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Insurance contracts

Partially updated March 2023

About the Insurance contracts guide

PwC is pleased to offer our updated *Insurance contracts* guide addressing accounting by insurance and reinsurance entities for insurance contracts.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues. The PwC guides should be read in conjunction with the applicable authoritative accounting literature.

References to US GAAP

Definitions, full paragraphs, and excerpts from the Financial Accounting Standards Board's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- Business combinations and *noncontrolling interests (BCG)*
- *Derivatives and hedging (DH)*
- *Equity method investments and joint ventures (EM)*
- *Fair value measurements (FV)*
- *Financial statement presentation (FSP)*
- *Foreign currency (FX)*
- *Loans and investments (LI)*

Summary of significant changes

The following is a summary of recent noteworthy revisions to the guide. Additional updates may be made to future versions to keep pace with significant developments.

Revisions made in March 2023

IG 7, Loss recognition (premium deficiency)

- **IG 7.3.2.1** was updated to clarify the amount subject to premium deficiency testing for universal life type contracts.
- **Question IG 7-1** was updated to clarify how to determine the appropriate discount rate used in the loss recognition test relating to universal life contracts.

IG 10, Presentation and disclosure

- **IG 10.4** related to transition presentation and disclosure for long-duration contracts was moved to **IG 11.5**.
- **IG 10.2.5** was updated to clarify the classification of payments of market risk benefits in the statement of cash flows.

IG 11, Effective date and transition

- **IG 11.4.2** was added to address the impact of ASU 2022-05, *Insurance: Transition for Sold Contracts*.
- **IG 11.5** now includes content from **IG 10.4** on transition presentation and disclosure for long-duration contracts.

Revisions made in May 2022

IG 5, Long duration contract liabilities

- **Question IG 5-28** was clarified and **IG 5.6.1** was updated to provide further details related to defining the terms of market risk benefits.

IG 6, Mortgage insurance, financial guarantee insurance, and guaranty funds

- **IG 6.1** was added to provide guidance on mortgage insurance.
- **IG 6.2** was added to provide guidance on financial guarantee insurance.

IG 9, Long-duration reinsurance

- **IG 9.8** was updated to address considerations related to defining the terms and derecognition of ceded market risk benefits.

IG 10, Presentation and disclosure

- Footnotes in **Figure IG 10-2** were enhanced to provide more detailed explanations of the components of the policyholders' account balances rollforward.
- **IG 10.5** and **IG 10.6** were added to address the presentation and disclosure for short-duration contracts.

IG 11, Effective date and transition

- **IG 11.3.3** was updated to address situations where management historically used a practical expedient to determine the deferred profit liability.
- **IG 11.3.9** was updated to clarify the transition impacts to the profits followed by losses liability for universal life-type contracts.

Revisions made in November 2021

IG 2, Classification of insurance contracts

- **Question IG 2-1, Question IG 2-2, Question IG 2-3, Question IG 2-4, and Question IG 2-5** were added, and **Question IG 2-6** was clarified, to address recent questions regarding the scoping of market risk benefits.
- **Figure IG 2-1 Part 2** was updated to clarify that limited payment contracts cannot be participating.
- **Figure IG 2-1 Part 3** was updated to clarify the process of evaluating whether market risk benefits and/or embedded derivatives exist, and the subsequent evaluation of the appropriate accounting framework for the remaining host contract.
- **Figure IG 2-2** was updated to reflect current developments on specific product classification.

IG 5, Long duration liabilities

- **Question IG 5-9** was added to address the treatment and disclosure of AOCI related to the liability for future policy benefits.
- **Question IG 5-19, Question IG 5-20, and Question IG 5-21** were added to address questions related to establishing cohorts for nonparticipating traditional life contracts.
- **Figure IG 5-3** was added to address the aggregation of additional contract features, such as riders or conversion features on nonparticipating traditional life contracts to respective cohorts.

IG 7, Loss recognition (premium deficiency)

- **IG 7.3.2.1** was updated and **Question IG 7-2** was added to address whether market risk benefits are included in the premium deficiency analysis for universal life contracts.

IG 9, Long duration reinsurance

- **IG 9.6.1.1** was updated to further describe the calculation of the ceded net premium ratio.
- **Example IG 9-2** was added to illustrate the calculation of the reinsurance recoverable using the “net cost” method.
- **Question IG 9-1** was added to address reinsurance of limited-payment contracts.

- The order of certain sections of **IG 9.9.1** was rearranged, certain content was retired, and sections were combined for clarity.

IG 10, *Presentation and disclosure*

- **Question IG 10-2** was updated to clarify the disclosure requirements for a company that elects to include the DPL in its liability for future policy benefits rollforward.

IG 11, *Effective date and transition*

- **Question IG 11-9** was updated to clarify the impacts to changes in assessments for additional liabilities for death or annuitization benefits.

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***Chapter 1:
Overview and scope of
insurance accounting***

1.1 Overview and scope of insurance accounting – chapter overview

The FASB issued new guidance, Accounting Standards Update 2018-12, *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts* (ASU 2018-12), that revises key elements of the measurement models and disclosure requirements for long-duration insurance contracts issued by insurers and reinsurers. It is the biggest change in US GAAP for life insurers in the last 40 years. The FASB's objective was to improve, simplify, and enhance accounting for long duration contracts.

This guide assumes that ASU 2018-12 has been adopted.

ASC 944 *Financial Services-Insurance* (ASC 944) provides guidance on various elements of insurance transactions, focusing principally on:

- Insurance revenue recognition
- Claim and benefit liability and related expense recognition
- Acquisition cost deferability and amortization

Guidance is also provided on balance sheet and income statement presentation and disclosure of insurance activities. In addition, ASC 944 provides incremental industry-specific accounting guidance on other accounting and financial reporting matters, including certain aspects of investment contract transactions, business combinations, and derivatives.

ASC 944 includes highly-specialized accounting guidance that is applicable only to insurance entities, as defined. The insurance contract accounting guidance within ASC 944 applies to those written (issued) contracts qualifying as insurance as well as assumed reinsurance contracts and purchased reinsurance contracts.

This chapter provides an overview of:

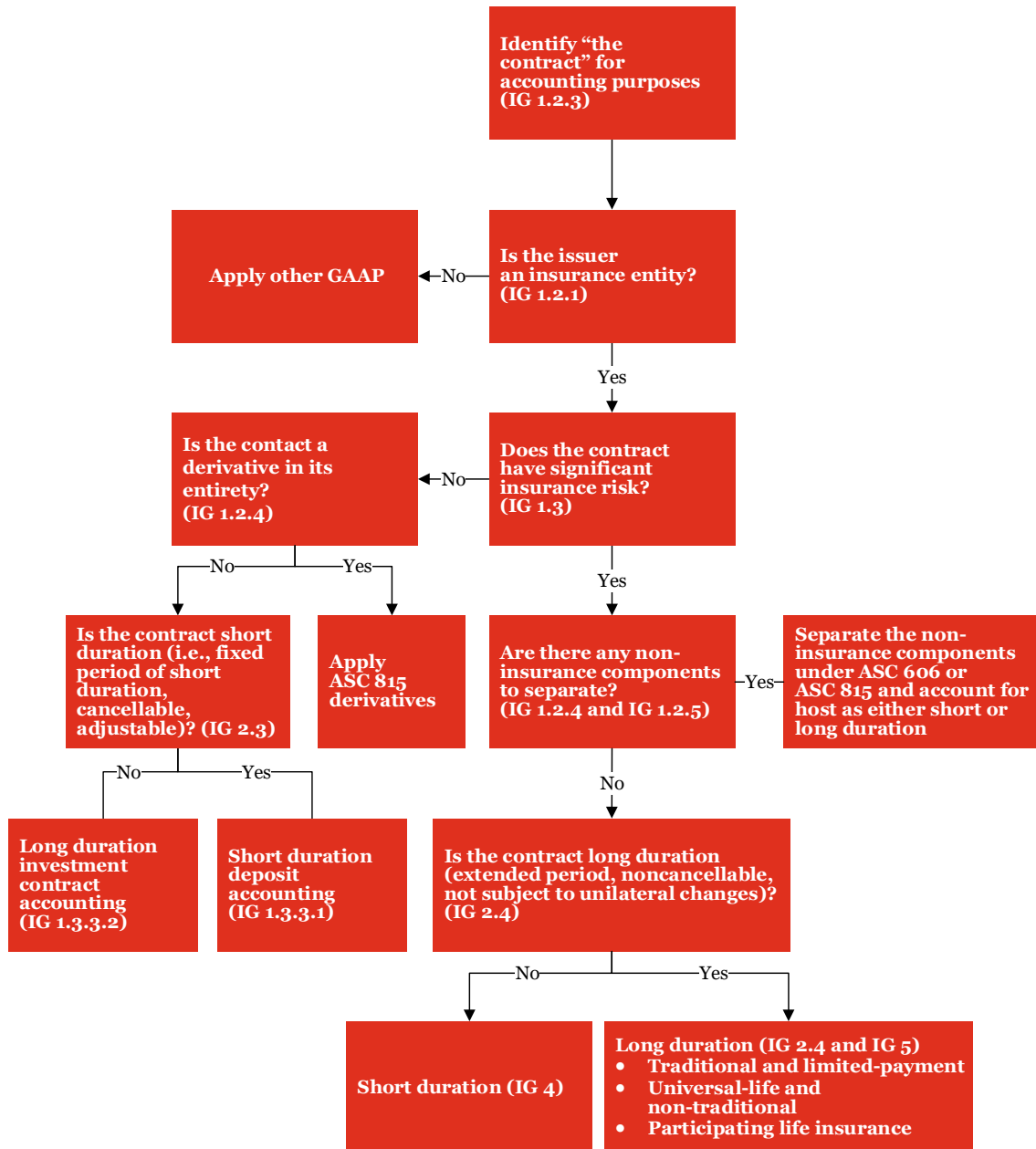
- The types of entities that are subject to the scope of ASC 944
- The types of transactions that are subject to the scope of ASC 944 either partially or totally
- The insurance risk analysis that determines whether a issued contract is subject to insurance (or reinsurance) accounting under ASC 944

1.2 Scope of ASC 944 guidance

Figure IG 1-1 illustrates the contract classification assessment for insurance contracts other than financial guarantee, mortgage insurance, and title insurance.

Figure IG 1-1

Contract classification assessment for insurance contracts



1.2.1 Entities subject to ASC 944

The accounting in ASC 944 is industry-specific guidance, meaning that the guidance is applicable only to insurance entities as defined in ASC 944-10-15. Evidence that an entity is an insurance entity may include that it:

- Holds an insurance license
- Is subject to reporting requirements with insurance regulators

- Reflects its insurance mission in its purpose statements and prospectuses filings
- Is subject to SEC Regulation S-X: Financial statement requirements: Article 7 – Insurance companies

Entities to which various subsections of ASC 944 apply include:

- Life and health insurance entities (stock and mutual entities)
- Property and liability (or “property/casualty”) insurance entities (stock and mutual entities)
- Title insurance entities
- Assessment entities
- Fraternal benefit societies
- Mortgage guaranty insurance entities
- Financial guaranty insurance entities
- Pools other than public-entity risk pools
- Syndicates
- Captive insurance entities
- Reinsurance entities
- Reciprocal exchanges or inter-insurance exchanges

1.2.2 Contracts subject to ASC 944

The purpose of insurance is to provide indemnification against loss or liability from specified events and circumstances that may occur or be discovered during a specified period. The insurer provides this protection to the policyholder in exchange for a premium.

Contracts qualify as insurance (or reinsurance) for accounting purposes if they transfer significant insurance risk, as described in IG 1.3. Contracts written by insurance entities that do not transfer significant insurance risk are generally accounted for as deposits (sometimes referred to as “investment contracts” in the context of long-duration contracts), as described in IG 1.3.

Contracts that in form are insurance or reinsurance may in substance have characteristics that require them to be accounted for totally or partially under other standards, such as ASC 815, *Derivatives and Hedging*, or ASC 606, *Revenue Recognition*.

1.2.3 ASC 944 scope – unit of account

In order to assess whether “a contract” is subject to ASC 944, it is important to use the appropriate unit of account. The unit of account for scoping purposes is generally the individual contract. However, in practice, as a simplification, scoping is done by product type. If done by product type, care

should be taken to make sure contracts are similar and do not include contracts both with and without significant insurance risk.

We believe that substance should govern over form in determining “the contract” for accounting purposes. Therefore, separate contracts with the same entity or related parties that are negotiated as a package with a single commercial objective, or when the amount of consideration paid in one contract depends on the price or performance of the other, should be viewed as a single contract for scoping purposes.

For certain measurements, ASC 944 explicitly requires grouping. Examples include:

- When truing up the net premium ratio for nonparticipating, traditional, and limited payment contracts, ASC 944 prescribes that a group cannot contain contracts with different issue years, but does not provide any more specific guidance on grouping.
- When determining whether a premium deficiency should be recognized for contracts other than nonparticipating traditional and limited payment contracts, ASC 944 specifies that for purposes of the premium deficiency test, contracts be grouped consistent with the insurer’s manner of acquiring, servicing, and measuring the profitability of its insurance contracts.

See IG 5.2 for further guidance on liability for policy benefits and determination/true-up of the net premium ratio.

1.2.4 ASC 944 scope — contracts subject to derivative guidance

The derivative accounting guidance in ASC 815-10-15-13 provides a scope exception for certain insurance contracts from derivative accounting in their entirety, and careful consideration is required to assess if a contract meets the scope exception or not. The insurance contracts that have significant insurance risk would generally meet the ASC 815 insurance derivative scope exception. However, they may still contain embedded derivatives.

Certain insurance, deposit and investment contracts issued by insurance entities may also be subject to the provisions of ASC 815, because they contain features that meet the definition of an embedded derivative.

Question IG 1-1 provides an example for equity-indexed annuities where the equity-indexed return portion of the contract is generally required to be separated from the host and accounted for as an embedded derivative.

Question IG 1-1

Is an equity-indexed annuity that provides an interest crediting rate on the account balance based on the performance of an equity index (e.g. S&P 500) with a contractually-specified minimum interest crediting rate a hybrid instrument that contains an embedded derivative?

PwC response

Yes. The host is an investment contract under ASC 944 (i.e., a debt host) with multiple embedded derivatives (a contract holder prepayment option and an equity-return feature). The prepayment option would typically require payment of the contract account balance less a specified non-indexed

surrender charge to the contract holder, and thus would generally be clearly and closely related to the debt host, provided it does not contain an embedded interest rate derivative under the guidance in ASC 815-15-25-26. However, the equity option component of an equity-indexed annuity requires separate accounting under ASC 815-15-25-1.

Under ASC 815, contracts or portions of contracts identified as derivatives or embedded derivatives are required to be recorded at fair value through income. When ASC 815 requires separate fair value measurement of an embedded derivative, the remaining component of the insurance contract (the host) would be evaluated under the scope of ASC 944.

See DH 3.2.5 and DH 4.6.2 for further guidance on the scope exceptions and assessing whether embedded derivatives need to be separated. See IG 5.7 for further guidance on measurement of derivatives and embedded derivatives in insurance and investment contracts.

1.2.5 ASC 944 scope - transactions subject to revenue recognition guidance

Insurance contracts that are in the scope of ASC 944 are exempt from the ASC 606 revenue recognition guidance. Insurance entities may also execute contracts that function entirely as service contracts, with no insurance elements, such as administrative services only (ASO) contracts. Such contracts would be in the scope of ASC 606. In certain instances, a contract may be partially within the scope of ASC 606 and partially within the scope of ASC 944 or financial instrument guidance, such as a high deductible policy that also contains claims handling services.

1.3 Insurance risk assessment

Classification of an issued contract (sometimes called a direct or written contract) as insurance or reinsurance requires that the contract have significant insurance risk. Contracts that fail to meet the significant insurance risk test are required to be classified as investment contracts. Classification is done at contract inception and is typically not reevaluated unless the contract is amended.

Explicit guidance on analyzing significant insurance risk in issued contracts is limited, but high-level guidance is found in the following references.

ASC 944-20-05-5

The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period.

ASC 944-20-05-6

Insurance contracts may be characterized generally by both of the following:

- a. the purchaser of an insurance contract makes an initial payment or deposit to the insurance entity in advance of the possible occurrence or discovery of the insured event.
- b. when the insurance contract is made, the insurance entity ordinarily does not know if, how much, or when amounts will be paid under the contract.

ASC 450-20-60-14

For contingencies related to an insurance contract or reinsurance contract that does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, see paragraph 720-20-25-1.

ASC 720-20-25-1

To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding entity by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding entity. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding entity is a deposit, it shall be accounted for as such.

Further guidance on the evaluation of insurance risk for short-duration and long-duration contracts is described below.

Risk transfer guidance for evaluating reinsurance ceded to an assuming reinsurer is more prescriptive and is discussed in IG 8.5 and IG 9.5.

1.3.1 Short-duration insurance risk assessment

The glossary in ASC 944-20-20 defines insurance risk and related terms.

Definition from ASC 944-20-20

Insurance risk: The risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

Underwriting risk: The risk arising from uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

Timing risk: The risk arising from uncertainties about the timing of the receipt and payments of the net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

Guidance on what constitutes insurance risk for direct insurance contracts written between insurers and policyholders is limited to the definitions in ASC 944-20-20. These general concepts apply to insurance contracts as well as to reinsurance contracts written between insurers and reinsurers.

In addition, more explicit, qualitative and quantitative risk transfer criteria exist for short-duration reinsurance contracts as the cash flows of a single reinsurance contract combine the gains and losses of numerous issued insurance contracts, which may be highly predictable in total (see IG 8.5). For example, in order for a reinsurance contract to pass the risk transfer test, there generally must be a reasonable possibility that the reinsurer will recognize a significant loss on the transaction. This evaluation is made by comparing all cash flows between the parties with the amounts paid or deemed to have been paid to the reinsurer.

Because there is limited guidance on risk transfer for direct contracts, the guidance on reinsurance risk transfer may be used by analogy. The ASC 720, *Other Expenses*, guidance on the accounting for insurance contracts by policyholders acknowledges the concept of risk transfer and notes that entities may find the conditions outlined in ASC 944 for reinsurance useful in assessing whether an insurance contract transfers risk.

1.3.2 Long-duration insurance risk assessment

Insurance risk for long-duration life insurance and annuity contracts focuses on the significance of mortality or morbidity risk (ASC 944-20-15). Mortality risk relates to the obligation to make payments that are contingent upon the death or continued survival of a specific individual or group. Morbidity risk relates to the relative incidence of disability due to disease or physical impairment.

An annuity contract that allows the holder to purchase an annuity at a guaranteed price on the settlement of the contract does not contain mortality risk until the annuity is purchased.

Annuity contracts may require an insurance company to make a number of payments that are not contingent on the survival of the beneficiary followed by life contingent payments. These contracts are considered insurance contracts unless:

- a) the probability that the life contingent payments are made is remote, and
- b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant.

If the mortality and morbidity risk in a long-duration life insurance or annuity contract is other than nominal, the contract should be classified as insurance. Nominal risk is defined as a risk of insignificant amount or remote probability. If nominal, the contract is classified as an investment contract.

There is a rebuttable presumption that a contract has significant mortality risk if a mortality benefit would vary significantly in response to capital markets volatility (see ASC 944-20-15-21). These contract features with other-than-nominal capital market risk need to be assessed to see if they meet the definition of a market risk benefit or an embedded derivative and are required to be accounted for at fair value. See IG 2.4.5 and DH 4.6.2, respectively, for more information.

The risk transfer analysis for long duration reinsurance requires that there be a reasonable possibility of significant loss to the reinsurer from the events insured by the underlying direct insurance contracts (see IG 9.5). The analysis of significant mortality or morbidity risk is the same as the criteria for direct contracts.

1.3.3 Contracts that fail the significant insurance risk criteria

Contracts that are written as insurance or reinsurance but fail the significant insurance risk test are accounted for as deposits. The accounting for the deposit depends on whether the contract is short duration or long duration.

1.3.3.1 Short-duration contracts without significant insurance risk

At inception, a deposit asset or liability is recognized based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract.

