upper-medium grade fixed-income instrument yield and record an adjustment to AOCI to reflect the difference between the remeasured liability and the liability measurement using the discount rate prior to transition.

Reinsurance recoverable balances are measured using assumptions consistent with those of the related direct liability and are affected by changes to the underlying insurance contracts. Therefore, if an insurer is required to record a transition adjustment to the liability for the effect of changes in discount rate, it will also be required to record a transition adjustment to the reinsurance recoverable. Because insurers record the transition adjustment for the change in the measurement of the liability to AOCI, we believe they should also record the transition adjustment for the change in the measurement of the reinsurance recoverable in AOCI. Although ASU 2018-12 does not provide specific transition provisions for such an adjustment to the reinsurance recoverable, the existing guidance in ASC 944-40-25-34 requires reinsurance recoverables to be "recognized in a manner consistent with the liabilities."

TRAN 1.8 At transition, how should insurers allocate DAC to the related policies or cohorts?

There is diversity in practice with respect to how DAC is allocated and subsequently accounted for prior to adoption of ASU 2018-12. Examples include insurers allocating DAC to individual contracts (i.e., at a seriatim level) and insurers allocating DAC to a product grouping or profit center.

Because ASU 2018-12 requires DAC to be amortized using assumptions consistent with those used in estimating the liability for the related contracts, at transition, an insurer may need to aggregate or disaggregate the previously recorded DAC to be consistent with the unit of account at which the related liabilities are being accounted. Insurers should develop a reasonable and appropriate allocation process that should be applied consistently to each of the cohorts that were previously included in a single unit of account.

TRAN 1.9 At transition, should an insurer record a cumulative-catch up adjustment for a change in the reinsurance recoverable balance if the insurer records a cumulative catch-up adjustment to the related liability for future policyholder benefits?

ASU 2018-12 prescribes a modified retrospective transition approach for adopting the guidance for the liability for future policyholder benefits, and in many circumstances, insurers will not be required to adjust the opening balance of the liability as of the transition date. However, an insurer will be required to record a cumulative catch-up adjustment under the modified retrospective approach if the revised net premium ratio at transition exceeds 100%. Additionally, if an insurer elects the retrospective approach, it will be required to record a cumulative catch-up adjustment to reflect the effect of applying the guidance in a period prior to the transition date.

As previously noted (see LFPB 6.2), we generally believe insurers should determine a separate net premium ratio when measuring reinsurance recoverable balances resulting from a ceded reinsurance contract. Under existing ASC 944 guidance, reinsurance recoverable balances are generally expected to be measured using assumptions consistent with those of the related direct liability of the underlying insurance contracts. Therefore, we believe insurers should update estimated cash flows to measure reinsurance recoverable balances and apply a consistent transition approach between any reinsurance recoverable and the liability for future policyholder benefits.

TRAN 1.10 At transition, should an insurer record a deferred profit liability when a separate deferred profit liability was not previously recorded and a breakeven discount rate was used? (updated December 2023)

Yes, at transition an insurer should recalculate the liability for future policyholder benefits using a discount rate based on the expected investment yield at the time the insurance contracts were issued.

Before the adoption of ASU 2018-12, rather than recognizing a separate deferred profit liability for single premium limited-payment contracts, some insurance entities adjusted the discount rate used in the measurement of the liability for future policy benefits such that the initial liability was calculated as the net premium (i.e., the gross premium minus acquisition costs). This approach achieved the objective of deferring gross premiums received in excess of the net premium in accordance with ASC 944-605-25-4A. In addition, the subsequent recognition of the deferred profit liability, whether accounted for separately or implicitly within the liability for future policyholder benefits, had the same effect on the financial statements.

However, under ASU 2018-12, the subsequent measurements of the liability for future policyholder benefits and of the deferred profit liability are different. While both liabilities are retrospectively adjusted for changes in cash flows using the same assumptions, the liability for future policyholder benefits is remeasured using updated discount rates while the discount rate assumptions included in the measurement of the deferred profit liability will continue to be that which was determined at contract issuance.