Deposit contracts that lack underwriting risk follow a financial instrument effective yield model, with the effective yield being a function of the deposit and future projected cash flows. Those contracts that have underwriting risk, but lack timing risk, require a discounted claim estimation measurement. For contracts with indeterminate risk, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums.

See IG 8.7 for further discussion on the accounting models for short-duration contracts that fail the risk transfer criteria.

1.3.3.2 Long-duration contracts without significant insurance risk

Long-duration life and health contracts that do not indemnify against mortality or morbidity risk are required to be accounted for as investment contracts. As noted in IG 2.5.1, deferred annuity contracts issued by insurers are typically classified as investment contracts during the accumulation phase. However, they may have longevity risk and thus ultimately be classified as an insurance contract if and when the contract holder elects life-contingent payments in the annuitization phase of the contract.

Any payments received for investment contracts are reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments. While investment contract liabilities are accounted for as deposits, some of the provisions within ASC 944 nevertheless apply to investment contracts. Examples include the guidance on deferred acquisition costs, contract modifications, separate accounts, and valuing annuitization benefit options during the accumulation phase of the contract.

See IG 5.5 for further discussion on the accounting for investment contracts issued by a direct insurer. See IG 9.4 for further discussion on deposit accounting for life reinsurance contracts that fail risk transfer.

1.4 FASB guidance for insurance contracts

In addition to the guidance in ASC 944, the FASB published a non-authoritative document entitled, *A Primer on Accounting Models for Long-Duration Life Insurance Contracts under US GAAP*, which discusses the accounting models that govern financial reporting of long-duration life insurance contracts under GAAP. Like all primers, it is neither comprehensive in scope nor complete in detail. Instead, it is an introduction to the three GAAP accounting models that are used by life insurance enterprises.

ASC 815, *Derivatives and Hedging*, provides guidance on the accounting for derivative financial instruments and accounting for hedging activities. Certain contracts issued by insurance companies may be subject to the provisions of ASC 815.

Figure IG 1-2 lists the paragraphs within ASC 815 that relate specifically to insurance products.

Figure IG 1-2
ASC 815 paragraphs related to insurance products

Codification reference	Insurance product
ASC 815-10-05-8 through ASC 815-10-05-15	Synthetic Guaranteed Investment Contracts
ASC 815-10-55-32 through ASC 815-10-55-36	Dual-Trigger Financial Guarantee Contracts
ASC 815-10-55-37 through ASC 815-10-55-40, ASC 815-10-55-132 through ASC 815-10-55-134, and ASC 815-15-55-12	Certain Insurance Contracts - Dual-Trigger Property and Casualty Insurance Contracts
ASC 815-15-55-1 through ASC 815-15-55-4	Features Involving Certain Currencies - Certain Insurance Contracts
ASC 815-15-55-58	Payment Alternatives for Variable Annuity Contracts
ASC 815-15-55-62 through ASC 815-15-55-72 and ASC 815-15-55-227 through ASC 815-15-55-238	Equity-Indexed Annuity Contracts
ASC 815-15-55-101 through 55-109	Equity-Indexed Life Insurance Contracts
ASC 815-15-55-101 through 55-109	Clearly and Closely Related Criterion - Credit-Sensitive Payments, Embedded Credit Derivatives (including guidance on reinsurer's receivable arising from a modified coinsurance arrangement)
ASC 815-15-55-120 through 55-127	Clearly and Closely Related Criterion - Market Adjusted Value Prepayment Options

ASC 944-815, *Derivatives and Hedging*, includes guidance on some specific issues relating to derivatives and insurance contracts.

ASC 950-350, *Financial Services - Title Plant*, established standards for costs associated with title insurance enterprises, title abstract enterprises, and title agents that use title plant in their operations.

1.5 AICPA guidance for insurance contracts

The AICPA has published industry-specific non-authoritative guidance as follows:

Industry Audit Guides:

- Audits of Property and Liability Insurance Companies
- Audits of Life and Health Insurance Entities

- Audits of Investment Companies (applicable to the financial statements of certain separate accounts)

Technical Practice Aid:

- AICPA Technical Questions and Answers Section 6300, *Insurance Companies*, provides guidance in a question-and-answer format for various accounting and reporting questions related to insurance company financial statements.

1.6 **SEC guidance for insurance contracts**

The SEC has issued various guides, regulations, and policies applicable to insurance enterprises that are public business entities, including:

- Regulation S-X Article 7, *Insurance Companies*, which provides rules for the form and content of insurance company financial statements filed with the SEC.
- SAB Topic 5.N, *Discounting by Property-Liability Insurance Companies (SAB 62)*, which states the SEC staff's position that discounting certain unpaid claims liabilities for short-duration contracts is acceptable in certain circumstances.
- SAB Topic 5.W, *Contingency Disclosures Regarding Property-Casualty Reserves for Unpaid Claim Costs (SAB 87)*, which documents the SEC staff's position that contingency disclosures concerning property/casualty reserves are usually not necessary for the general uncertainties inherent in the reserve estimation process, but that these disclosures are necessary in situations involving specific uncertainties.
- SEC FRP 403, *Insurance Companies*, which includes SEC policies on the following financial statement disclosure requirements:
 - Consolidation and supplementary segment disclosures
 - Statutory accounting and applicability to Mutual Life Insurance Companies
 - Investment disclosures
 - Reserves for unpaid claims and claim adjustment expenses of property and casualty underwriters
- S-K 801 and S-K 802, *Industry Guides*, which require disclosures contained in SEC Industry Guide 6 and Guide 4 - *Disclosures concerning unpaid claims and claim adjustment expenses of property/casualty underwriters*. In addition, the SEC staff has required insurance company registrants to make the disclosures required by SEC Industry Guide 3 - *Statistical disclosure by bank holding companies - section III - Loan Portfolio*, concerning the mortgage loan portfolio of the registrant. Revisions to Guide 3 are being considered by the SEC staff; one of the revisions being considered would make the Guide applicable to all companies with significant involvement in lending and investing activities.
- SEC Financial Reporting Manual, *Section 2010.6*, which provides considerations related to acquisitions of blocks of insurance policies representing the acquisition of a business.

1.7 ***National Association of Insurance Commissioners guidance***

Regulatory reporting by insurance companies follows statutory accounting principles ("statutory" or "SAP"). The National Association of Insurance Commissioners (NAIC) provides the following publications to assist in preparing and filing the statutory Annual Statements:

- NAIC Accounting Practices and Procedures Manual
- NAIC Annual Statement Instructions for Life, Accident and Health Insurance Companies
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Health Entities
- NAIC Annual Statement Instructions for Title Insurers
- NAIC Annual Statement Instructions for Fraternal Benefit Companies
- NAIC Financial Examiners' Handbook
- Purposes and Procedures Manual of the NAIC's Securities Valuation Office
- States' Prescribed Differences from NAIC Statutory Accounting Principles

The accounting practices and procedures promulgated by the NAIC are subject to specific state regulation, rulings, and guidance.

All states have adopted the NAIC Accounting Practices and Procedures Manual ("the Manual"); however, most states have adopted laws and regulations that conflict with some provisions of the Manual. See the NAIC publication, *States' Prescribed Differences from NAIC Statutory Accounting Principles*, for discussion of state-specific variances.

***Chapter 2:
Classification of insurance
contracts—updated November
2021***

2.1 Classification of insurance contracts – overview

Insurance contracts are generally classified as either short duration or long duration. The distinction is based on the period of time of the insurance protection and the flexibility each party has in changing the terms of the contract. The classification, as well as other characteristics, has a significant effect on the accounting for a contract.

2.2 Scope and relevant guidance for insurance contracts

ASC 944-20, *Insurance Activities*, provides accounting models for different types of insurance contracts as well as investment contracts that have no significant insurance risk. ASC 825-10 allows a fair value measurement option to be elected instead of the ASC 944 measurement for insurance contracts. This option is an instrument-by-instrument election and may only be made at the time the contract is entered into. See FV 5.3 for discussion of fair value measurements.

2.3 Short-duration insurance – classification and measurement

A short-duration contract provides insurance coverage for a fixed period of short duration. The contract may have a specified term, such as one year. Alternatively, the term may not be specified, but may enable the insurer at the end of a specified period to cancel the contract or adjust the provisions of the contract, such as the amount of premiums or coverage provided, for future insured events. Typically, short-duration contracts would not have a duration of more than 3 to 5 years.

Under the short-duration insurance accounting model:

- Premiums are recognized as revenue over the coverage period in proportion to the amount of insurance protection provided, which in many cases is on a straight-line basis.
- Losses are recognized when insured events occur, based on the estimated ultimate cost to settle the claims, and are adjusted to reflect changes in estimates during the life of the contract.
- Eligible deferred acquisition costs are capitalized and amortized in proportion to premium revenue recognized.
- Cash flows from premiums and claims are included in cash flow from operations.

Short-duration contracts may contain embedded derivatives, which could require bifurcation under ASC 815, as described more fully in DH 4.6.2.

Most property and liability insurance contracts are short-duration contracts. Examples include homeowners, automobile, commercial property, workers' compensation, general liability, professional liability, and accident and health insurance. Life insurers may write certain types of coverages that are classified as short duration, such as group life, group long-term disability, and group short-term disability products.

See IG 4 for further information on the short-duration insurance contract accounting model.

2.4 Long-duration contracts – classification and measurement

A long-duration contract is one that is not subject to unilateral changes in its provisions and requires the performance of various functions and services (including insurance protection) for an extended period. Examples include contracts that are noncancelable or guaranteed renewable by the insurer, such as most life insurance and annuity contracts.

Long-duration contracts are further classified into several broad categories based on the product terms. These categories dictate the accounting model to be followed for revenue and cost recognition. These categories are discussed in the sections that follow.

Figure IG 2-1 provides a framework for determining the accounting classification for long-duration contracts.

Figure IG 2-1
Classification of long-duration life insurance contracts

Figure IG 2-1 Part 1

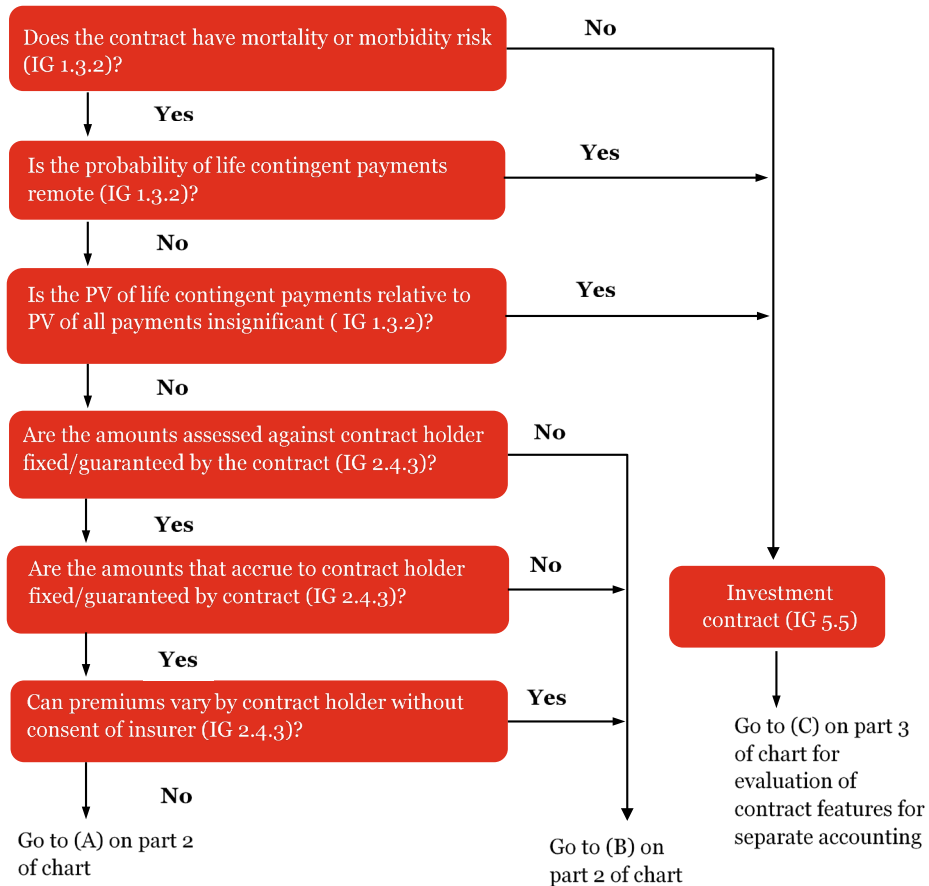
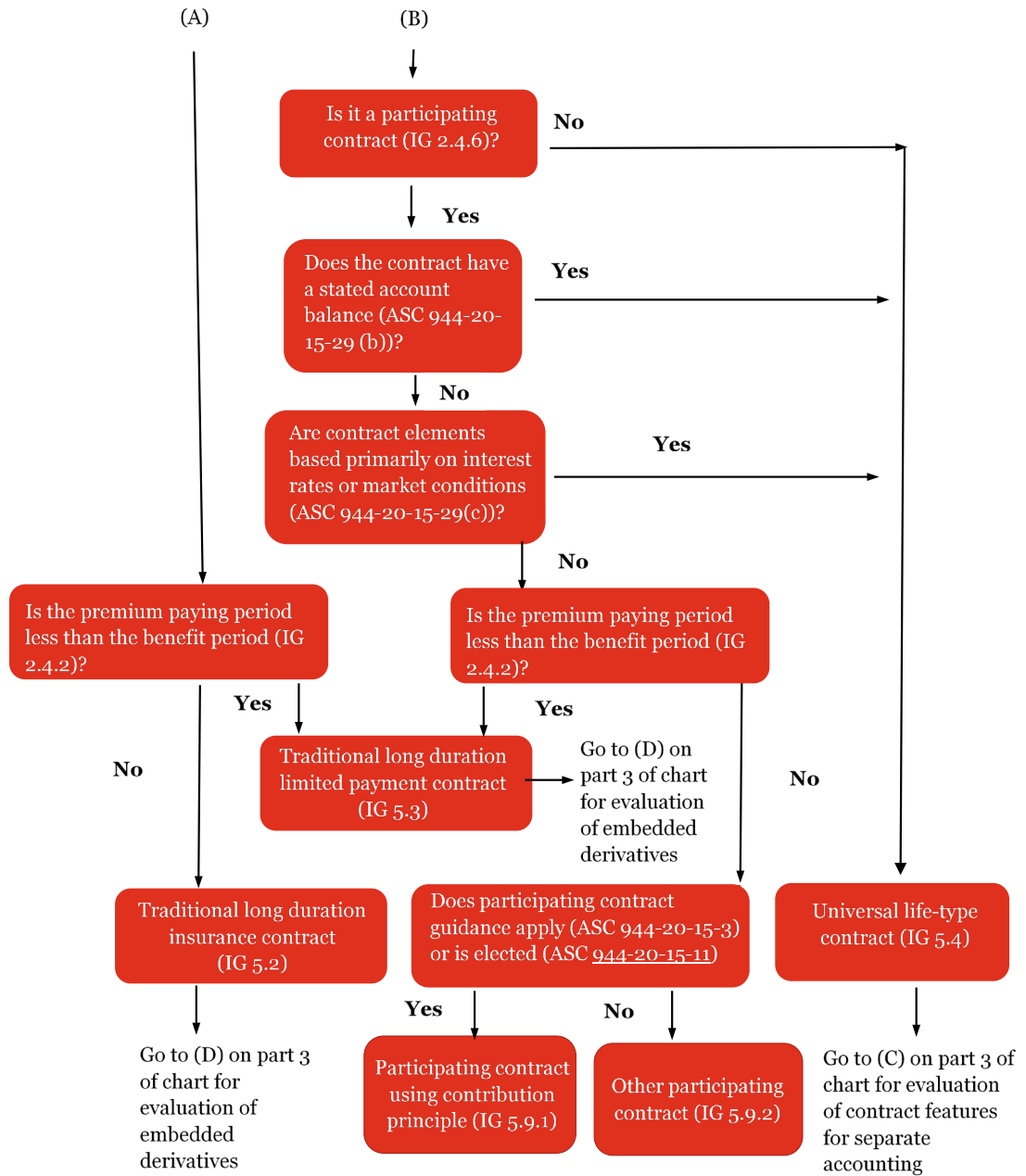
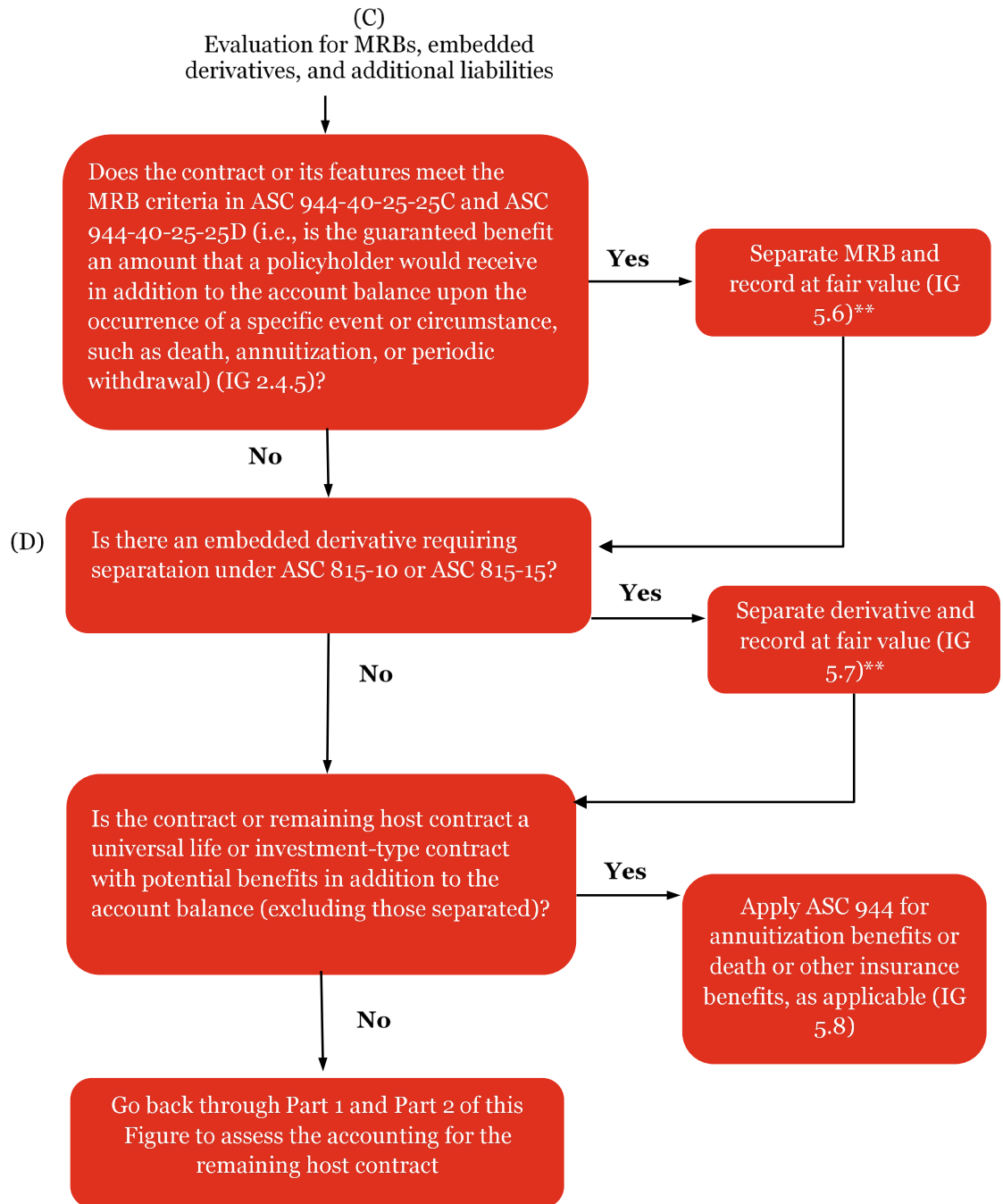


Figure IG 2-1 Part 2



* These contracts do not use the contribution principle and therefore follow the traditional long duration model and specific dividend guidance per IG 5.9.2

Figure IG 2-1 Part 3



**Upon separating features from a universal life contract, an entity should reassess mortality and morbidity risk (i.e., if no risk remains, the host contract is an investment contract)

2.4.1 Traditional long-duration insurance – classification and measurement

These contracts provide a specified, fixed amount of insurance benefit in exchange for a fixed premium, either upfront, for a fixed number of payments, or payable each year the policy is kept in force. Examples include whole-life insurance, guaranteed renewable term-life insurance and long-term disability insurance. See IG 5.2 for measurement guidance relating to traditional long-duration insurance contracts.

Under the traditional long-duration accounting model:

- Premium revenue is recognized when due.
- A liability for future policyholder benefits is recorded as the present value of estimated future policy benefits and related expenses less the present value of estimated future net premiums. As a result, expected insurance benefits (i.e., estimated future death, disability, or other claims and any surrender benefits) are accrued over the life of the contract in proportion to premium revenue recognized. This method is referred to as the “net premium ratio” approach.
- Eligible deferred acquisition costs are capitalized and amortized to expense each period on a straight-line basis over the expected term of the related contract (see IG 3).
- All assumptions (except for the expense assumptions) utilized in the “net premium ratio” approach, including mortality, morbidity, and terminations, are required to be reviewed (and updated as necessary) on an annual basis or more frequently if evidence suggests that assumptions should be revised. The updated cash flows used in the calculation are discounted using the discount rate or curve on the original contract issue date (the locked in discount rate). The revised net premium ratio is used to measure benefit expense based on recognized premium revenue in the period. The difference between the updated opening period and previous ending period liabilities due to updating the net premium ratio is presented as a remeasurement gain or loss (cumulative catch-up adjustment) in current earnings.
- A remeasurement of the liability is also required using a current discount rate. The difference between the ending period liability measured using the discount rate on the original contract issue date and the liability measured using the current rate is recorded in accumulated other comprehensive income.
- All premium and claim cash flows are classified as operating cash flows in the statement of cash flows.

2.4.2 Traditional limited-payment – classification and measurement

Traditional long-duration limited-payment contracts provide a specified, fixed amount of insurance benefit that extends beyond the period or periods in which premiums are collected. Fees assessed are also fixed or guaranteed. Examples include single pay life insurance and a life-contingent payout annuity. A life contingent payout annuity promises to pay a stream of fixed or variable periodic payments for the life of the insured (annuitant) that ends upon the death of the annuitant. See IG 5.2 long duration contract liabilities for measurement guidance related to limited-payment contracts.

- Under the traditional “limited pay” accounting model, premium revenue is recognized when due. Gross premium received in excess of the net premium is deferred (sometimes referred to as a

“deferred profit liability” or “DPL” and amortized in relation to the discounted amount of insurance in force (for life insurance) or expected future benefit payments (for annuity contracts).

- Expected insurance benefits are accrued as a liability for future policyholder benefits.
- Eligible deferred acquisition costs are capitalized and amortized to expense each period on a straight-line basis over the expected term of the related contract.
- All premium and claim cash flows are classified as operating cash flows in the statement of cash flows.

2.4.3 Universal life-type contracts – classification and measurement

Universal life-type contracts have charges or provide benefits that are not fixed and guaranteed. ASC 944-20-15-26 describes universal life-type contracts.

ASC 944-20-15-26

For purposes of the scope application of the Long-Duration Subsections of this Subtopic, universal life-type contracts include contracts that provide either death or annuity benefits and are characterized by any of the following features:

- a. One or more of the amounts assessed by the insurer against the policyholder, including amounts assessed for mortality coverage, contract administration, initiation, or surrender, are not fixed and guaranteed by the terms of the contract.
- b. Amounts that accrue to the benefit of the policyholder, including interest accrued to policyholder balances, are not fixed and guaranteed by the terms of the contract.
- c. Premiums may be varied by the policyholder within contract limits and without consent of the insurer.

If the mortality or morbidity risks are other than nominal, the fees assessed for insurance benefits and the amounts that accrue to the policyholder are not fixed and guaranteed, and the premiums vary within contract limits and without the consent of the insurer, then the contract should be classified as a long-duration universal life-type contract.

According to ASC 944-20-15-12, contracts providing insurance benefits other than death or annuity benefits, such as disability benefits, but that meet one of the three criteria in ASC 944-20-15-26, should also be accounted for under the universal life-type model. In addition, ASC 944-20-15-27 through ASC 944-20-15-30 note that certain types of contracts that in form are “participating contracts” may be considered universal-life type contracts.

A principal component of most universal life-type contracts is an account balance on which interest is credited to policyholders and from which assessments are deducted for mortality (or other insurance) risk and contract administration. In the absence of a stated account balance or a similar explicit or implicit contract value, the cash surrender value measured as of the balance sheet date should be accrued. However, in the event it is determined that only the cash surrender value should be accrued, it may be appropriate to reconsider the product classification. Generally, a significant and flexible

investment component is incorporated into each universal life-type product, and it is unlikely that a universal life-type policy could function without maintaining at least an implicit account balance.

Under the universal life-type accounting model:

- Revenue consists of mortality (or other insurance) fees and contract administration assessments and is recognized when due. Premiums are considered deposits and not recognized as revenue.
- Fees and assessments collected in advance of the service rendered are deferred and recognized over the periods benefited.
- The account balance is recognized as a liability. The liability is updated each period for fee and assessment deductions and increased for interest or returns credited to the account balance. Persistency bonuses are accrued as a liability over the period preceding the bonus crediting.
- Insurance benefits (e.g., death or surrender benefits) in excess of the account balance are generally recognized as expenses in the period incurred unless the design of the product is such that future charges are insufficient to cover the benefits, in which case an additional liability is accrued over the life of the contract.
- Eligible deferred acquisition costs are capitalized and amortized to expense each period on a straight-line basis over the expected term of the related contracts.
- Premiums deposited and withdrawals are classified as financing cash flows in the statement of cash flows. There is diversity in practice in how interest credited is presented in the statement of cash flows; it may be presented as either operating or financing. Excess payments upon death are treated as operating cash outflows.

These contracts sometimes include market risk benefits and embedded derivatives that require bifurcation and fair value accounting either under ASC 944 or under ASC 815, respectively, as described more fully in IG 5.6 and IG 5.7. Guidance related to accounting and reporting by insurance enterprises for certain nontraditional long-duration contracts and for separate accounts is provided in the universal life-type contracts and nontraditional contract benefits subsections of ASC 944-40-25 (see IG 5.8).

2.4.4 Variable contracts– classification

Variable contracts with significant insurance risk are considered universal life contracts under ASC 944 and use the accounting model described in IG 2.4.3. The contract holder's payments (deposits) are credited to a policyholder account balance. The contract holder directs the allocation of the account value among various investment alternatives which can include separate or general account options. The policyholder account balance is credited with the results of the investment return on their selected investment allocations, which depending on the selection may be positive or negative as the amount of investment risk the policyholder bears varies with the allocation chosen. The contract may be surrendered for the current account balance (typically less a surrender charge). After a specified period of time, the policyholder may elect to apply the account balance to purchase a payout annuity, which is treated as a separate contract at the annuity purchase date.

For most of the investment options offered in a variable contract, in order to hedge and keep track of the investment returns owed to the policyholder, the insurance company invests in investment

alternatives selected by the policyholder using a separate account structure. A separate account is a separate investment account established and maintained within an insurance entity under specific state insurance laws and regulations. Its assets are recorded as “separate account assets” in an insurer’s balance sheet as they are owned by the insurance company.

2.4.4.1 Insurance company separate account – classification—updated May 2022

Separate accounts are generally established by life insurance companies to fund individual and group contracts. A separate account is an investment account established and maintained by an insurance entity under relevant state insurance law to which funds have been allocated for certain contracts of the insurance entity, typically at the direction of the contract holder. The insurance company will usually establish several separate accounts, each of which can have different investment objectives. Separate accounts are similar to mutual funds, however, unlike mutual funds, the separate account assets are legally owned by the insurance company. Consequently, the separate account assets are recorded on the balance sheet of the insurance company.

Separate accounts have to meet the specified criteria in ASC 944-80-25-2 in order to apply the separate account model as described in ASC 944-80-25-3. These criteria include being insulated legally from the insurer’s general account liabilities and passing all investment performance through to the contract holder. If these criteria are met, the separate account model can be applied, which includes the following:

- Separate account assets are measured at fair value through income and reported as a summary total, with an equivalent summary total reported for separate account liabilities.
- Related investment performance and the corresponding amounts credited to the contract holder are offset in the same line in the statement of operations, netting to zero.

Insurance entities should not combine separate account and general account interests in the same investment when assessing consolidation of that investment, unless the separate account interests are held for the benefit of a related party policyholder as described in ASC 944-80-25-3f. In addition, specialized investment company accounting regarding consolidation should be applied to the separate account. Therefore, an insurer is not required to consolidate an investment in which a separate account holds a controlling financial interest if the investment is not or would not be consolidated in the standalone financial statements of the separate account.

ASC 944-80-25 also provides guidance on accounting for the portion of the separate account not allocated to contract holders, which is often referred to as “seed money.” The guidance requires that the proportionate interest in the separate account be accounted for in a manner consistent with similar assets held by the general account (i.e., by “looking through” the separate account to the underlying assets). If the interest in the separate account is less than 20%, and the underlying investments of the separate account meet the definition of securities under ASC 320-10 or ASC 321-10, the portion of the separate account value may be reported as an investment in equity securities.

Insurance companies prepare and issue standalone GAAP separate account financial statements which are subject to the guidance applicable to investment companies in ASC 946. See the AICPA Audit and Accounting Guide for Investment Companies for guidance. Key elements of these financial statements include disclosure of the individual invested assets held at year end, and investment performance for the year measured in terms of the change in contract holder unit values. Some separate account

financial statements may include a significant amount of investments that are not publicly traded and have no readily determinable current market value.

2.4.4.2 Variable contracts with guarantees – classification

Many variable contracts have been enhanced to offer protection against the downside risk borne by contract holders from the selected investment alternatives. The amount of protection provided and the triggers for payment of the additional “guaranteed minimum benefit” (GMXB) vary and may be offered in different combinations.

Some GMXBs may provide that the policyholder benefits will not be less than the amount of deposits less withdrawals. Other GMXBs provide for a specified rate of return on that amount (often referred to as a “roll up”). Still others provide that the amount will be equal to a specified anniversary date value (often referred to as a “reset”) or the highest anniversary value (often referred to as a “ratchet”).

GMXBs may be paid to contract holders or their beneficiaries based upon different events:

- Guaranteed minimum death benefit (GMDB): provides the beneficiary a guaranteed minimum amount upon the death of the contract holder, regardless of the available account balance
- Guaranteed minimum income benefit (GMIB): provides the contract holder a guaranteed minimum amount available to annuitize, regardless of the available account balance
- Guaranteed minimum accumulation benefit (GMAB): provides the contract holder a guaranteed minimum amount of account balance at the end of a specified period, regardless of the available account balance
- Guaranteed minimum withdrawal benefit (GMWB): provides the contract holder a specified percentage of a guaranteed minimum amount that can be withdrawn annually until that guaranteed amount is depleted, regardless of the available account balance
- Guaranteed minimum withdrawal benefit for life (GMWBL): provides the contract holder a specified percentage of a guaranteed minimum amount that can be withdrawn annually for life, regardless of the available account balance

These GMXB features typically are market risk benefits that require fair value accounting under ASC 944. However, see IG 2.4.5 for discussion of the exception for insurance benefits in universal life-type contracts, and see IG 2.4.5 for discussion of the assessment of whether other-than-nominal capital market risk exists. IG 2.4.5 also provides further guidance on initial and subsequent measurements of market risk benefits in insurance and investment contracts.

2.4.5 Classification of market risk benefits

The market risk benefit (MRB) is an amount that a policyholder receives in addition to the account balance upon the occurrence of a specific event or circumstance, such as death, annuitization, or periodic withdrawal that involves protection from capital market risk.

ASC 944-40-25-25C introduces the term MRB.

ASC 944-40-25-25C

A contract or contract feature that both provides protection to the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk shall be recognized as a market risk benefit.

Features that meet the definition of MRBs are accounted for at fair value. The portion of the fair value change attributable to a change in the instrument-specific credit risk of the written MRB is recognized in other comprehensive income and not in net income. MRB balances and changes in their measurement are presented separately in the statement of financial position and the statement of operations.

Market risk benefits can be present in variable and fixed annuity contracts and in certain life insurance contracts. ASC 944-40-25-25D (b) notes that an MRB does not include the death benefit component of a life insurance contract (i.e., the difference between the account balance and the death benefit amount). However, an MRB may be present in a life insurance contract if it provides for protection from capital market risk for other benefits, for example, a GMAB or GMWB on a variable universal life insurance contract. MRBs may also be present in universal life insurance contracts that provide for an option to settle the contract upon surrender or death with an annuity determined using guaranteed fixed interest rates.

As noted in IG 2.4.4.2 MRB features in contracts include GMXBs, such as GMDBs and GMIBs in annuity contracts, which were previously accounted for under a model that recognizes the cost of these features over the life of the contracts. MRB features also include GMABs and GMWBs previously accounted for as embedded derivatives, as well as GMWB for life benefits, for which there was previously diversity in accounting practice. For variable annuity contracts, the host contract will be measured excluding the separated features (including MRBs and any embedded derivatives) and may be further separated into different accounting units consistent with where the policyholder elected the funds to be invested (the separate accounts or the fixed account).

ASC 944-40-25-25D further establishes what is an MRB.

ASC 944-40-25-25D

In evaluating whether a contract or contract feature meets the conditions in paragraph 944-40-25-25C, an insurance entity should consider that:

- a. Protection refers to the transfer of a loss in, or shortfall (that is, the difference between the account balance and the benefit amount) of, the contract holder's account balance from the contract holder to the insurance entity, with such transfer exposing the insurance entity to capital market risk that would otherwise have been borne by the contract holder (or beneficiary).
- b. Protection does not include the death benefit component of a life insurance contract (that is, the difference between the account balance and the death benefit amount). This condition does not apply to an investment contract or an annuity contract (including an annuity contract classified as an insurance contract).

- c. A nominal risk, as explained in paragraph 944-20-15-21, is a risk of insignificant amount or a risk that has a remote probability of occurring. A market risk benefit is presumed to expose the insurance entity to other-than-nominal capital market risk if the benefit would vary more than an insignificant amount in response to capital market volatility.

ASC 944-40-25-25D(a) notes that protection refers to the transfer of a loss in, or shortfall of, the contract holder's account balance and clarifies that "loss in, or shortfall of" is the difference between the account balance and the benefit amount. Despite the connotation of "loss in, or shortfall of" as protecting against a loss to the account balance, the consideration in ASC 944-40-25-25D(a) should include any difference between the account balance and the guaranteed benefit amount. The guaranteed benefit is an amount that a policyholder would receive in addition to the account balance upon the occurrence of a specific event or circumstance, such as death, annuitization, or periodic withdrawal. For example, a fixed-indexed annuity product that has a guaranteed minimum death benefit that pays a return that is two times the investment returns credited to the account balance is deemed to be providing "protection" to the policyholder's account balance even though the account balance may not have incurred an investment loss.

The "death benefit component of a life insurance contract" exclusion in ASC 944-40-25-25D(b) is referencing the legal policy form of the contract (i.e., a life insurance contract rather than an annuity contract). It is not focusing on the accounting classification of the contract under ASC 944 (i.e., insurance contract or an investment contract). As such, the death benefit components of traditional universal life and variable life products are not considered MRBs.

Question IG 2-1 addresses whether health or disability riders on universal life contracts need to be assessed under the MRB guidance.

Question IG 2-1

Are other insurance benefits on life insurance contracts, such as health or disability riders, required to be assessed under the MRB guidance?

PwC response

No. The death benefit exception in ASC 944-40-25-25D(b) explicitly refers to the legal policy form of the contract (i.e., a life insurance contract rather than an annuity contract) and explicitly states that the exception does not apply to an investment or annuity contract. While the exception does not explicitly include or exclude other types of insurance benefits, ASC 944-20-15-12 states that "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 a result, consistent with the death benefit exception, disability and health benefits features on universal life contracts are not required to be assessed under the MRB guidance.

A contract or contract feature is presumed to have other-than-nominal capital market risk if the cash flows related to the contract or contract feature will vary significantly in response to capital market volatility. Nominal risk is defined in ASC 944-20-15-21 as a "risk of insignificant amount or remote probability" of occurring. The FASB's master glossary notes that capital market risk includes price, interest rate, and foreign exchange risk.

Question IG 2-2, Question IG 2-3, Question IG 2-4, Question IG 2-5, and Question IG 2-6 address the assessment of whether other-than-nominal capital market risk exists.

Question IG 2-2

When assessing for the existence of MRBs in a contract with multiple investment options (e.g., general account vs. separate account options), is the assessment performed before or after allocating the hybrid contract into discrete units of measurement based on the selected investment options?

PwC response

The assessment of the existence of an MRB is made at the contract level, before allocating the contract to its separate account and general account units of measurement.

Question IG 2-3

Is the assessment of whether MRBs exist performed at inception of a contract only, or may the conclusion be reassessed in future periods (e.g., if market conditions were to deteriorate)?

PwC response

The assessment can only be performed at initial recognition of the contract. ASC 944-40-25-25B(a), which addresses recognition of market risk benefits, states “An insurance entity shall first determine at contract inception whether such benefits should be accounted for under the provisions of paragraph 944-40-25-25C.”

Question IG 2-4

Should a policyholder’s ability to transfer funds between investment options or deposit new funds into their account balance be considered in the assessment of whether an MRB exists?

PwC response

Yes. In order to determine whether an other-than-nominal capital market risk exists, an entity must project the cash flows related to the contract or contract feature and assess the significance of the potential guaranteed payments compared to the account balance. Therefore, an entity should consider all contractual cash flows of the feature being assessed, including transfers or future deposits, in its determination of whether an MRB exists.

Question IG 2-5

Can probability of economic scenarios be considered in overcoming the presumption that a contract or contract feature has other-than-nominal capital market risk?

PwC response

Yes. As discussed above, nominal risk is defined as a risk of insignificant amount or remote probability of occurring. A full range of capital market scenarios should be considered in determining whether the insurance entity is subject to and the contract holder is protected from other-than-nominal capital

market risk, but may exclude certain capital market scenarios that have a remote probability of occurring. Entities should first determine whether significant losses exist within any of the economic scenarios. If no significant losses exist in any economic scenarios, the capital market risk would likely be deemed to be nominal (i.e., not an MRB). If significant losses exist, but only in economic scenarios that have a remote likelihood of occurring (e.g., in the tail scenarios in a stochastic scenario set or those scenarios which are highly unlikely to occur), the capital market risk could be deemed to be nominal. Where significant losses exist in economic scenarios that are not remote, including multiple scenarios that are in aggregate not remote, the contract or contract feature exposes the entity to other-than-nominal capital market risk. Some companies may exclude scenarios they have determined to be highly unlikely in their models. The assessment of what is remote requires judgment, however, a full set of scenarios (both modeled and not modeled) must be considered in the assessment.

Question IG 2-6 discusses how to consider contract holder utilization in the analysis of an MRB.

Question IG 2-6

Can expected contract holder utilization or mortality (i.e., incidence or likelihood of contract holder election of a feature or death) be factored into the analysis of determining if an MRB exists (i.e., in assessing whether the insurance entity is subject to/contract holder is protected from other-than-nominal capital market risk)?

PwC response

No. The assessment as “other than nominal” is performed as if the contract holder elected the benefit (for annuitization guarantees) or died (for death benefits) and thus the criterion of “more than a remote probability of occurring” excludes expectations of contract holder behavior or death. That is, the fact that contract holder election or death is remote does not impact the assessment of whether the market risk benefit, if elected or triggered by death, could be significant. However, if the annuitization or death benefit is determined to be an MRB, the expected contract holder utilization and mortality should be considered in the determination of the fair value of the feature as market participants would consider these assumptions.

Question IG 2-7 discusses if two-tier annuities should be assessed as MRBs.

Question IG 2-7

Should two-tier annuity contracts be assessed under the MRB guidance in ASC 944-40-25-25C and ASC 944-40-25-25D?