When an insurer applies the modified retrospective transition approach, the insurer is required to not use a breakeven discount rate but rather apply a discount rate that would have been used in the measurement of the liability for future policyholder benefits immediately before transition, in accordance with ASC 944-40-30-

9 before the adoption of the ASU 2018-12. Insurers may consider the expected investment yields and provisions for adverse deviation that were applied in the measurement of traditional premium-paying long-duration contracts sold in the same time frame as the single-premium limited-payment contract, updated for changes as a result of loss recognition, if applicable.

When an insurer applies the retrospective transition approach, the liability for future policyholder benefits will be measured using an upper-medium grade fixed-income instrument yield determined at contract inception, and a separate deferred profit liability is recognized in accordance with ASC 944-605-25-4A and ASC 944-605-30-2A.

TRAN 1.11 At transition, how should an insurer account for indirect effects as a result of the adoption of ASU 2018-12? (updated December 2023)

In accordance with ASC 250, *Accounting Changes and Error Corrections,* indirect effects are recognized in the period in which the accounting change is made (i.e., 1 January 2023 for SEC issuers that are not SRCs). ASC 250-10-45-8 states, "Indirect effects that would have been recognized if the newly adopted accounting principle had been followed in prior periods shall not be included in the retrospective application."

TRAN 1.12 At transition, how should an insurer account for the retrospective adoption of the market risk benefit guidance and its impact on the change in the carrying value of business acquired that resulted from a business combination prior to the effective date? (updated December 2023)

ASU 2018-12 does not impact the aggregate acquisition date fair values of the insurance and reinsurance contracts at the purchase date of the business combination. However, ASU 2018-12 prescribes a retrospective adoption of the market risk benefit guidance, which will require insurers to adjust the allocation of the acquisition date fair value of the contracts to their related components (e.g., VOBA, additional liabilities, MRBs) to reflect changes in the measurement of the contracts in accordance with ASC 944-805-30-1(a). This will likely result in an adjustment to the carrying amount of the insurance contracts acquired, changing the carrying value of the VOBA.

For example, assume that at the time of a business combination, the acquiring insurer estimated that the insurance contracts acquired had a $100 total fair value and a carrying amount of $110, resulting in VOBA of $10 (measured as the difference between the fair value and the carrying amount of the acquired insurance contracts).

Assume that when the acquiring insurer adopts the market risk benefits guidance on a retrospective basis as required by ASC 944-40-65-2f, it is determined that there is a market risk benefit that would have had a carrying value of $10 at the time of the business combination. This means that the carrying amount of the acquired insurance contracts increased to $120 from $110 due to the adjustment. This would result in an increase in the VOBA at the date of the business combination to $20 from $10 (measured as the difference between the fair value of $100 and the carrying amount of $120 of the acquired insurance contracts). As a result of the increase in the VOBA, the insurer also needs to adjust the amortization between the date of the business combination and the transition date by amortizing the additional VOBA in a manner consistent with the insurer's accounting policy before the adoption of ASU 2018-12.

Insurers should also follow the same principles as above when applying the transition guidance in ASU 2018-12 to ceded reinsurance arrangements that include market risk benefits not previously accounted for when accounting for a business combination. This could result in a change to the carrying amount of the cost of a reinsurance asset or liability that was initially recorded at the inception of the reinsurance contract. As a result of the change in the cost of reinsurance, the insurer would also need to adjust the amortization between the date of the business combination and the transition date by amortizing the new cost of reinsurance in a manner consistent with the insurer's accounting policy before the adoption of ASU 2018-12.

TRAN 1.13 At transition, how should an insurer account for the retrospective adoption of the market risk benefit guidance and its effect on the historical amortization of acquisition costs? (updated December 2023)

ASC 944-40-65-2 does not specify whether to apply the retrospective transition guidance for market risk benefits before or after applying the modified retrospective transition guidance for the liability for future policy benefits, DAC and balances amortized on a basis consistent with DAC. For insurers that historically used the present value of estimated gross profits (EGPs) as the basis for the amortization of certain DAC, the order of operations for the adoption of ASU 2018-12 could yield a different amortization of DAC before the transition date of the guidance, resulting in a different carryover basis of the DAC balance upon adoption of the guidance.