PwC response

Yes. Two-tiered annuities provide potential benefits in addition to the account balance that are payable only upon annuitization. Two-tier annuities are required to be assessed under the MRB guidance. ASC 944-40-35-20 states that for two-tier annuities, an additional liability recognized in accordance with ASC 944-40-25-26 through ASC 944-40-25-27 or a market risk benefit, as applicable, should be recognized during the accumulation phase for the benefit in excess of the accrued account balance. A two-tier annuity that contains a feature that both provides protection to the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk is recognized as a market risk benefit.

2.4.5.1 Reinsurance contracts in scope of MRBs

Market risk benefits can be present in contracts written by both insurance and reinsurance entities. A reinsurance entity may assume all or a portion of market risk benefits associated with various GMXB features. ASC 944-40-25-40 clarifies that both the assuming reinsurance entity and the ceding entity are subject to the MRB guidance. The account balance for purposes of the assessment of whether the reinsurance contract is or contains an MRB in accordance with ASC 944-40-25-25D refers to the underlying contract between the direct insurance entity and the contract holder. Refer to IG 9.8 for additional considerations regarding the reinsurance of market risk benefits.

2.4.5.2 Classification of MRB – interaction with ASC 815 and other guidance

ASC 944-40-25-25B provides the order of analysis when assessing contract features that provide potential benefits in addition to the account balance to determine whether the additional benefits are MRBs, derivatives or embedded derivatives, or additional annuitization, death, or other insurance benefits.

Classification is important due to the differences in measurement between the models. Like derivatives, MRBs are recorded at fair value. However, under derivative accounting, the entire change in fair value is recorded through income, whereas for MRBs, the portion of the change in the value due to changes in instrument-specific credit risk is recognized in OCI. The application of the MRB guidance may result in a feature that was previously recognized as a derivative now being recognized as an MRB. In addition, certain contractual features may have capital market risk, such as interest rate risk, but may not meet the definition of either an MRB or a derivative because the features are not an amount in addition to the account balance (e.g., a variable interest rate return on a fixed annuity or universal life account balance) or they may be life insurance benefits in a life insurance contract.

The scope exception guidance in ASC 815-10-15-13, which indicates contracts not subject to the derivative guidance in ASC 815, has been expanded to include market risk benefits in addition to the existing exclusion for insurance contracts.

Figure IG 2-1 Part C provides a decision tree for determining the accounting model for contract features in insurance and investment contracts that provide potential benefits in addition to the account balance, as detailed in ASC 944-40-25-25B.

2.4.5.3 Classification of MRB - types of market risk benefits

Periodic interest crediting features applied to account balances are not considered MRBs. This includes features in which the interest crediting is directly or indirectly linked to the performance of an underlying portfolio of investments or an equity index (e.g., variable annuities and universal life) and those for which there is a guaranteed minimum interest crediting rate on the account balance (e.g., deferred fixed annuities). The interest crediting features on an account balance do not provide a benefit to the contract holder in addition to the account balance, but instead are defining the return provided on the account balance. The interest crediting feature simply provides that the policyholder account balance will be credited with a return that can be positive, negative, or zero depending on the crediting feature. For certain products, such as fixed-indexed annuities with interest crediting rates linked to an equity index, the interest crediting feature of the contract is not considered an MRB and will continue to be accounted for as embedded derivatives under ASC 815.

A traditional annuitization guarantee in a deferred annuity product (i.e., contract specifies the mortality table and the interest rate to be used to determine future annuity payments using the account balance as the base) is an MRB if the insurance entity is exposed to other-than-nominal capital market risk. The feature is providing “protection” from the difference between the periodic payment promised by the annuitization guarantee and the account balance and is economically similar to a variable annuity with a GMIB. However, if the annuitization guarantee only locks in the mortality table, but the interest rate to be used to calculate the annuitization payments will be based on market rates at the future annuitization date, there is no MRB feature because the contract holder is not protected from capital market risk.

Figure IG 2-2 provides examples of some common products issued by insurance and reinsurance entities that may have features with capital market risk and analyzes whether such contract features would meet the definition of an MRB.

Figure IG 2-2

Analysis of MRB for common products and features for market risk benefit accounting

Base product	Benefit feature	Benefit feature previous accounting model	Market risk benefit under ASC 944-40-25-25C and 25D? (if no, follow previous accounting model)
Annuity contracts			
Fixed annuity	Interest crediting rate on the account balance at the discretion of the insurance entity that is often indirectly based on return on unspecified general account assets with a contractually-specified guaranteed minimum interest crediting rate	ASC 944-825-25-1 to ASC 944-825-25-2	No. The interest crediting feature is not providing a potential benefit in addition to the account balance.
Fixed annuity-market value adjusted annuity	The contract provides for a return of principal plus a fixed rate of return if held to maturity, or alternatively, a market-adjusted value if the surrender option is exercised by the contract holder before maturity. The market-adjusted value is typically based on current interest crediting rates being offered for new market value annuity purchases.	ASC 944-40-25-25	No. The surrender feature is not providing a potential benefit in addition to the account balance. Amount received upon surrender is account balance adjusted for interest rate changes; contract holder is in effect absorbing capital market risk rather than being protected from it.
Fixed-indexed annuity (FIA)/ Equity-indexed annuity (EIA)	Interest crediting rate on the account balance is based on performance of an equity index (e.g., S&P 500) with a contractually-specified minimum interest crediting rate	ASC 815-15	The equity index crediting is part of the account balance and is an embedded derivative.

Base product	Benefit feature	Benefit feature previous accounting model	Market risk benefit under ASC 944-40-25-25C and 25D? (if no, follow previous accounting model)
Variable-indexed annuity	Interest crediting rate on the account balance based on performance of an equity index (e.g., S&P 500). Interest crediting rate may be negative and may have a "buffer" in which the insurance entity absorbs certain downside risk (e.g., first 10% loss) with remaining risk with contract holder.	ASC 815-15	The analysis is the same as the preceding product; it depends on the termination provisions of the contract.
Fixed-indexed annuity (FIA)/ Equity-indexed annuity (EIA)/ Variable-indexed annuity	GMXBs (i.e., GMDB, GMIB, GMAB, GMWB, GMWB for life)	ASC 944-40-30-26 to ASC 944-40-30-29 or ASC 815-15 (varies based on feature)	Yes. These guarantee features are providing a potential benefit in addition to the account balance for difference between the guaranteed benefit and the account balance.
Deferred fixed annuity	Annuitization guarantee provides calculation of annuitization periodic payments based on guaranteed minimum interest rate as described in ASC 815-15-55-58.	ASC 944-40-30-26 to 944-40-30-29	Yes, if the risk is other-than-nominal at inception; expected utilization is not considered when making the assessment. The guarantee feature is providing a potential benefit in addition to the account balance for the difference between the guaranteed benefit (i.e., periodic payments promised by the annuitization guarantee) and the periodic payments using current interest rates.
Deferred variable annuity	Interest crediting rate on the account balance is equal to investment returns from designated investment funds.	ASC 944-80-25-3a	No. The interest crediting feature is not providing a potential benefit in addition to the account balance.
Deferred variable annuity with GMXBs, reinsurance of GMXB features	GMXBs (i.e., GMDB, GMIB, GMAB, GMWB, GMWB for life)	ASC 944-40-25-26 to ASC 944-40-25-27A or ASC 815 (various based on specific feature)	Yes. These guarantee features are providing protection to the contract holder (or cedant) for the difference between the guaranteed benefit and the account balance.

Base product	Benefit feature	Benefit feature previous accounting model	Market risk benefit under ASC 944-40-25-25C and 25D? (if no, follow previous accounting model)
Life insurance products			
Universal life	Interest crediting rate on the account balance at the discretion of the insurance entity, often indirectly based on return on unspecified general account assets. Contract may or may not provide guaranteed minimum interest crediting rate.	ASC 944-40-30-16 to ASC 944-40-30-19	No. The interest crediting feature is not providing a potential benefit in addition to the account balance.
Universal life	A no lapse guarantee/universal life secondary guarantee, where the death benefit remains in force even if the account balance is insufficient to pay the cost of insurance assuming minimum funding requirements are met.	ASC 944-40-30-20 to ASC 944-40-30-24	No. The death benefit component of a life insurance product is excluded from the scope of the MRB guidance.
Universal life	Interest crediting rate on the account balance is based on performance of an equity index (e.g., S&P 500).	ASC 815-15	It depends on the termination provisions of the contract. If the equity index crediting earned to date is available upon surrender at any time, the equity index crediting is part of the account balance and is an embedded derivative.
Universal life	Death benefit is based on the performance of an equity index.	ASC 944-40-30-20 to ASC 944-40-30-24	No. The death benefit component of a life insurance product is excluded from the scope of the MRB guidance.
Universal life	An option to settle the contract upon surrender or death with an annuity determined using guaranteed fixed interest rates.	ASC 944-40-25-26 to ASC 944-40-25-27A	Yes. The annuitization option is providing protection for the difference between the guaranteed benefit and the account balance.
Variable universal life	Interest crediting rate on the account balance is equal to investment returns from designated investment funds.	ASC 944-80-25-3a	No. The interest crediting component does not provide a potential benefit in addition to the account balance.
	Upon death, in one version of the product, the policyholder receives the greater of account balance and fixed death benefit; in another version, the policyholder receives	ASC 944-40-30-16 to ASC 944-40-30-19	No. The death benefit component of a life insurance product is excluded from the scope of the MRB guidance.

Base product	Benefit feature	Benefit feature previous accounting model	Market risk benefit under ASC 944-40-25-25C and 25D? (if no, follow previous accounting model)
	the account balance plus the fixed death benefit.		
Variable universal life	Benefits other than death benefits, for example, a GMAB or GMWB on the account balance component	ASC 944-40-25-26 to ASC 944-40-25-27A or ASC 815 (various based on specific feature)	Yes. The benefit is providing protection for the difference between the guaranteed benefit and the account balance.

2.4.6 *Classification of participating life insurance contracts*

Participating life insurance contracts include certain contracts issued by mutual life insurance entities and certain stock life insurance entities that have both of the following characteristics, as described in ASC 944-20-15-3.

ASC 944-20-15-3(b)

Participating life insurance contracts denote those that have both of the following characteristics:

1. They are long-duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurance entity.
2. Annual policyholder dividends are paid in a manner that both:
 - a) Identifies divisible surplus
 - b) Distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in the actuarial literature as the contribution principle).

The participating insurance contract accounting model is viewed as a hybrid of the traditional long-duration and universal life-type models:

- Premium revenue is recognized when due.
- A liability for future policyholder benefits is recorded as the present value of estimated future policy benefits and related expenses less the present value of estimated future net premiums (benefits and related expenses) using locked-in assumptions, along with a terminal dividend liability, when applicable.
- Unlike the traditional model, mortality and discount rates used to calculate the liability for future policy benefits are based on contractual terms and are not related to actual or anticipated experience. In this way, the liability for future policyholder benefits is meant to be a proxy for the

universal life-type contract account balance liability, as participating life insurance contracts typically do not have a stated account balance.

- Annual dividends are accrued as a policyholder expense as declared.
- Eligible deferred acquisition costs are capitalized and amortized on a straight-line basis over the expected term of the related contracts.

Some participating contracts were isolated for regulatory cash flow purposes when mutual life insurers demutualized. This isolation structure is called a “closed block.” ASC 944-805 provides guidance on the specialized accounting for demutualization and closed block transactions.

In accordance with ASC 944-20-15-28, limited-payment participating contracts that are not in substance universal life-type contracts are classified as limited-payment contracts (i.e., not participating contracts).

2.5 Classification of other insurance contracts

This section addresses the accounting considerations for contracts that are not accounted for as long-duration insurance contracts.

2.5.1 Classification of investment contracts

Investment contracts are those contracts written by an insurer that do not subject the insurer to significant mortality or morbidity risk. An example is a guaranteed investment contract (GIC) or similar debt-like instrument under which funds are received from contract holders and accrue interest at a stated rate, which can be fixed or variable.

Certain annuities may qualify as investment contracts. Some annuities have a deferral (or “accumulation”) phase and a payout phase. The accumulation phase is the period in which deposits are received from contract holders and an account balance is credited with interest until maturity or a payout annuity is elected with the right to surrender the contract at any time for cash. If there are no death or other insurance benefit riders, and thus no insurance risk, the contract is classified as an investment contract (e.g., fixed annuities and fixed (equity) indexed annuities in the accumulation phases).

In contrast, the payout or “annuitization” phase of an annuity (i.e., the period during which the contract holder is receiving periodic payments or the account value is extinguished for contracts with a guaranteed withdrawal benefit) is a separate contract for accounting purposes, as noted in ASC 944-20-15-17 and ASC 944-40-35-16.

ASC 944-20-15-17

A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.

ASC 944-40-35-16

On the date of annuitization or extinguishment of the account balance, the additional liability related

to the cumulative excess benefits will be derecognized and the amount deducted will be used in the calculation of the liability for the payout annuity.

At the annuitization date, the payout annuity is classified as an investment contract if the periodic payments are for a “period certain” rather than life contingent.

Certain reinsurance contracts that reinsure directly written investment contracts or that reinsure directly written insurance contracts but fail to pass significant insurance risk to the reinsurer would also be classified as investment contracts, as further described in IG 2.5.1.

Under the investment contract accounting model:

- Payments received are reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.
- Eligible deferred acquisition costs are capitalized and amortized to expense on a straight-line basis over the expected term of the related contracts if specified criteria are met, otherwise using a constant effective yield method.
- Deposits received and withdrawal payments are classified as financing cash flows in the statement of cash flows.

These contracts may contain embedded derivatives or MRBs that require separation under ASC 815 or ASC 944, as described more fully in IG 1.2.4 and IG 2.4.5. If all death and insurance benefit features within a contract are classified as market risk benefits or embedded derivatives, and thus there is no remaining insurance risk in the contract, the remaining host contract would be considered an investment contract.

See IG 5.5 for further information on investment contracts.

2.5.2 Classification of assumed or written reinsurance contracts

Reinsurance is a transaction in which an insurer (assuming entity), in exchange for consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding entity or cedant). Regardless of its form, any transaction that indemnifies an insurer against loss or liability relating to insurance risk and meets the specified risk transfer criteria is subject to reinsurance accounting.

ASC 944 guidance on reinsurance focuses principally on:

- Determining whether significant risk transfer has passed between the cedant and the assuming company (as described further in IG 8.5 and IG 9.5) and
- Accounting by the cedant for purchased reinsurance that meets the risk transfer criteria.

No specific guidance is provided in ASC 944 for the accounting by the assuming entity since the assuming entity is in substance providing insurance protection to the ceding company. Reinsurance contracts assumed follow the applicable guidance for direct insurance contracts, including short duration and long duration classifications.

See IG 8 for further guidance on the short-duration reinsurance model and IG 9 for further guidance on the long-duration reinsurance model.

Reinsurance of other types of coverage, such as financial guarantee, is not explicitly covered in ASC 944. In practice, such transactions are accounted for by analogy to the reinsurance guidance in ASC 944.

Chapter 3: ***Acquisition costs***

3.1 Acquisition costs — chapter overview

Insurance entities incur costs relating to the acquisition of new and renewal insurance contracts. Acquisition costs are often substantial, especially for life insurance entities when significant upfront commissions (as well as other acquisition related costs) are incurred in the process of underwriting long-duration contracts that have substantial future recurring premium payments.

Insurance entities are required to defer acquisition costs that meet certain specified criteria and charge them to expense over the lives of the related policies.

This chapter provides guidance relating to:

- the types of costs that are deferrable as DAC
- the DAC amortization methods
- the types of sales inducements that are deferrable
- the impact on DAC of internal replacements (i.e., transactions in which product benefits, features, rights, or coverages are modified)
- DAC considerations for reinsurance contracts

3.2 Acquisition costs — scope and relevant guidance

ASC 944-30, *Acquisition Costs*, establishes requirements for the accounting for and financial reporting of acquisition costs. This includes related considerations for internal replacement transactions (i.e., when a product benefit or feature is modified) and reinsurance.

The types of costs that are deferrable are consistent among the various insurance models (i.e., short-duration, long-duration, financial guarantee and title insurance). See IG 2 for a description of the various models. In addition, although investment contracts issued by insurance entities lack insurance risk, the types of costs related to these contracts that are deferrable follows the DAC guidance. Although the types of costs that are deferrable is uniform among the various types of insurance and investment contracts, the method of amortization varies depending on the specific insurance model classification, as further described in IG 3.5.

3.2.1 Acquisition costs for contracts accounted for at fair value

Certain contracts issued by insurance entities may be subject to the provisions of ASC 815, *Derivatives and Hedging*. These contracts are measured at fair value; thus, DAC would not be established in conjunction with these contracts. Similarly, acquisition costs for insurance contracts that have been elected to be measured at fair value under the fair value option would also not be deferred and instead would be recognized as an expense in the period incurred.

3.3 Acquisition costs — unit of account and “grouping”

In general, the unit of account for initial and subsequent measurement of insurance and investment contracts is the individual contract, unless indicated otherwise. For certain purposes, including the

allocation of DAC for initial deferral purposes, insurance contracts are required or allowed to be grouped.

ASC 944-30-25-1B provides guidance on the grouping of short-duration insurance contracts for the allocation of DAC at initial deferral. Contracts issued in the same period are typically grouped together. In practice, the “same period” may be considered to be the same quarter, or in some cases, the same year.

ASC 944-30-25-1B

To associate acquisition costs with related premium revenue, for acquisition costs that are charged to expense in proportion to premium revenue recognized under Subtopic 944-605, capitalized acquisition costs shall be allocated by groupings of insurance contracts consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts.

ASC 944-30-35-3A provides guidance on the grouping for long-duration contracts. For purposes of the DAC amortization, contracts may be grouped consistent with the grouping used in estimating the liability for future policy benefits (or any other related balance) for the corresponding contracts and thus would be subject to the same annual cohort limitation required in ASC 944-40-30-7. However, DAC may also be amortized on an individual contract basis.

3.4 Deferrable acquisition costs and initial measurement

ASC 944-30-25-1A and ASC 944-30-25-1AA include four categories of acquisition costs that may be deferred.

ASC 944-30-25-1A

An insurance entity shall capitalize only the following as acquisition costs related directly to the successful acquisition of new or renewal insurance contracts:

- a. Incremental direct costs of contract acquisition.
- b. The portion of the employee's total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:
 - (1) Underwriting
 - (2) Policy issuance and processing
 - (3) Medical and inspection
 - (4) Sales force contract selling.
- c. Other costs related directly to the insurer's acquisition activities in (b) that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred.

ASC 944-30-25-1AA

The costs of direct-response advertising shall be capitalized if both of the following conditions are met:

- a. The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising. Paragraph 944-30-25-1D discusses the conditions that must exist in order to conclude that the advertising's purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising.
- b. The direct-response advertising results in probable future benefits. Paragraph 944-30-25-1G discusses the conditions that must exist in order to conclude that direct-response advertising results in probable future benefits.

All of the types of acquisition costs that are eligible for deferral share the attribute of being directly related to a sale. For a cost to be considered direct, it must result directly from and be essential to the contract acquisition or renewal. Certain costs incurred by an entity, such as rent, equipment, and general overhead, are considered indirect costs of contract acquisition, as these costs do not result directly from and are not essential to the contract transaction and would have been incurred regardless of whether or not the insurance policy was issued. Indirect costs must be charged to expense as incurred.

The following sections provide an overview of each of the four categories of potentially deferrable costs.

3.4.1 Incremental direct costs of a contract acquisition

A cost to successfully acquire an insurance contract must have both of the following characteristics in order to be deferred:

- The cost results directly from, and is essential to, the contract transaction
- The cost would not have been incurred by the insurance entity had the contract transaction not occurred

ASC 944-30-55-1 describes these costs as including the following:

- An agent/broker commission or bonus for successful policy issuance
- Medical and inspection fees for successful policy issuance

These costs are variable in nature and relate directly to a contract acquisition and are incremental, as the commission, bonus, or other inspection costs would not have been incurred had the policy or policies not been issued. Such costs may be deferred regardless of whether they are incurred in transactions with employees, non-employees, or other parties.

Although not specifically mentioned in the guidance, most premium taxes qualify for deferral. Premium taxes are amounts assessed on insurers by states, and are calculated based on the amount of premium paid by residents of the state to the insurance entity. Tax rates may vary by state and type of insurance entity, but are applied to the premiums collected by the insurer in determining the total tax

expense incurred. By analogy, we believe excise taxes calculated based on contract sales would also be eligible for deferral.

Question IG 3-1 addresses whether a sales bonus is a direct cost.

Question IG 3-1

Insurance Company pays sales agents a \$5,000 bonus upon the sale of the agent's 100th policy. May Insurance Company defer this bonus as an incremental direct cost of contract acquisition?

PwC response

Yes. ASC 944-30-55-1 provides that an insurance entity may fully defer an agent or broker commission or bonus for successful contract acquisition or acquisitions as an incremental direct cost of contract acquisition. Although the agent must sell 100 policies in order for Insurance Company to incur this cost, the \$5,000 bonus is incremental and direct to the 100th policy.

Question IG 3-2 addresses whether a bonus paid under a variable bonus structure can be deferred.

Question IG 3-2

Insurance Company pays an agent a bonus based on achieving a specified sales target in a given year (e.g., \$150,000 in sales), but with the amount of the bonus varying depending on a second variable, such as the loss ratio of the contracts brought in by the agent. For example, the bonus will be \$3,000 if a 90% loss ratio is achieved, \$4,000 if an 80% loss ratio is achieved, and \$5,000 if a 70% loss ratio is achieved. May Insurance Company defer this bonus as an incremental direct cost of acquisition?

PwC response

Probably. We view these sliding scale bonus arrangements as “dual trigger” contracts. In this case, the payment is based on sales, but the amount of the commission is partially based on another variable. We do not believe that the fact that the measurement is based in part on another variable would preclude an entity from deferring the bonus. However, in order to be deferrable, the primary driver of the bonus should be reaching the sales target, and that target should be substantive and not at such a low level as to virtually guarantee achievement.

3.4.2 Employee compensation and fringe benefits

The portion of employees' total compensation and payroll-related fringe benefits directly related to time spent performing the following activities for which an insurance policy was issued (often referred to as “successful efforts”) is deferred:

- Underwriting
- Issuing and processing policies
- Performing medical and other inspections
- Selling insurance contracts

The portion of compensation to be deferred excludes any compensation that is otherwise deferred as an incremental direct cost of contract acquisition in ASC 944-30-25-1A(a), as discussed in IG 3.4.1. The portion of internal selling agent and underwriter fixed salaries and benefits attributable to unsuccessful efforts is expensed as incurred.

ASC 944-30-55-1C defines payroll-related fringe benefits and provides examples of such benefits.

ASC 944-30-55-1C

Payroll-related fringe benefits include any costs incurred for employees as part of the total compensation and benefits program. Examples of such benefits include all of the following:

- a. Payroll taxes
- b. Dental and medical insurance
- c. Group life insurance
- d. Retirement plans
- e. 401(k) plans
- f. Stock compensation plans, such as stock options and stock appreciation rights
- g. Overtime meal allowances.

Example IG 3-1 analyzes employee compensation costs eligible for deferral when compensation includes vacation pay.

EXAMPLE IG 3-1

Determination of employee compensation costs eligible for deferral when compensation includes vacation pay

Insurance Company has a direct sales employee with total compensation of \$100,000, including vacation pay. The employee works 1,800 hours in the current year engaged only in successful direct sales activities and the employee's remaining 200 hours are vacation time. 80% of the employee's hours were for successful efforts after considering vacation time. What portion of this employee's compensation is eligible for deferral?

Analysis

We believe that vacation pay can be considered a payroll-related fringe benefit. However, vacation *time* is viewed as idle time (i.e., time employees are not actively involved in acquisition efforts), and as such, vacation time should be factored into the computation of employee successful efforts.

Therefore, the portion of the employee's total compensation eligible for deferral as DAC would be \$80,000 (\$100,000 X 80% success rate).

For pension-related compensation, the components of net periodic benefit cost eligible to be deferred as part of employee compensation and payroll-related fringe benefits directly related to successful contract acquisitions is limited to the service cost component. Although this is not explicit in ASC 944, ASC 330-10-55-6A notes that the service cost component of net periodic pension cost and net periodic postretirement benefit cost is the only component directly arising from employees' services provided in the current period and therefore is the relevant amount to be considered for deferral.

In some cases, the identification of deferrable acquisition costs is straightforward (e.g., commissions paid to the direct sales agent who negotiated the sale). However, in other cases, compensation arrangements and the various distribution systems of insurance entities (e.g., branch, independent retailer, captive agent, wholesaler) may be complex and require careful consideration to determine which costs are deferrable.

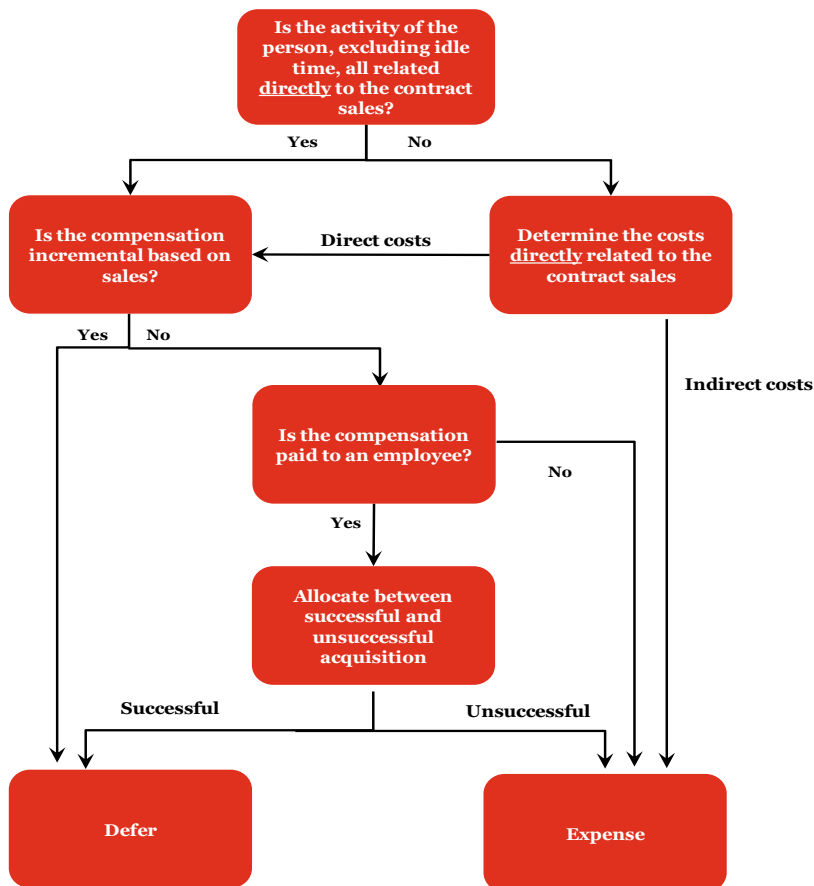
In such cases, judgment will be required to:

- Identify whether a particular cost represents a “direct” cost of acquisition
- Identify whether a person is an “employee” for purposes of payroll-related costs
- Determine the portion of employee time that relates to successful versus unsuccessful efforts

Figure IG 3-1 illustrates the assessment process for determining which compensation costs are deferrable.

Figure IG 3-1

Distinguishing deferrable and non-deferrable acquisition compensation costs



3.4.2.1 *Definition of an employee*

The employee compensation and fringe benefits "bucket" relates solely to *employee* compensation and payroll-related fringe benefits; compensation paid to third parties is excluded. ASC 944-30 provides no explicit definition of "employee." In certain cases (e.g., captive agent structures), the relationship between the entity and the agent is more akin to one of an employer/employee, despite the legal form of that relationship. This requires careful consideration of the facts and circumstances. For instance, if the captive agents receive health benefits from the entity, work out of the insurance entity's branch office, are under the control of the entity's managing general agents, and are exclusive to the entity, then it may be appropriate to treat these agents as employees, and, therefore, a portion of the captive agents' compensation may be deferred.

3.4.2.2 *Direct versus indirect costs*

As noted in IG 3.4, a cost must be directly related to a sale in order to be eligible for deferral. For a cost to be considered direct, it must result directly from and be essential to the contract acquisition or renewal.

Managerial compensation

Careful consideration of compensation paid to executives and managerial personnel who may only spend a portion of their time directly involved in the sales effort is necessary in order to appropriately identify the portion of such costs that may be deferred. In addition, in certain instances, a cost may be incremental (i.e., it varies based on sales volume), but it is not direct (e.g., it is paid to a supervisory regional sales manager who did not participate directly in an individual sale), and thus would not be eligible for deferral.

ASC 944-30-55-1G provides implementation considerations for managerial compensation.

ASC 944-30-55-1G

The portion of the total compensation of executive employees that relates directly to the time spent approving successful contracts may be deferred as acquisition costs. For example, the amount of compensation allocable to time spent on policies actually issued after approval by a contract approval committee is a component of acquisition costs.

In addition, certain employee managers may spend time directly approving sales, reviewing and approving specific contractual terms of customized contracts, as well as participating in and performing sales calls and other contract acquisition efforts and processes. Time spent on such detailed efforts may extend beyond traditional supervision of the sales force and may be more directly attributable to successful contract acquisition efforts, depending on the level of the employee manager's involvement in these efforts and processes.

A key part of the determination will focus on whether the employee manager's time was spent on more than supervision alone. If so, the portion of the employee manager's time and other expenses that can be directly linked to a specific successful policy issuance would be deferrable.

In contrast, an employee manager's time spent supervising, monitoring, and training employees is an indirect cost of contract acquisition that would be expensed as incurred. In general, we would not expect a significant portion of an employee manager's time to be directly attributable to contract acquisition efforts, unless there are unique facts and circumstances or specific types of complex or

customized contracts for which the manager plays a more substantial role in the actual acquisition of the policies.

When employee managers are paid a fixed compensation, such as a salary, which covers the portion of their time spent directly on contract acquisition efforts, a determination would need to be made of the amount attributable to successful versus unsuccessful contract acquisition efforts. In addition, when employee managers are paid variable compensation, such as commissions or a bonus when the sales force that they supervise achieves a certain level of sales, a determination would need to be made of the amount attributable to contract acquisition efforts.

Question IG 3-3 addresses whether a manager's incentive bonus is eligible for deferral.

Question IG 3-3

Insurance Company pays employee managers a \$5,000 bonus upon the sale of the 100th policy by the respective sales force that the employee managers supervise. May Insurance Company defer this bonus as an incremental direct cost of contract acquisition?

PwC response

It depends. Despite the fact that the employee manager's compensation is based on sales volume, only the portion of compensation spent directly approving sales or participating in contract acquisition efforts would be deferrable. The portion of the bonus relating to indirect activities that they perform, such as training, supervision, and support, despite being incremental, would not be eligible for deferral.

Employee wholesalers

Fixed and variable compensation may be paid to employee wholesalers, whose job is to support the distribution of insurance products sold through third party "retailers," such as banks and insurance agencies. There are many types of wholesaler activities; some may involve more direct involvement in the sale of products than others. For example, direct activities may include working with a retailer to customize a product for a specific prospective policyholder, participating in sales meetings with a customer, providing detailed illustrations of how the product works for the broker to take back to the customer, or approving the contract sale.

Activities that would typically be indirect for which the related compensation would not be deferrable may include marketing campaigns, developing contract illustrations for future sales, training staff or brokers, developing relationships with brokers, and acquiring broker shelf space for the entity's products.

Variable compensation may be paid to the wholesalers based on the sales volume achieved in their particular geographic territory or product line. It is important to focus on the activities that the wholesaler is performing to determine what portion, if any, of any variable or fixed compensation is directly related to a sale. Only the portion of variable and fixed compensation directly related to the sales effort would be deferrable and, for fixed compensation, the successful efforts percentage would need to be applied. Allocating time spent on direct activities in wholesaler arrangements, as with manager arrangements, can be challenging; the guidance does not prescribe that a particular methodology be applied.

Example IG 3-2 illustrates three different ways in which employee wholesaler compensation may be attributed to successful efforts deferral.

EXAMPLE IG 3-2

Determination of employee wholesaler compensation costs eligible for deferral when compensation is comprised of both fixed and variable compensation

Insurance Company employs a wholesaler who receives both fixed and variable compensation to support the distribution of insurance products sold through the insurance entity's third party "retailers." The wholesaler performs a variety of activities, some of which relate directly to the sale of insurance products.

Variable compensation	\$200,000
Fixed compensation	\$50,000
Total compensation	\$250,000

- The wholesaler spent 20% of his time directly involved in specific contract sales
- There is an 85% success rate

What amount of the wholesaler's fixed and variable compensation is eligible for deferral by Insurance Company?

Analysis

Insurance Company needs to determine the portion of wholesaler activity that is directly related to selling, underwriting, inspecting, or issuance of the product, as opposed to indirect involvement in supporting and supervising the distribution channel. Direct means essential to the successful sale, and that the wholesaler must have had an active participation in the sale, such as participating in the sales meetings or approving the contract. Supervision and support alone do not qualify as direct and, as such, the portion of compensation relating to these efforts would not qualify for deferral. A variety of methodologies may be employed in order to apportion the wholesaler compensation costs that may be deferred.

- Option A: Apply the 20% ratio representing the wholesaler time spent on direct sales activities to (1) the variable compensation and (2) the successful portion of fixed compensation. That is, deferred costs relating to incremental direct compensation would be $20\% \times \$200,000$ (\$40,000), and deferred costs relating to fixed compensation would be $20\% \times (\$50,000 \times 85\%)$ or \$8,500, for total deferrable compensation costs of \$48,500 relating to the employee wholesaler.
- Option B: Assume that incremental direct costs under ASC 944-30-25-1A(a) are limited to costs that are 100% direct and variable (such as commissions to direct selling agents). Therefore, in situations when the employee is performing both direct and indirect sales activities, the entire compensation, including the variable component, is allocated to the employee compensation and fringe benefits "bucket" under ASC 944-30-25-1A(b). Applying the 20% ratio representing wholesaler time spent on direct sales activities to the total compensation and then applying a

success factor would result in total deferrable compensation costs of \$42,500 ($\$250,000 \times 20\% \times 85\%$).

- Option C: Assume that variable compensation is paid for direct acquisition activities and that fixed compensation is paid for indirect activities, assuming a constant rate is earned per hour for all activities. The rate assumed for specific activities would require sufficient documentation of the rationale for that rate. Assuming a 2,000-hour work year, the rate per hour would be $\$250,000/2000$ hours, or \$125 per hour. Applying that rate to the 400 hours of direct sales activity (2000 hours \times 20%) would result in \$50,000 of deferrable compensation. Under this method, there is no success rate applied, because the \$50,000 of deferrable compensation is assumed to be only related to the variable compensation. That is, all the direct sales activity is paid through variable compensation, and the remainder of that compensation as well as all of the fixed compensation would be attributed to non-direct activities.

We believe that any of these methods would be an acceptable interpretation for determining the wholesaler compensation costs eligible for deferral. Once a methodology is defined and implemented by an insurance entity, this methodology should be consistently applied, unless facts and circumstances unique to that insurance entity support the use of a differing methodology. In none of the alternative scenarios would the \$200,000, though a form of “incremental” compensation, be deferred in its entirety because the wholesaler spent only 20% of his time directly involved in acquisition efforts.

Overriding commissions to brokers and agents

Overriding commissions, also called overwriting commissions, are payments to brokers, managing general agents, or any other agents on a particular line of insurance written by other agents within a geographical area. These amounts may be separately specified in the contractual agreements in addition to the sales commission amounts due to sales agents that are deferred as incremental direct costs.

It is important that insurance entities analyze the nature of the services being provided in exchange for the overriding commission payments. Although overriding commissions may be incremental in nature, they may not be direct. Since these amounts are separate from sales commissions, it is possible that they are payments for costs associated with training, rent, general supervision, compliance, or other administration and overhead costs, which would be indirect costs of contract acquisition that would be expensed as incurred.

Commission and bonus payments inherently include amounts to compensate agents for solicitation and other indirect costs incurred by the agent. However, if the overriding commissions are not separately distinguishable from sales commissions, or are incurred in transactions with independent third parties when there is limited access to the information about the specific nature of the activities performed for those commissions, the overriding commissions are potentially deferrable. We believe entities should defer agent or broker overriding commissions and bonuses incurred in transactions with independent third parties if they are incremental direct costs of contract acquisition, or are incurred in transactions with independent third parties when there is limited access to information about the specific nature of the activities performed for that commission.

3.4.2.3 *Successful versus unsuccessful contract efforts*

ASC 944-30-55-1E provides implementation guidance for the determination of successful-efforts.

ASC 944-30-55-1E

The successful-efforts accounting notion utilized at an entity-wide level may result in a standard costing system that does not accurately reflect the amount of costs that may be deferred and amortized under this Subtopic. Successful acquisition efforts can be determined as a percentage of each function (for example, application, underwriting, and medical and inspection) and may be based on the percentage, adjusted for idle time and time spent on activities for which the related costs cannot be deferred, of successful and unsuccessful efforts determined for each function.

Standard costing may be used to estimate the costs to be deferred when the costs of acquisition are similar among a group of contracts, whereas actual costs may need to be identified separately in other contracts. In practice, a variety of techniques are applied to determine the costs associated with the successful acquisition of new or renewal insurance contracts. In some instances, insurers may find it sufficient to estimate costs relating to successful efforts by comparing the number of policies issued to the total number of applications processed. In other situations, entities may find that it takes more time to approve a policy than to decline coverage to a potential policyholder. In the latter situation, entities may decide that time studies focusing on the amount of time and effort an employee spent approving and issuing contracts are a better determinant of costs associated with successful contracts.

Once employee efforts are assigned, the proportional effort pertaining to “successful efforts” is applied to an employee’s compensation (i.e., salary and related compensation) in order to determine the portion of total employee compensation eligible for deferral under ASC 944-30-25-1A(b).

3.4.3 *Other costs directly related to the acquisition activities*

ASC 944-30-55-1A includes examples of other costs directly related to the acquisition activities.

ASC 944-30-55-1A

Examples of other costs related directly to the insurer’s acquisition activities in paragraph 944-30-25-1A(b) that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred include all of the following:

- a. Reimbursement of costs for air travel, hotel accommodations, automobile mileage, and similar costs incurred by personnel relating to the specified activities
- b. Costs of itemized long-distance telephone calls related to contract underwriting
- c. Reimbursement for mileage and tolls to personnel involved in on-site reviews of individuals before the contract is executed.

Costs must be directly attributable to the insurer's acquisition of a contract to be deferrable. In addition, only the portion of such costs that ultimately resulted in a successful sale is eligible for deferral.

3.4.4 *Direct-response advertising costs*

ASC 720-35-05-4 defines advertising.

ASC 720-35-05-4

Advertising is the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image or to create or stimulate a desire to buy the entity's products or services. Advertising generally uses a form of media—such as mail, television, radio, telephone, facsimile machine, newspaper, magazine, coupon, or billboard—to communicate with potential customers.

General advertising is not an acquisition cost. Therefore, in accordance with ASC 720-35-25-1, general purpose advertising costs should be expensed either as incurred or the first time the advertising takes place.

Certain direct-response advertising costs may be deferred provided they meet the conditions outlined in ASC 944-30-25-1AA. Direct-response advertising costs may be deferred if the primary purpose of the advertising is to elicit sales to customers that have responded specifically to the advertising and the direct-response advertising results in probable future benefits.

3.4.4.1 *Primary purpose to elicit sales from direct response advertising*

The first condition for deferring direct-response advertising is that the primary purpose of the advertising is to elicit sales from customers who can be shown to have responded specifically to the advertising. To meet this condition, the sale must be the direct result of the advertising (i.e., no other significant efforts are needed to elicit the sale). Insurance entities should consider whether the advertising campaign merely solicits potential policyholder interest or inquiry, with additional sales, underwriting, and other policy issuance efforts to be completed after the potential policyholder has initially responded to the advertising. If this is the case, the advertising campaign would not represent direct-response advertising eligible for deferral.

A significant lapse of time between the advertising activity and the ultimate sale in an environment of broad general advertising may disqualify the sale as being deemed a direct result of the advertising. Sales prices for the specific product are also necessary in the advertising to demonstrate no substantial effort is needed in addition to the solicitation.