Insurers can adopt the DAC transition guidance on a modified retrospective basis without any revisions as a result of applying the market risk benefit guidance on a retrospective basis. That is, the opening DAC balance at the transition date will be the same as the closing balance before transition, only updated for the removal of any related amounts previously recorded in AOCI for items such as shadow DAC adjustments.

Alternatively, insurers can revise the historical DAC amortization to reflect the change in the present value of EGPs as a result of applying the guidance on market risk benefits and establish a new carrying amount for DAC to be used in the modified retrospective DAC transition guidance (ASC 944-40-65-2c). The result of changes to the DAC carrying amount are recorded as an adjustment to retained earnings at transition.

Insurers should apply this accounting policy election on an entity-wide basis and disclose it in accordance with ASC 944-40-65-2g and 65-2h.

Disclosures

DISC 1.1 Are insurers required to disclose a separate rollforward for deferred profit liabilities?

ASU 2018-12 does not require disclosure of a rollforward for deferred profit liabilities (DPL) related to limited-payment contracts. ASC 944-40-50-6 requires rollforwards from the beginning balance to the ending balance for the liability for future policyholder benefits related to limited-payment contracts, but the DPL may not be characterized as a component of the liability for future policyholder benefits. Instead, the DPL is accounted for in accordance with ASC 944-605, which does not provide any specific disclosure requirements for the DPL.

Insurers may conclude that including information related to the DPL within the liability for future policyholder benefits rollforward of limited-payment contracts provides decision-useful information to users of the financial statements. If this conclusion is reached, we believe insurers could elect to include information related to the DPL within the rollforward of the related liability for future policyholder benefits, as a separate rollforward or as accompanying information.

DISC 1.2 How should the effect of foreign currency transactions be reflected in the rollforward disclosures?

Existing guidance in ASC 830, *Foreign Currency Matters*, requires entities to remeasure foreign currency transactions in the entity's functional currency and then, if needed, further translate the functional currency financial statements into the reporting currency. ASU 2018-12 requires that insurers disclose rollforwards for the insurance balances (e.g., liabilities for future policy benefits, market risk benefits, deferred acquisition costs) and reconcile the ending balances to the balances reported in the balance sheet and revenue and interest within the rollforwards to amounts reported in the income statement. However, the guidance does not specify how to reflect the effect of foreign currency transactions in the rollforward.

At the date a foreign currency transaction is recognized, each asset, liability, revenue, expense, gain or loss arising from the transaction should be initially measured in the functional currency of the recording entity using the exchange rate in effect at that date or an appropriately weighted average exchange rate for revenues and expenses. As such, we believe the rollforward disclosures should be prepared using these remeasured amounts. Subsequently, at each balance sheet date, balances related to certain of these transactions should be adjusted to reflect the current exchange rate. This subsequent remeasurement should be recorded in current period net income and reflected as a separate item in the rollforward.

If an insurer's functional currency is a foreign currency, the financial statements must be translated into the reporting entity's reporting currency. When translating amounts to the reporting currency, ASC 830 requires entities to use a current exchange rate to translate assets and liabilities at subsequent measurement periods and allows entities to use a weighted average exchange rate to translate income statement transactions that pertain to a period of time (e.g., insurance activities such as accrued interest, net premiums). Translation adjustments resulting from translating the entity's financial statements into the reporting currency are reported in OCI.

For purposes of the rollforward, we believe it may be appropriate for insurers to reflect translation adjustments as a reconciling item analogizing to ASC 715-20-50-1. That guidance requires entities to provide a reconciliation of the beginning and ending balances of the benefit obligation for its pension plans and other postretirement benefit plans and disclose a separate line item in the reconciliation for foreign currency translation adjustments.

To achieve this presentation, an insurer would first prepare the rollforwards for the insurance balances using the books and records denominated in the functional currency. The insurer would then translate the beginning and ending balances using exchange rates as of the respective balance sheet dates (i.e., the rates used for the translation of the functional currency balance sheet amount to reporting currency). In addition, the insurer would translate the activity within the rollforward (i.e., each individual line item) using its existing accounting policy (i.e., a specific rate or a weighted average exchange rate for the period). The insurer would separately disclose the difference attributable to foreign currency translation as a separate line item in the rollforward disclosure.

DISC 1.3 How should an insurer reflect recovery of acquisition costs (e.g., ceding commission) within the DAC rollforward? (updated December 2023)

Recoveries of acquisition costs, such as a ceding commission, are accounted for as a reduction in the applicable unamortized acquisition costs in accordance with ASC 944-30-35-64 and, therefore, should be included in the DAC rollforward. We believe this reduction could be presented as either a separate line item in the DAC rollforward or included in another relevant item as long as the footnote includes commentary describing the change in the DAC balance.

Other

OTHER 1.1 Is an insurer's previous election to measure certain insurance liabilities at fair value revocable upon adoption of ASU 2018-12?

Under current guidance, some insurers may have elected to measure certain insurance liabilities (e.g., arrangements reinsuring SOP 03-1 liabilities of certain contracts) under the fair value option in ASC 825-10. ASU 2018-12 provides no explicit provisions allowing entities to reconsider previous fair value elections. Therefore, previously elected fair value options made in accordance with ASC 825-10 are irrevocable.

Furthermore, ASC 825-10-25-4 outlines events when an entity can make a new fair value election (e.g., the point at which the entity first recognizes the instrument). An entity's adoption of a new accounting standard does not qualify as an event that would allow a new election; therefore, insurers are prohibited from making new fair value elections for any instruments held before adopting the ASU unless facts and circumstances are consistent with one of the prescribed events outlined in ASC 825-10-25-4.

OTHER 1.2 If an insurer currently uses EGPs to amortize cost of reinsurance or VOBA, is it required to revise the amortization methodology for those items to a basis consistent with DAC?

ASC 944 continues to require unearned revenue liabilities and deferred sales inducement balances to be amortized on a basis consistent with DAC. In current practice, many insurers also amortize other balances (e.g., cost of reinsurance and VOBA) on a basis consistent with DAC.

Under today's guidance, DAC related to traditional long-duration and limited-payment contracts is amortized based on premiums, and DAC related to nontraditional long-duration contracts is amortized based on a pattern in which EGPs are expected to be recognized over the life of the contracts. The new amortization approach for all contracts under ASU 2018-12 (including traditional long-duration, limited-payment and nontraditional long-duration) requires insurers to amortize DAC on a constant level basis over the expected life of the contracts, independent of profitability or revenue.

The transition guidance in ASU 2018-12 (ASC 944-40-65-2c) indicates that, upon adoption of the guidance, insurers should apply the revised DAC methodology to "balances amortized on a basis consistent with [DAC], either as required by [ASC 944] or as a result of an accounting policy election." If an insurer uses premiums or EGPs to amortize cost of reinsurance or VOBA for any policies before adopting ASU 2018-12, the insurer should determine whether the accounting policy is "aligned" to the DAC amortization methodology.

If an insurer concludes that its existing accounting policies for cost of reinsurance and VOBA are aligned to the DAC amortization methodology, it should change the amortization method so it is consistent with the revised DAC methodology. We believe this policy would be prescribed by ASU 2018-12 and meet the justification for a change in accounting principle described in ASC 250-10-45-13. Therefore, it would not be considered a voluntary change in accounting principle. In contrast, if the insurer concludes the existing accounting policy is an independent method based on EGPs, it is not required under ASU 2018-12 to change the amortization method.

If an insurer currently uses premiums or EGPs to amortize cost of reinsurance or VOBA and wants to change the amortization method to a basis other than the revised DAC methodology prescribed in ASU 2018-12, the insurer should consider the requirements in ASC 250, *Accounting Changes and Error Corrections*, as it relates to a voluntary change in accounting policy.

OTHER 1.3 Which "shadow" adjustments are affected by ASU 2018-12?

ASU 2018-12 eliminates the practice of recording "shadow adjustments" to many balances, which are recorded to reflect the effect unrealized gains and losses on available-for-sale securities would have if those gains and losses were realized.

Under current guidance, DAC for universal life-type and long-duration participating contracts is amortized based on EGPs. If an insurer holds available-for-sale securities, the effect of unrealized gains and losses would be included in the EGPs in accordance with ASC 320-10-S99-2. ASU 2018-12 prohibits insurers from using profit emergence (e.g., amortizing based on EGPs) as a basis for amortizing DAC; therefore, it also eliminates the practice of recording shadow adjustments to these DAC balances.