In order to conclude that the advertising elicited the sale, ASC 944-30-25-1D requires that the insurance entity maintain documentation of responses that identify the name of the customer and the specific advertising that elicited the sale. Examples of such documentation are included in ASC 944-30-25-1D.

Excerpt from ASC 944-30-25-1D

Examples of such documentation include the following:

- a. Files indicating the customer names and the related direct-response advertisement

- b. A coded order form, coupon, or response card, included with an advertisement, indicating the customer name
- c. A log of customers who have made phone calls to a number appearing in an advertisement, linking those calls to the advertisement.

3.4.4.2 Probable future benefits of direct-response advertising

The second condition for deferring direct-response advertising costs is that such advertising will result in probable future benefits. The "probable future benefits" of direct-response advertising activities are defined in ASC 944-30-25-1F.

ASC 944-30-25-1F

The probable future benefits of direct-response advertising activities are probable future revenues arising from that advertising in excess of future costs to be incurred in realizing those revenues.

ASC 944-30-25-1P provides that the revenues utilized in determining probable future revenues are limited to primary revenues, which are revenue from sales to customers receiving and responding to the direct-response advertising. Such revenues should exclude those generated from other acquisition efforts. Probable revenues for insurance entities may include renewal premiums or fees expected to be earned over several future accounting periods. Such revenues must be able to be reliably predicted and are substantially the result of the direct-response advertising being assessed (i.e., it does not result from later significant additional direct-response advertising).

Deferral requires persuasive evidence that demonstrates that future benefits from the current advertising campaign will be similar to the results of past direct-response advertising activities that produced future benefits in accordance with ASC 944-30-25-1G. Such evidence should include verifiable historical results from past direct-response campaigns. Attributes to consider in determining whether the results will be similar to past campaigns include the nature of the current campaign vis-a-vis prior campaigns in areas such as the: (a) demographics of the targeted audience, (b) method of advertising, (c) similarities of the products offered, and (d) economic condition of the targeted audience and the marketplace in general. For example, results of a previous campaign targeted only to high-income zip codes would not represent acceptable historical evidence for a future broad-based campaign. Similarly, results of a prior campaign for automobile insurance products in New Jersey would not necessarily be considered predictive of a future campaign for automobile insurance products in Wisconsin because of different traffic levels and demographics.

The criteria for assessing probable future benefits are stringent. As such, it is unlikely that deferral would be acceptable for a recently formed entity or line of business because, in part, asset recognition assumes that the specific entity's prior operating statistics demonstrate future benefits. ASC 944-30-25-1H indicates that industry statistics are not considered objective evidence that the direct-response advertising will result in future benefits in the absence of a reporting entity's operating history. The operating history for other products or services may only be used if it can be demonstrated to have a high degree of correlation to the product or service being evaluated.

3.4.4.3 *Direct-response advertising – basis of measurement*

Unlike the requirement in ASC 944-30-25-1A for deferrable acquisition costs to be related directly to the successful acquisition of insurance contracts, the entire cost of a qualifying advertising campaign can be deferred into direct-response advertising costs in accordance with ASC 944-30-25-1J. The direct-response advertising campaign is undertaken with the expectation that not all targets will enter an insurance contract but that the benefits created by the customers who do will justify the total advertising spend. As such, the cost of the qualifying advertising campaign for all prospective customers, not only the cost related to the portion of the potential customers that are expected to respond to the advertising, are deferred.

Since deferred advertising costs are subsequently accounted for as DAC for classification and amortization purposes, the deferred advertising costs are amortized over the initial contract period.

3.4.4.4 *Distinguishing direct-response advertising and sales efforts*

Question IG 3-4 addresses the accounting for call center costs.

Question IG 3-4

Some insurance entities may have sales call centers in which employees contact or receive phone calls from prospective and existing policyholders in an effort to acquire or renew insurance policies.

Are costs of call centers considered part of an insurance entity's direct-response advertising costs or other contract acquisition costs?

PwC response

Although the entity may be able to determine which of the placed calls result in new or renewed insurance contracts and these may result in future benefits, we believe that generally these efforts should be considered employee sales costs rather than direct-response advertising. Therefore, generally, the entity should analyze the compensation and other costs incurred for the sales call centers to determine their eligibility under the deferral requirements in ASC 944-30-25-1A.

Some insurance entities may also choose to have call centers receive responses to direct-response advertising. Whether these costs are deferrable depends on the relationship between the advertising campaign and the efforts and activities conducted by the entity's call center. If the entity's call center receives phone calls in response to specific qualified direct-response advertising, the entity's call center costs associated with administering the campaign may be considered a direct response advertising cost.

3.4.5 *DAC application examples of compensation arrangements*

Example IG 3-3, Example IG 3-4, and Example IG 3-5 provide interpretive guidance on the determination of the portion of employee compensation that may be deferred when compensation costs are comprised of fixed salaries, variable commission, payroll-related fringe benefits, or a combination thereof.

EXAMPLE IG 3-3**Determination of employee compensation costs eligible for deferral when total compensation is fixed salaries**

Insurance Company pays employee sales agents a \$100,000 fixed salary. Insurance Company has performed various analyses, including time studies, and determined the following information with regard to three employee agents:

	Time attributed to successful contract acquisition efforts	Fixed salary
Agent 1	55%	\$100,000
Agent 2	85%	\$100,000
Agent 3	75%	\$100,000

The time attributable to successful contract acquisition efforts excludes time spent on activities unrelated to the acquisition of insurance policies and idle time. The employee agents receive no other payroll fringe benefits. What amount is deferrable for each agent?

Analysis

Insurance Company should first identify any incremental direct costs of contract acquisition. Employee sales agent compensation is a direct acquisition cost. However, the \$100,000 fixed salary is not an incremental contract acquisition cost because Insurance Company will pay this amount regardless of whether any insurance policies are issued.

Next, Insurance Company should determine the portion of each agent's total compensation and fringe benefits (excluding any compensation that is deferred as incremental direct costs of contract acquisition, which in this example is none) directly related to time spent selling insurance contracts. This is accomplished by applying each agent's percentage of time attributable to successful efforts to each agent's eligible fixed compensation.

This analysis is illustrated as follows:

	Agent 1	Agent 2	Agent 3
Fixed salary	\$100,000	\$100,000	\$100,000
Time attributed to successful efforts	55%	85%	75%
Compensation cost attributable to successful efforts (deferrable)	\$55,000	\$85,000	\$75,000

EXAMPLE IG 3-4**Determination of employee compensation costs eligible for deferral when compensation is comprised of fixed salaries and variable commission**

Insurance Company pays its employee sales agents the greater of a \$100,000 fixed salary or a variable commission, defined as 25% of annual premiums for insurance policies sold. Insurance Company has performed various analyses, including time studies, and determined the following information with regard to three of its employee agents:

	Time attributed to successful contract acquisition efforts	Fixed salary	Variable commission amount
Agent 1	55%	\$100,000	\$80,000
Agent 2	85%	\$100,000	\$150,000
Agent 3	75%	\$100,000	\$120,000

The time attributable to successful contract acquisition efforts excludes time spent on activities unrelated to the acquisition of insurance policies and idle time. The employee agents receive no other payroll fringe benefits. What amount is deferrable for each agent?

Analysis

Insurance Company should first identify the incremental direct costs of contract acquisition. Employee sales agent compensation, including fixed salary and variable commission amounts, is a direct acquisition cost. However, the \$100,000 fixed salary is not an incremental contract acquisition cost because Insurance Company will pay this amount regardless of whether any insurance policies are issued. In contrast, the commission amounts paid above the \$100,000 fixed salary are incremental, because Insurance Company would not have incurred costs over \$100,000 if the employee agents had not successfully acquired the contracts over the specified sales threshold. Since the variable commission amounts in excess of the fixed salary are incremental direct costs, these may be deferred.

Next, Insurance Company should determine the portion of the employee agents' total compensation and fringe benefits (excluding any compensation that is deferred as incremental direct costs of contract acquisition) directly related to time spent selling insurance contracts. This is accomplished by applying each employee agent's percentage of time attributable to successful efforts to each agent's eligible compensation. This amount (i.e., fixed compensation) does not include any of the incremental direct costs attributable to the variable commission amounts that may be deferred.

This analysis is illustrated as follows:

	Agent 1	Agent 2	Agent 3
Fixed salary (1)	\$100,000	\$100,000	\$100,000
Time attributed to successful efforts	55%	85%	75%
Fixed compensation cost attributable to successful efforts (2)	\$55,000	\$85,000	\$75,000
Variable commission (25% of premiums)	\$80,000	\$150,000	\$120,000
Incremental direct compensation - amount of variable commission in excess of fixed salary (3)	N/A	\$50,000	\$20,000
Deferrable compensation costs [(2)+(3)]	\$55,000	\$135,000	\$95,000

Accordingly, for agent 2, Insurance Company would record total employee compensation expenses of \$15,000 (total compensation of \$150,000 less \$135,000 deferred costs) in its income statement and \$135,000 of DAC on the balance sheet. In subsequent reporting periods, this asset would be amortized to income as an acquisition cost expense.

EXAMPLE IG 3-5

Determination of employee compensation costs eligible for deferral when compensation is comprised of variable commission and fringe benefits

Insurance Company pays an employee sales agent a variable sales-based commission of \$80,000, as well as \$20,000 of other payroll-related fringe benefits for medical and dental insurance and 401(k) plan contributions. The entity has determined that the sales force, of which this agent is a member, is successful 90% of the time it spends directly acquiring new or renewal policies. What portion of the total cost incurred by Insurance Company related to this agent's compensation is eligible for deferral under the guidance in ASC 944-30?

Analysis

Insurance Company should first identify the incremental direct costs of contract acquisition. The terms of the sales-based commission arrangement require Insurance Company to compensate the agent for each contract acquired on a contract-by-contract basis. In other words, the agent is only compensated for acquired contracts. As such, the entire variable sales-based commission of \$80,000 is an incremental direct cost of contract acquisition and may be deferred because Insurance Company would not have incurred the \$80,000 sales-based commission if the entity had not successfully acquired the contracts to earn this amount.

Next, Insurance Company should determine the portion of the agent's total compensation (excluding any compensation that is deferred as incremental direct costs of contract acquisition) and payroll-related fringe benefits directly related to time spent selling insurance contracts that have actually been

acquired. In this fact pattern, the payroll-related fringe benefits that should be deferred by Insurance Company are \$18,000 ($\$20,000 * 90\%$), representing the successful efforts portion of these costs. This amount does not include any of the incremental direct costs attributable to the sales-based commission amount, which was determined to be deferrable in its entirety. Therefore, \$98,000 of this agent's total compensation and payroll-related fringe benefits of \$100,000 is eligible for deferral under ASC 944-30.

3.4.6 DAC – initial recognition and measurement

Incurred acquisition costs that meet the criteria for deferral in ASC 944-30-25-1A through ASC 944-30-25-1AA are deferred and amortized into acquisition expenses in future periods. As required by ASC 944-30-30-2, acquisition costs, including future contract renewal costs, should not be deferred or amortized before the incurrence of those costs.

3.4.7 Non-deferrable acquisition costs

In accordance with ASC 944-720-25-2, acquisition costs of new and renewal business that are not deferred because they do not meet the criteria for deferral in ASC 944-30-25-1A through ASC 944-30-25-1AA and certain indirect costs are required to be charged to expense as incurred. Additionally, certain costs are required to be charged to expense as incurred, such as those relating to investments, general administration, policy maintenance costs, product development, market research, and general overhead, in accordance with ASC 944-40-30-15.

ASC 944-30-55-1F describes other types of acquisition costs that would fail to meet any of the categories of deferrable costs.

ASC 944-30-55-1F

All other contract acquisition-related costs, including costs related to activities performed by the insurer for soliciting potential customers (except direct-response advertising capitalized in accordance with paragraph 944-30-25-1AA), market research, training, and administration, should be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful contract acquisition efforts, and idle time should be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and should be charged to expense as incurred.

Unsuccessful contract acquisition efforts are related to the non-incremental time and other costs incurred that do not result in the issuance of policies. For example, although time and travel costs may be incurred in selling insurance policies, the insurer will not issue a policy to every individual or group solicited. The costs associated with these unsuccessful solicitations are not deferrable.

Idle time represents the time employees are not actively involved in performing underwriting, issuing and processing, performing medical and other inspections, and selling insurance contracts. Idle time can be caused by many factors, including lack of work, training, delays in workflow, and equipment failure. Idle time can be measured through the establishment of standard costs, time studies, ratios of productive and nonproductive time, and other methods.

Pursuant to ASC 944-30-55-1B, costs for software dedicated to contract acquisition, including the associated amortization expenses, are not eligible for deferral as DAC, since these costs would have been incurred regardless of whether or not the insurance policy is issued. The guidance in ASC 985, *Software*, should be considered in determining the accounting treatment for software costs.

3.4.7.1 *Non-deferrable costs for certain long-duration contracts*

For long-duration contracts and, in practice, investment contracts, acquisition costs, such as commissions and premium taxes that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period, may not be deferred in accordance with ASC 944-30-25-4. Instead, these costs should be considered maintenance or other period costs and should be charged to expense in the period incurred.

Additionally, trail commissions that are calculated as a percent of account balance are typically not deferrable. However, for premium-based commissions on universal life insurance products that have flexible premiums, we believe that even constant percentage of premium commissions may be deferrable because the premium payments are not level and recurring; they are at the discretion of the policyholder.

3.4.7.2 *Non-deferrable costs – exclusivity arrangements*

An insurance entity may enter into a relationship with a retailer, or other party, in which the insurance entity pays an upfront amount in exchange for exclusive rights to the retailer's customers and distribution channels to sell the insurance entity's products (e.g., warranty contracts). At the time the agreement is signed with the retailer, there are no contracts that have been entered into with the retailer's customers. Under ASC 944-30, an insurance entity may only defer acquisition costs relating to the successful acquisition of new or renewal insurance contracts. As these payments are made in connection with entering into an exclusive relationship with the retailer, before the insurance entity has entered into any insurance contracts with customers, and are not refundable based on the volume of any insurance contracts subsequently negotiated, the payment does not meet the definition of a deferrable insurance acquisition cost. However, in certain instances, if specified criteria are met, it may be appropriate to conclude that the payment for the exclusivity arrangement represents an identifiable intangible asset accounted for under ASC 350-30. In other fact patterns—for example, if the upfront payment is conditional upon future sales—it may represent a prepaid commission.

3.5 *Subsequent accounting for deferred acquisition costs*

The subsequent accounting for deferred acquisition costs (DAC), including the basis or method of DAC amortization, the amortization period, and recoverability assessment, is dependent on whether the contract is classified as short-duration, long-duration, or an investment contract. ASU 2018-12 does not change the subsequent accounting for DAC for short-duration contracts.

3.5.1 *Short-duration contracts – subsequent accounting for DAC*

Deferred acquisition costs (DAC) for short-duration contracts are required to be charged to expense in proportion to premium revenue recognized in accordance with ASC 944-30-35-1A. In practice, an insurer may accomplish this by calculating a ratio and applying this ratio to unearned premiums. This ratio, sometimes referred to as the “equity in unearned premiums” ratio, is computed as DAC divided by written premiums. ASC 944-30-35-2 indicates that if short-duration contract acquisition costs are

determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and the period used, once determined, are required to be applied to applicable unearned premiums throughout the period of the contracts. Example IG 3-6 illustrates how this guidance could be applied in practice.

EXAMPLE IG 3-6

Amortization of short-duration DAC

On December 31, 20X1, Insurance Company has an unearned premium balance of \$300 and DAC balance of \$45 for a group of contracts (Grouping A). Insurance Company determines that qualifying acquisitions costs for deferral are 15% of written premium on January 1, 20X2 consistent with the previous period for Grouping A. On January 1, 20X2, new contracts are issued in Grouping A for a written premium of \$1,000.

At the end of the first quarter, Grouping A has an unearned premium balance of \$900.

How would Insurance Company derive the amount of ending DAC and related amortization for the first quarter for contract Grouping A?

Analysis

Insurance Company would calculate the ending DAC balance by multiply the period-end unearned premiums balance of \$900 by 15%, which is the percentage relationship of costs incurred to premiums for contracts issued or renewed for this grouping of contracts (resulting in DAC at period end of \$135).

To compute the amortization of deferred acquisitions costs to be recognized in current period earnings, Insurance Company would calculate the change in DAC. Acquisition costs deferred in the period were \$150 (written premium of \$1,000 X 15%). Therefore, the current period expense is \$60 (\$45 beginning balance, plus \$150 new DAC, less the ending balance of \$135).

In accordance with ASC 944-30-35-63, unamortized DAC for short-duration contracts are subject to premium deficiency testing in accordance with the provisions of ASC 944-60. See IG 7.2 for guidance on premium deficiency testing.

3.5.2 Long-duration contracts – subsequent accounting of DAC

The DAC amortization model for all insurance contracts classified as long duration is the same and impacts the following types of contracts, as noted in ASC 944-20-05-14 and further discussed in IG 2:

- Traditional fixed and variable annuity and life insurance contracts
- Universal life-type contracts
- Nontraditional fixed and variable annuity and life insurance contracts
- Participating life insurance contracts
- Group participating pension contracts

DAC is amortized on a straight-line basis over the expected term of the related contracts. No interest accrues on unamortized DAC. This is consistent with other industries' amortization methods for deferred costs that are not measured using present value techniques. The principle is that deferred costs represent historical rather than future cash flows and therefore are not monetary items.

DAC is not subject to impairment testing. DAC is viewed similar to debt issuance costs, which are amortized over the debt term as part of the cost of funding and are not subject to impairment testing. Therefore, for traditional long-duration insurance contracts and limited-payment contracts, DAC balances are excluded from the net premium ratio. The premium deficiency test for other long-duration insurance contracts will also exclude the DAC balance. There is no separate DAC recoverability test for any type of investment contract.

There is no concept of "shadow DAC" adjustments recorded in AOCI as the amortization method is not impacted by realized gains and losses.

3.5.2.1 Long-duration contacts – method of DAC amortization

DAC is amortized to expense on a straight-line basis, either at the individual or grouped contract level over the expected term of the related contracts in accordance with ASC 944-30-35-3A. Contracts may be grouped as long as the amortization approximates straight-line amortization at an individual contract level. Contracts should be grouped consistent with the grouping used to estimate the liability for future policy benefits (or other related balances) for the corresponding contracts. The amortization method should be applied consistently over the expected term of the related contracts. If contracts within a group are different sizes, they may need to be weighted to achieve the straight-line pattern.

Question IG 3-5 addresses the DAC amortization on a group basis.

Question IG 3-5

How should an insurance entity evaluate if the grouped contract method "approximates" amortization at an individual contract level?

PwC response

The group level amortization method needs to create a "straight-line pattern" to meet the objective of amortizing the DAC over the expected life of the group. The amortization method needs to reflect (1) DAC as derecognized when a policy is no longer in force and (2) that contracts within a group may be of different sizes (e.g., face value or notional). The assumptions used in the amortization method need to be updated when the expected life of the group changes. An insurance entity is not required to demonstrate that the dollar amount of group basis amortization would be the same as on an individual contract basis. In fact, the amortization amount between the two bases is expected to be different when actual experience differs from expectations. This interpretation is consistent with the views expressed by the FASB staff on their November 2018 webcast, IN FOCUS: FASB Accounting Standards Update on Insurance.

The new guidance does not require a specific method to achieve the approximate straight-line amortization of grouped contracts. For example, while insurance in force may be an appropriate basis to weight contracts within a group for certain types of business (such as whole life and renewable term insurance), a different basis may be needed for other types of coverage, such as long-term care or

when multiple in-force amounts are involved (such as additional accidental death benefits). However, under ASC 944-30-35-3A, amortization amounts are not permitted to be a function of revenue or profit emergence. The amortization method is required to be applied consistently over the expected term of the related contracts. All assumptions (e.g., terminations) should be consistent with those used to determine the liability for future policy benefits or related balances for the associated contracts.

Question IG 3-6 addresses if grouping is an entity-wide decision.