Additionally, ASC 944 requires unearned revenue liabilities, deferred sales inducements and terminal dividends on participating contracts to be amortized on a basis consistent with DAC. Because of the explicit reference to DAC amortization methodology, ASU 2018-12 also eliminates the practice of recording such shadow adjustments to these balances.

In current practice, many insurers also amortize other balances such as cost of reinsurance or VOBA on a basis consistent with DAC. Insurers should determine whether such accounting policies are specifically aligned to the DAC amortization methodology or whether the accounting policies are independent methods based on EGPs. If an insurer concludes the accounting policies are specifically aligned to the DAC amortization methodology, ASU 2018-12 requires the insurer to change the amortization method to be consistent with the revised DAC methodology and, therefore, eliminates shadow adjustments to these balances. In contrast, if an insurer concludes that the amortization policy for cost of reinsurance or VOBA is an independent method based on EGPs, ASU 2018-12 does not require it to change the amortization method, and the practice of recording shadow adjustments would remain.

Shadow adjustments will remain for certain balances or analyses that continue to consider investment performance within the measurement process. For example, such adjustments will remain for certain additional liabilities for death or other benefit features (i.e., SOP 03-1 liabilities) that do not meet the criteria of market risk benefits and continue to consider expected margins from investments classified as available for sale in the determination of the assessments used in measuring the liability.

Similar to the shadow adjustments described, "shadow loss recognition" adjustments could be recorded as a result of premium deficiency testing when an insurer considers expected investment yield (of assets classified as available for sale) in the analysis. ASU 2018-12 eliminates premium deficiency testing for traditional long-duration and limited-payment contracts, but such adjustments could remain for premium deficiency testing of the present value of future profits (i.e., VOBA) for acquired business and for the policyholder account balances for nontraditional (i.e., universal life-type) long-duration contracts.

OTHER 1.4 If an insurer currently uses EGPs to amortize the cost of reinsurance or VOBA and previously recorded shadow adjustments to OCI as a result of that amortization pattern, how should the insurer account for the amounts in AOCI at transition?

Insurers using EGPs as an amortization basis may have recorded shadow adjustments to cost of reinsurance or VOBA balances to reflect the effect that unrealized gains and losses on available-for-sale securities would have on cash flows generated by the related policies, as if those gains and losses had been realized. The transition guidance in ASC 944-40-65-2c requires insurers to adjust the transition date opening amounts of DAC (and balances amortized on a basis consistent with DAC) for the removal of any amounts in AOCI.

If an insurer concludes the cost of reinsurance or VOBA amortization policy is aligned to DAC amortization, it should record transition adjustments to remove any amounts in AOCI resulting from such adjustments. However, such balances may remain in AOCI if an insurer concludes the amortization policy is not aligned to DAC amortization (i.e., the amortization pattern is independently based on EGPs).

OTHER 1.5 For public companies that prepare interim financial statements, in which reporting periods should companies include the transition disclosures required by ASU 2018-12? (updated December 2023)

Public entities should include these disclosures in each interim period of the year of adoption until the Form 10-K filing.

Consistent with ASC 250-10-50-2, the transition disclosures required by ASU 2018-12 should be included during the year of adoption, in each interim period after adoption of the standard.

OTHER 1.6 How would a change in accounting principle made in accordance with ASC 250 interact with the transition requirements of ASU 2018-12?

ASC 250 requires retrospective application for a change in accounting principle. The effects of the change in accounting principle must be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented, with an offsetting cumulative effect adjustment recorded to retained earnings.

Generally, we believe if an insurer elects a change in accounting principle in the same period it adopts ASU 2018-12, it should separately measure and attribute any changes in the carrying amounts of assets and liabilities between the principle change and adoption of the new guidance. That is, if an insurer elects a change in accounting principle (unrelated to ASU 2018-12) during the same period as adopting ASU 2018-12, the effect of the change in accounting principle would need to be measured and disclosed separately from the transition effects of ASU 2018-12. Additionally, ASC 250 disclosures regarding a voluntary change in accounting principle would need to be made in the notes to the financial statements.