Question IG 3-6

Does grouping of policies versus individual policies (i.e., seriatim) for DAC amortization purposes need to be an entity-wide decision or can it vary by product or other level of grouping?

PwC response

The guidance requires that the amortization be charged to expense on a constant level basis (either grouped or individual) over the expected term. Grouping is allowed as long as it approximates straight-line amortization. ASC 944-30-35-3A notes that the method should be applied consistently over the term of the contracts. Therefore, the method should not be switched from seriatim to grouping (or vice versa) over the term of those contracts.

Question IG 3-7 addresses the DAC amortization on a group basis.

Question IG 3-7

What basis may be used to weight a group of universal life insurance policies when determining DAC amortization?

PwC response

DAC should be amortized on a straight-line basis (considering expected terminations). Therefore, any method that achieves that pattern would be acceptable. Net amount at risk, which would typically decrease over the life of a universal life product, and account balances that change with interest crediting and fees over the life of a contract would not be appropriate bases for weighting. Using premium deposits as a base may result in an acceptable approximation of the straight-line requirement.

ASC 944-30-35-3B requires that unamortized DAC be reduced for actual experience in excess of expected experience. As a result, contract terminations (e.g., due to lapse or death) would result in a write off of the DAC associated with the terminated contracts, causing an additional charge to income if terminations are more than what was assumed. Changes in future assumptions (e.g., about the expected duration of contracts or amount of coverage expected to be in force) are applied by adjusting the amortization rate prospectively rather than through a retrospective catch up adjustment.

Question IG 3-8 addresses updating the DAC amortization assumptions.

Question IG 3-8

Can an insurance entity update its DAC amortization for actual insurance in force changes in an interim period when such changes were not updated for the calculation of the liability for future policy benefits (i.e., updating the net premium ratio for the associated cohort)?

PwC response

Yes. DAC must be amortized using assumptions that are consistent with the related liability for future policy benefits. ASC 944-40-35-6 requires that the liability for future policy benefits be updated for actual experience at least on an annual basis and more frequently if cash flow assumptions are being updated. Cash flow assumptions need only be updated in interim reporting periods if evidence suggests that the assumptions should be revised. If an entity has determined that the actual experience incurred in the period was not significant enough to warrant an update to the net premium ratio, reflecting the actual insurance in force for the period within the DAC would not alter the decision that no update to the liability for future policy benefits was needed. If the entity chooses to update insurance in force for the insignificant change for DAC, it would not violate the principle that the assumptions be consistent between the two measurements as the differences in assumptions are insignificant.

DAC is amortized to expense on a straight-line basis, either at the individual or grouped contract level over the expected term of the related contracts. The expected term of the contract considers the entire accounting term of the contract in which there are contractual cash flows, including the period over which claims are expected to be paid. For example, this would include the claims settlement period for contracts such as long-term care or disability. Prior to ASU 2018-12 adoption, DAC is amortized in proportion to premium revenue recognized for traditional long-duration contracts such as these.

When determining the expected term of the accounting contracts for amortization of DAC relating to deferred annuity contracts, the payout phase should not be combined with the accumulation phase in accordance with ASC 944-30-35-3 because the payout phase is required to be accounted for as a separate contract if and when annuitization is elected. Therefore, only the expected term of the accumulation phase is considered for DAC amortization.

For immediate annuities, any DAC generated on the immediate annuity sale is amortized over the period in which annuity payments are expected to be made on a straight-line basis. Prior to ASU 2018-12, DAC related to immediate annuities is amortized in proportion to premium revenue recognized.

Question IG 3-9 addresses the DAC amortization contract period.

Question IG 3-9

For a contract with a GMWB feature, is the “expected term of the related contract(s)” noted in ASC 944-30-35-3A the term of the accounting contract or the legal contract?

PwC response

The “expected term of the related contract(s)” is referring to the accounting contract term. The guidance on liability valuation (ASC 944-40-35-8B) provides that upon extinguishment of the account balance (i.e., when the account balance goes to zero) for a GMWB feature, the related contract has

ended for accounting purposes, even if the legal contract survives. That date marks the end of one accounting contract (the deferred annuity contract with an MRB recorded at fair value) and the beginning of a new contract (the payout annuity). The payout phase is viewed as a separate contract and is not combined with the accumulation phase, as noted in ASC 944-30-35-3. Therefore, the DAC should be amortized over the accounting contract term with no unamortized DAC remaining for policies in the payout annuity accounting contract.

Example 2 in ASC 944-30-55-7 illustrates the amortization method for a group of 5-year term products with \$80 of DAC when there are no expected terminations. Straight-line amortization results in \$16 of DAC being amortized in each of the 5 years. In Example IG 3-7, we have modified the ASC 944-30-55-7 example to assume a declining persistency rate. When terminations are expected, amortizing on a straight-line basis over the expected life of the group yields a declining amortization pattern as policies lapse, as illustrated in Example IG 3-7.

EXAMPLE IG 3-7

DAC amortization with a declining persistency rate

Insurance Company insures a group of long-duration guaranteed-renewable 5-year term life insurance products that are grouped and amortized in proportion to the amount of insurance in force with a declining persistency rate. The persistency rate assumption is expected to be 90% at 12/31/20X1, 80% at 12/31/20X2, 70% at 12/31/20X3, 60% at 12/31/20X4, and 0% at 12/31/20X5. In 20X1, \$80 of acquisition costs were deferred. This example assumes all lapses and deaths occur on the last day of the year.

For simplicity, it is assumed that the insurance entity has no interim reporting and issues only annual financial statements. If the entity instead issued quarterly financial statements, the beginning of the period would be the beginning of the current quarter for purposes of both the interim and annual financial statements.

How should Insurance Company calculate annual DAC amortization?

Analysis

Insurance Company should calculate annual amortization expense as follows. The adjusted face amounts at 12/31 of each year end are also the amounts at 1/1 of each succeeding year.

Year	Adjusted face amount (D)	Annual amortization (D)*(C)	DAC balance
1/1/20X1	\$1,000	\$0	\$80
12/31/20X1	900	20	60
12/31/20X2	800	18	42
12/31/20X3	700	16	26

12/31/20X4	600	14	12
12/31/20X5	0	12	0
Total units	4,000* (A)		
DAC	\$80 (B)		

Amortization rate (B/A) = 2% (C)

*4,000 represents the total beginning of 20X1 units (1,000) plus the ending units for years 20X1 through 20x5 (i.e., 1,000 + 900 + 800 + 700 + 600 + 0)

Example IG 3-8 demonstrates an acceptable method of recording the change in current period persistency and the impact on DAC expense.

EXAMPLE IG 3-8

Impact of a change in current period persistency and expected future persistency on DAC expense

Insurance Company insures a group of long-duration guaranteed-renewable 5-year term life insurance products that are grouped and amortized in proportion to the amount of insurance in force with a declining persistency rate. At inception of the block of contracts, the persistency rate assumption is expected to be 90% at 12/31/20X1, 80% at 12/31/20X2, 70% at 12/31/20X3, 60% at 12/31/20X4, and 0% at 12/31/20X5. In 20X1, \$80 of acquisition costs were deferred. However, actual terminations are in excess of those expected (60% of policies remain at the end of year 20X2 rather than expected persistency of 80%) and future expected persistency assumptions are revised for years 20X3 to 20X5 as shown below. Deaths and lapses are assumed to occur on the last day of the year.

For simplicity, it is assumed that the insurance entity has no interim reporting and issues only annual financial statements. If the entity instead issued quarterly financial statements, the beginning of the period would be the beginning of the current quarter for purposes of both the interim and annual financial statements.

How should Insurance Company calculate the impact on DAC expense of the actual experience in Year 2 and of future changes to persistency assumptions in Years 3-5?

Analysis

One approach that Insurance Company may adopt to calculate the impact on DAC of the actual experience different than expected and the annual amortization expense, consistent with the

methodology used in Example 2 in ASC 944-30-55-7B, is as follows. The adjusted face amounts at 12/31 of each year end are also the amounts at 1/1 of each succeeding year.

Year	Adjusted face amount (D)	Annual amortization (D)*(C)	DAC balance
1/1/20X1	\$1,000	\$0	\$80
12/31/20X1	900	20	60
12/31/20X2 expected	800	18	42
12/31/20X2 actual	600		
Experience adjustment *(\$42 X (800-600)/800)		10.5*	31.5
12/31/20X3	500	12.6	18.9
12/31/20X4	400	10.5	8.4
12/31/20X5	0	8.4	0
Total beginning and ending units in remaining years 20X3- 20X5	1,500** (A)		
Remaining DAC 1/1/20X3	31.5 (B)		
20X3 Revised amortization rate (B/A) = 2.1% (C)			

**1,500 represents the total beginning of 20X3 units (600) plus the revised ending units for the remaining years 20X3 through 20x5 (i.e., 600 + 500 + 400 + 0).

Due to actual terminations in excess of those expected, an experience adjustment of \$10.5 is recorded in addition to the annual amortization of \$18. As illustrated, the amortization pattern is revised on a prospective basis beginning in year 20X3. This approach is consistent with the FASB illustration in Example 2 in ASC 944-30-55-7, which determines the current period amortization based on the beginning of the period estimates of persistency.

Other approaches may also be acceptable as long as they meet the FASB principle to approximate a straight-line basis, cannot have unamortized DAC remaining for policies that have terminated, and cannot recapture previously amortized DAC. For example, if an entity revises its estimates of persistency during the period, it may decide to calculate the current period's amortization expense based on observed persistency in the current period reflecting the revised actual persistency in its current period amortization rate, as illustrated in Example IG 3-9.

Example IG 3-9 discusses an alternative acceptable method of recording the change in current period persistency and the impact on DAC expense.

EXAMPLE IG 3-9

Impact of a change in current period persistency and expected future persistency on DAC expense - Alternative acceptable method

Insurance Company insures a group of long-duration guaranteed-renewable 5-year term life insurance products that are grouped and amortized in proportion to the amount of insurance in force with a declining persistency rate. At inception of the block of contracts, the persistency rate assumption is expected to be 90% at 12/31/20X1, 80% at 12/31/20X2, 70% at 12/31/20X3, 60% at 12/31/20X4, and 0% at 12/31/20X5. In 20X1, \$80 of acquisition costs were deferred. However, actual terminations are in excess of those expected (60% of policies remain at the end of year 20X2 rather than expected persistency of 80%) and future expected persistency assumptions are revised for years 20X3 to 20X5 as shown below. Deaths and lapses are assumed to occur on the last day of the year.

Rather than follow the method illustrated in Example IG 3-8, Insurance Company may calculate the year 2 amortization expense based on observed persistency in the current period as follows. The adjusted face amounts at 12/31 of each year end are also the amounts at 1/1 of each succeeding year.

For simplicity, it is assumed that the insurance entity has no interim reporting and issues only annual financial statements. If the entity instead issued quarterly financial statements, the beginning of the period would be the beginning of the current quarter for purposes of both the interim and annual financial statements.

Year	Adjusted face amount (D)	Annual amortization (D)*(C)	DAC balance
1/1/20X1	\$1,000	\$0	\$80
12/31/20X1	900	20	60
12/31/20X2 expected	800		
12/31/20X2 actual	600	22.5	37.5
12/31/20X3	500	15	22.5
12/31/20X4	400	12.5	10

12/31/20X5	0	10	0
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Total beginning and ending units in remaining years 20X2-20X5 2,400* (A)

Remaining DAC 1/1/20X2 60 (B)

20X2 Revised amortization rate (B/A) = 2.5% (C)

*2,400 represents the total beginning of 20X2 units (900) plus the revised ending units for the remaining years 20X2 through 20X5 (i.e., 900 + 600 + 500 + 400 + 0).

This alternative approach determines the current period amortization based on the end of the period estimates of persistency. That is, unlike the approach shown in IG 3-8, under the alternative approach the units in the denominator of the allocation formula have been adjusted to reflect known changes in persistency during the current year (from 800 to 600) as well as the decreased persistency expected for future periods (from 700 and 600 down to 500 and 400). As such, no separate experience adjustment is recorded as the amortization pattern is revised on a prospective basis at the beginning of the period based on the period's actual experience. Under this approach, Insurance Company would utilize known information and current best estimates at the end of the period for purposes of calculating the current period DAC amortization.

The current period amortization rate would take into account all adjustments for changes in actual and expected persistency including (1) experience variances (i.e., the difference between expected and actual terminations) on current period amortization, (2) the resulting impact on future in force (i.e., the impact of what happened in the current period on remaining periods), and (3) the impact of any future persistency assumption change (i.e., the update of future projections).

Question IG 3-10 discusses whether the estimate of persistency should be the same for all products.

Question IG 3-10

May an entity determine the current period DAC amortization based on the beginning of the period estimate of persistency for some products, but use an end of the period estimate of persistency for other products?

PwC response

Example 2 in ASC 944-30-55-7 illustrates an approach that determines the current period DAC amortization based on the beginning of the period estimates of persistency. However as noted in Example IG 3-9, there is an alternative acceptable approach to calculate DAC amortization in the current period taking into account the actual persistency observed in the current period. The selection of a beginning of the period or end of the period approach is an accounting policy choice that should be applied on a consistent basis to similar transactions. Amortization including or excluding actual

persistence in the period is an allocation methodology that would typically be unaffected by different product provisions, and therefore, we expect an entity to have a consistent policy for all its long-duration products that are subject to the DAC guidance.

3.5.3 Investment contracts – subsequent accounting for DAC

ASU 2018-12 simplified the DAC amortization model for certain investment contracts. See IG 2.5.1 for guidance on the classification of investment contracts. Investment contracts that have significant surrender charges or that yield significant revenues from sources other than the investment of contract holders' funds will follow the new DAC amortization guidance in ASC 944-30-35-3 through ASC 944-30-35-3C (discussed in IG 3.5.2.1). However, the new guidance does not apply to certain other investment contracts accounted for as interest bearing or other financial instruments, as noted in ASC 944-825-25.

The assessment of the significance of the surrender charges and/or other sources of revenue other than the investment of contract holders' funds is a matter of judgment. If the surrender charges are similar in effect to banks' and other financial institutions' "early withdrawal penalties" for certificate of deposits (CDs) or other time deposits, the charges should be accounted for in a manner similar to banks' accounting for early withdrawal penalties. However, if the surrender charges have a greater effect than early withdrawal penalties on the revenue anticipated to recover acquisition costs, they are more similar to surrender charges on universal life-type insurance contracts than to banks' early withdrawal penalties. Different types of investment contracts issued by one company may fall into either category. Consideration should be given to the period during which the charges may be imposed; early withdrawal penalties normally apply to the entire life of a CD, while insurance contract surrender charges normally phase-out over a stated time period. Consideration should also be given to the economic effects of the surrender charge.

3.5.3.1 Other investment contracts – method of DAC amortization

Other investment contracts that (1) do not include significant surrender charges and (2) the investment of contract holders' funds are the only significance source of revenue, are accounted for interest bearing or other financial instruments. Accordingly, as required by ASC 944-30-35-20, deferred acquisition costs for these other investment contracts should be amortized using the interest method under ASC 310-20 (effective yield method). The incidence of surrenders can be anticipated for purposes of determining the amortization period if the surrenders are probable and can be reasonably estimated and the rate of amortization is adjusted for changes in the incidence of surrenders consistent with the handling of principal prepayments under ASC 310-20. The objective of the interest method is to arrive at periodic interest income, net of fees and costs, that reflects a constant effective yield on the net policy liabilities.

3.6 Sales inducements

Sales inducements are benefits provided to policyholders that are in excess of current market conditions or other similar contracts. The three main types of sales inducements are immediate bonuses, persistency bonuses, and enhanced crediting-rate bonuses. Immediate bonuses, sometimes referred to as day 1 bonuses, are additional amounts credited to policyholders' account balances upon signing the contract. A persistency bonus is an additional amount credited to a policyholder's account balance at the end of a specified period if the contract remains in force at that date. An enhanced

crediting-rate bonus is a higher crediting rate for a specified period in relation to other similar contracts.

The sales inducement benefits that meet specified criteria are deferred as assets rather than being immediately expensed. The guidance in ASC 944-30-25-6 and ASC 944-30-25-7 specifies the criteria to be met for a sales inducement to be deferred:

ASC 944-30-25-6

Paragraph 944-30-25-7 addresses sales inducements that may be deferrable if the insurance entity can demonstrate that the sales inducement amounts have both of the following characteristics:

- a. The amounts are incremental to amounts the entity credits on similar contracts without sales inducements.
- b. The amounts are higher than the contract's expected ongoing crediting rates for periods after the inducement, as applicable; that is, the crediting rate excluding the inducement should be consistent with assumptions used in contract illustrations and interest-crediting strategies.

Due to the nature of day-one bonuses and persistency bonuses, the criteria in items (a) and (b) generally are met for such sales inducements.

ASC 944-30-25-7

Amounts specified in the preceding paragraph shall be deferred and amortized using the same methodology and assumptions used to amortize capitalized acquisition costs if the sales inducements have both of the following characteristics:

- a. The sales inducements are recognized as part of the liability under paragraph 944-40-25-12.
- b. The sales inducements are explicitly identified in the contract at inception.

The assessment of "similar" contracts is limited to contracts issued in the same interest-crediting period that provide interest rate crediting for the same period and contain other comparable contract features. Comparable contract features may include the type of contract (e.g., single premium deferred annuity, flexible premium deferred annuity, variable annuity, universal life, variable universal life), annuity guarantee rates, and the existence of similar types of charges (e.g., surrender charges, mortality and expense charges, administrative expenses) although amounts may differ between the similar contracts.

3.6.1 Subsequent accounting for deferred sales inducements

Deferred sales inducement assets associated with universal life-type contracts are required to be amortized on a straight-line basis and do not accrete with interest in accordance with ASC 944-30-35-18. For deferred sales inducement assets, the current guidance explicitly requires that amortization be based on the same methodology, factors, and assumptions used to amortize DAC. This is because these also represent past payments or fees that have been deferred. Therefore, these balances are subject to the same amortization approach as DAC. However, because sales inducements are amount payable to policyholders, the amortization is recognized as a component of benefit expense, and not as a component of acquisition expenses.

While DAC is a deferred third-party cost similar to a debt issuance cost, and therefore not subject to an impairment test, the nature of sales inducement assets relating to universal life insurance contracts is different. These balances are contract cash flows and therefore should be included in universal life insurance premium deficiency tests. That is, the deferred amounts would be part of the net liability balance that would be compared to future net cash flows to determine if the net liability balance is sufficient to cover future net cash outflows.

3.7 *Modifications or exchanges of insurance contracts*

An insurance entity's new products may be more attractive than an existing product. As a result, insurance entities may give policyholders the ability to replace their existing policies. Additionally, insurance entities modify certain provisions in existing policies to improve the marketability of their insurance products in a changing and innovative marketplace, or to decrease the operational or administrative burden of accounting and servicing a wide variety of policy types.

Guidance relating to accounting by insurance entities for DAC in connection with modifications or exchanges of insurance contracts applicable to all short-duration and long-duration contracts, including investment contracts, and reinsurance contracts is in ASC 944-30-35-24 through ASC 944-30-35-63. The fundamental concept is that DAC relates to a contractual relationship and not a customer relationship. Modifications of insurance contracts that substantially change the replaced contracts should be considered as new contracts and the related DAC written off. Internal replacements of insurance contracts that do not substantially change the replaced contracts are considered continuations of the replaced contracts and the related DAC is maintained.

In addition to the ASC guidance, the AICPA issued guidance in a question-and-answer format with the AICPA Technical Questions and Answers (TQA) publication, specifically section 6300 – Insurance companies. Figure IG 3-2 provides an index of the relevant TQAs.

Figure IG 3-2

Index of AICPA TQAs addressing modifications and replacements

TQA #	Subject	IG Guide Reference
6300.25	Integrated/Nonintegrated Contract Features in Applying FASB ASC 944-30	IG 3.7.4
6300.26	Evaluation of Significance of Modification in Applying FASB ASC 944-30	IG 3.7.5.1
6300.27	Changes in Investment Management Fees and Other Administrative Charges in Applying FASB ASC 944-30	IG 3.7.5.2
6300.28	Definition of Reunderwriting for Purposes of Applying FASB ASC 944-30	IG 3.7.3 & IG 3.7.5.1
6300.29	Contract Reinstatements in Applying FASB ASC 944-30	IG 3.7.5

6300.30	Commissions Paid on an Increase in Insurance Coverage or Incremental Deposits in Applying FASB ASC 944-30	IG 3.7.6.4
6300.31	Participating Dividends and the Interaction of Guidance in FASB ASC 944	IG 3.7.4
6300.32	Premium Changes to Long Duration Contracts in Applying FASB ASC 944-30	IG 3.7.1.1
6300.33	Evaluation of Changes Under FASB ASC 944-30-35-37(a)	IG 3.7.5.1
6300.34	Nature of Investment Return Rights in FASB ASC 944-30-35-37(b)	IG 3.7.5.2

3.7.1 *Application of the internal replacements accounting model*

ASC 944-30-35-24 through ASC 944-30-35-56 identifies a sequence of steps to determine whether an internal replacement results in a substantially changed contract.

Before applying these steps, an insurer must determine if the modification or exchange meets the definition of an internal replacement, as defined in ASC 944.

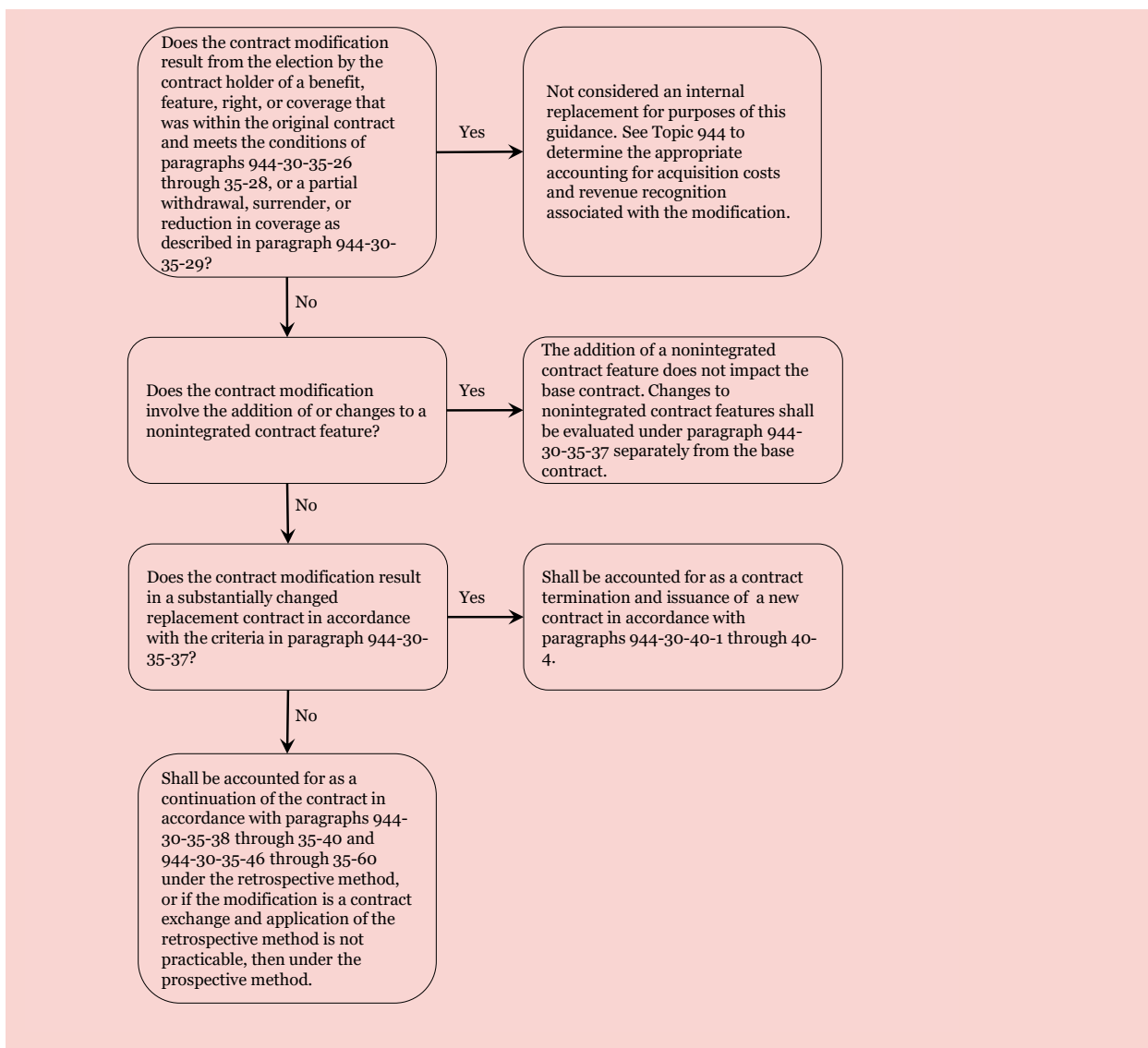
Definition from ASC 944-30-20

Internal Replacement: A modification in product benefits, features, rights, or coverages that occurs by a contract exchange; by amendment, endorsement, or rider to a contract; or by the election of a benefit, feature, right, or coverage within the contract.

This initial determination highlights that certain actions executed by an insurance entity, such as changing cost of insurance charges, interest crediting rates, or similar provisions within ranges outlined in the contract, without any other changes in benefits or coverages, are generally not modifications to the contract and are not internal replacements.

ASC 944-30-55-11

A flowchart summarizing the accounting model set out in the Internal Replacement Transactions Subsections of this Subtopic follows.



3.7.1.1 Internal replacements

An internal replacement is a modification in product benefits, features, rights, or coverage that occurs by any of the following:

- Legal extinguishment of one contract and issuance of another contract (referred to as a contract exchange)
- Amendment of, endorsement or rider to, an existing contract
- Election of a benefit, feature, right, or coverage within a contract

The definition of an internal replacement is very broad. Modifications of insurance contracts take a variety of legal forms and as such, the substance of the modification, rather than its legal form, dictates the accounting for changes to existing contracts. Therefore, most modifications to insurance contracts may be considered internal replacements and subject to analysis under ASC 944-30-35-24 through

ASC 944-30-35-56. Furthermore, while "product feature" is not a defined term, we believe this term includes premiums, fees, or other assessments, and thus changes in premiums, fees, or assessments not within ranges outlined in the original contract, whether increases or decreases, would be considered internal replacements subject to analysis under the internal replacements accounting model.

Question IG 3-11 addresses whether changes considered in the initial contract are modifications.

Question IG 3-11

Are changes to premium rates on a long-duration insurance contract for which the insurer has the contractual right to change premium rates considered modifications as contemplated in ASC 944-30?

PwC response

It depends. Changes to a group insurance contract's premium or benefits based on the insurer's consideration of the actual experience of an individual contract holder (i.e., an individual employer) or the renegotiation of premiums or benefits with an individual contract holder, even without any explicit underwriting, generally would meet the definition of an internal replacement subject to analysis under ASC 944-30. In situations in which the revised premium rate is determined based on a formula specified in the contract that involves objective inputs not subject to insurer discretion or the change is made for an entire class of contracts, the revision would generally not meet the definition of an internal replacement.

3.7.2 Modifications from contract holder elections within original contract

In accordance with ASC 944-30-35-26, modifications resulting from the election by the contract holder of a feature or coverage that was within the original contract are not internal replacements if all of the following conditions are met:

ASC 944-30-35-26

- a. The election is made in accordance with terms fixed or specified within narrow ranges in the original contract.
- b. The election of the benefit, feature, right, or coverage is not subject to any underwriting.
- c. The insurance entity cannot decline to provide the coverage or adjust the pricing of the benefit, feature, right, or coverage.
- d. The benefit, feature, right, or coverage had been accounted for since the inception of the contract.

ASC 944-30-35-26 does not explicitly define what a "narrow" range is as used in the first criterion. However, the terms must be specific enough that the contract holder is able to evaluate whether to elect the feature in current and future market conditions and the range should be narrow enough to provide a meaningful guarantee to the contract holder. Contractual provisions that allow the contract holder to add future coverages at then-current rates, subject to stated minimums and maximums, generally are not specific enough to meet the first criterion. An important factor in addressing this criterion is whether the range has commercial substance to the contract holder's decision to invest in

the original contract. If inclusion of the option and the option price range made an economic difference to the contract holder as compared to a contract that instead provides for election of the option at the then-current market rate, this would indicate a narrow range.

With respect to the second criterion, in certain situations, an insurer may perform limited procedures for the election of a specific benefit included in the original contract. To the extent the procedures are limited and do not involve insurer discretion or judgment to accept the risk or price the election, the procedures would typically not be considered underwriting.

The rationale for the last criterion is that if the provision in question was truly part of the original contract, the entity should have accounted for the feature since the contract's inception and therefore election of the feature is not a new contract (i.e., the option to elect the feature was accounted for as a derivative under ASC 815, market risk benefit, or as an additional liability in accordance with the applicable guidance in ASC 944). If a contract feature should have been accounted for under ASC 815 or ASC 944, and the entity has either been accounting for it since contract inception or has made a determination at the inception of the contract (and since) that the provision was/is immaterial, the election of the feature would not be an internal replacement.

ASC 944-30-35-28 treats the accumulation phase of a deferred annuity contract as separate and distinct from the annuitization phase, even if annuitization is in accordance with terms fixed in the original contract. Therefore, the existence of an annuitization option in a deferred annuity will not change the requirement to amortize DAC over the accumulation (deferral) phase of an annuity contract.

3.7.3 Modifications – partial withdrawals, surrenders, coverage reductions

In accordance with ASC 944-30-35-29, partial withdrawals, surrenders, or reductions in coverage allowed by the original contract or required by state law or regulation are not internal replacements as long as there are no re-underwriting or other modifications to the contract that would require evaluation under ASC 944-30-35-37.

Question IG 3-12 addresses whether certain modifications required by state law are internal replacements.

Question IG 3-12

In the event that policyholders fail to make premium payments in accordance with a previously purchased whole-life policy, all states have enacted non-forfeiture laws that require insurers to modify coverage on existing policies rather than allowing the contract to terminate. These modifications include reducing the face amount of the existing policy to a level that has been fully funded by previous premium payments (known as reduced-paid-up insurance) or conversion of a whole life policy to extended term insurance. Are these modifications considered internal replacements?

PwC response

No. These changes would meet the provisions of ASC 944-30-35-29 and, therefore, would not be internal replacements.

3.7.4 *Integrated and nonintegrated contract features*

Internal replacements that do not meet the criteria established in ASC 944-30-35-26 through ASC 944-30-35-28 or ASC 944-30-35-29 require further analysis. The next step in the analysis is to determine whether the internal replacement is a nonintegrated contract feature. If the internal replacement meets the definition of a nonintegrated feature, as defined in ASC 944-30-35-30 and ASC 944-30-35-31, it is not considered a substantial change in the original (base) contract, and no further analysis is required. The nonintegrated feature would be accounted for similar to a separately issued contract. If the contract feature being modified is integrated, the transaction should be analyzed under ASC 944-30-35-37 to determine if the original contract is substantially changed. Figure IG 3-3 summarizes the definitions of integrated and nonintegrated features for short-duration and long-duration contracts.

Figure IG 3-3

Definitions of integrated and nonintegrated features for short-duration and long-duration contracts

Contract type	Integrated	Nonintegrated
Long-duration (ASC 944-30-35-30)	Contract features for which the benefits can only be determined in conjunction with the account value or other contract holder balances related to the base contract	Contract features for which the determination of benefits provided by the feature is not related to or dependent on the account value or other contract holder balances of the base contract
Short-duration (ASC 944-30-35-31)	Contract features for which there is explicit or implicit re-underwriting or repricing of existing components of the base contract	Contract features that provide coverage that is underwritten and priced only for that incremental insurance coverage and do not result in the explicit or implicit re-underwriting or repricing of other components of the contract

Underwriting and pricing for nonintegrated features are typically executed separate from other components of the contract and theoretically could be purchased separately as an insurance contract, similar to a rider. In contrast, an integrated contract feature is one in which benefits provided by the feature can be determined only in conjunction with the account value or other balance relating to the base contract. However, the fact that the premiums to fund the additional or modified benefits are paid from the base contract's value is not by itself an indication that the benefit feature is integrated.

In limited circumstances, it may not be clear if a contract feature is integrated or non-integrated, such as changes to the premium payment period of a life insurance contract from 10 years to 5 years, when the death benefit remains unchanged and the option was not part of the original contract provisions. As noted in TQA 6300.25, a contract feature is presumed to be integrated unless it clearly meets the definition of a non-integrated contract feature.

An example of an integrated contract feature for a short-duration contract is the addition of, or change to, an experience refund provision in a worker's compensation insurance contract.

Examples of integrated contract features for long-duration contracts include guaranteed minimum death benefits (GMDBs), guaranteed minimum income benefits (GMIBs), guaranteed minimum

accumulation benefits (GMABs) and guaranteed minimum withdrawal benefits (GMWBs), as well as no lapse guarantees and secondary guarantees. These are integrated contract features because, in all cases, the benefit provided can only be determined in conjunction with the account value of the annuity contract.

Examples of nonintegrated contract features for short-duration contracts include a newly acquired automobile added to an existing personal automobile contract and a personal articles floater added to a homeowner's contract.

Examples of nonintegrated contract features for long-duration contracts may include a long-term care rider added to an annuity or disability contract, a term life rider added to an annuity contract, and an accidental death benefit feature added to a traditional life contract.

Waiver of premium benefits added to a traditional life contract is considered a nonintegrated modification. When added to a universal life type contract, waiver of premium could be integrated or nonintegrated, depending on the design of the benefits. A universal life waiver benefit that pays a fixed target premium would be considered nonintegrated but a similar benefit that pays cost of insurance (COI) charges would be considered integrated because the account balance is a factor in the determination of the COI charge.

Question IG 3-13 discusses whether paid-up addition features are internal replacements.

Question IG 3-13

Do paid-up addition features (benefit allowing policyholders to use dividends to purchase additional increments of insurance) offered under certain participating life insurance meet the definition of an internal replacement? If so, are these features considered integrated or nonintegrated features?

PwC response

Paid-up addition features may in certain instances meet the conditions relating to contract holder elections as described in ASC 944-30-35-26 and as such would not be considered internal replacements. See IG 3.7.2 for additional information on the contract holder election criteria. However, in other instances, such paid-up additions may be considered internal replacements, but would generally meet the criteria to be considered a nonintegrated feature.

If the internal replacement meets the definition of a nonintegrated feature, it is not considered a substantial change in the base contract, and no further analysis is required. The nonintegrated contract feature or coverage would thus be accounted for in a manner similar to a separately issued contract. Furthermore, as nonintegrated contract features, benefits, or coverages are more akin to separate contracts, any future modifications to such features are evaluated on a stand-alone basis (i.e., apart from the existing base contract).

3.7.5 Determination if substantially changed contract

If the internal replacement involves integrated contract features or coverages, an insurance entity is required to determine whether the contract has changed substantially because of the modification. A modified contract that is substantially unchanged from the replaced contract should be accounted for as a continuation of the replaced contract, whereas a contract modification that substantially changes

the replaced contract should be accounted for as an extinguishment of the replaced contract and the issuance of a new contract in accordance with ASC 944-30-35-36.

An internal replacement involves contracts that are substantially unchanged only if all of the conditions noted in ASC 944-30-35-37 are met.

ASC 944-30-35-37

An internal replacement (other than those described in paragraphs 944-30-35-26 through 35-29) is determined to involve contracts that are substantially unchanged only if all the following conditions exist:

- a. The insured event, risk, or period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.
- b. The nature of the investment return rights (for example, whether amounts are determined by formulas specified by the contract, pass through of actual performance of referenced investments, or at the discretion of the insurer), if any, between the insurance entity and the contract holder has not changed.
- c. No additional deposit, premium, or charge relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract, is required to effect the transaction; or if there is a reduction in the original benefit or coverage, the deposit, premiums, or charges are reduced by an amount at least equal to the corresponding reduction in benefits or coverage.
- d. Other than distributions to the contract holder or contract designee or charges related to newly purchased or elected benefits or coverages, there is no net reduction in the contract holder's account value or, for contracts not having an explicit or implicit account value, the cash surrender value, if any.
- e. There is no change in the participation or dividend features of the contract, if any.
- f. There is no change to the amortization method or revenue classification of the contract.

If any of the conditions are not met, an internal replacement is determined to involve a replacement contract that is substantially changed from the replaced contract.

Example 2 (see paragraph 944-30-55-33) illustrates the application of this guidance.

If any of these conditions are not met, an internal replacement is considered a replacement contract that is substantially changed from the replaced contract. The analysis is performed using the terms of the contract immediately before and after the modification.

Question IG 3-14 addresses whether reinstated contracts are substantially unchanged.

Question IG 3-14

An insurance entity reinstated a lapsed contract for which it no longer had an obligation to pay claims. Does the reinstated contract meet the conditions of a substantially unchanged contract?

PwC response

If an insurer decides to reinstate a lapsed contract for which it no longer had an obligation to pay claims, the lapsed contract would have been extinguished and the reinstated contract would be considered a newly issued contract for accounting purposes at the date the reinstatement occurs. The reinstated contract would not meet the conditions of a substantially unchanged contract as the lapsed contract has already been terminated.

3.7.5.1 Changes in insured event, risk, or period of coverage

The evaluation of whether there are significant changes in insurance risk or period of coverage is done prospectively as events occurring prior to the internal replacement are irrelevant to the replacement transaction. Therefore, when assessing the significance of a change in insurance risk or the period of coverage, the remaining period of coverage of the replaced contract is compared to the remaining period of coverage provided by the replacement contract. The prospective comparison is consistent with the guidance for debt modifications in ASC 470-50-40.

Judgment must be used to determine whether there are significant changes in the "degree" of mortality, morbidity, or other insurance risk, considering the specific facts and circumstances of the modification. The focus should be on the substance of the changed risks of the contract between the insurance entity and the contract holder. The guidance in ASC 944-30-35-37(a) does not prescribe a specific approach for analyzing the significance of the change in insurance risk. However, the implementation guidance of Example 2 in ASC 944-30-55-33 through ASC 944-30-55-76 provides several example approaches that could be applied when assessing the change in the degree of insurance risk for various products and features.

Examples of factors to consider in determining whether there has been a significant change in insurance risk because of an internal replacement include:

- Changes in the actuarially estimated costs of benefit features (e.g., death benefits, claim costs)
- Changes in the relationship between the expected cost of the benefit and the charges for the benefit, as described in ASC 944-30-55-39 with regard to a universal life contract.
- Changes in the benefit ratio (i.e., comparing the change in the relationship between future projected guarantee benefits and total assessments under the contract).
- Changes in the net amount at risk before and after the modification

Entities should develop accounting policies for assessing the significance of a change in insurance risk in an internal replacement and consistently apply those policies for similar types of internal replacements. Certain approaches may be more appropriate than others depending on the type of internal replacement. When selecting an assessment approach, consideration should be given to the substance of the change between the insurer and the contract holder.

When assessing the replacement of a return-of-premium GMDB with a ratchet-type GMDB, the implementation guidance in ASC 944-30-55-65 concludes that although the actual mortality event is the same, the risk has changed because of the combined effects of mortality and investment events. In arriving at this conclusion, the change was analyzed using the gross expected mortality costs as an indicator of a significant change in the degree of mortality risk. ASC 944-30-55-66 has an example of a change in MRB benefits that is not a substantial change as the mortality costs remain similar.

Question IG 3-15 addresses how to consider re-underwriting under ASC 944-30-35-37(a).

Question IG 3-15

Would the re-underwriting of a contract in and of itself indicate a change in the kind or degree of insurance, thereby precluding an insurance entity from meeting criterion in ASC 944-30-35-37(a)?

PwC response

It depends. The re-underwriting of an entire contract would be considered an indicator of a substantial change in the insurance risk rather than an absolute requirement. Situations in which more limited procedures are performed, especially those that involve only a specific risk or component of a contract and do not involve insurer judgment or discretion with respect to acceptance or rejection of the insured or discretion as to price, do not appear to meet the definition of re-underwriting. An example of a more limited procedure would be one in which limited procedures are performed to validate an insured's statement that they are currently a non-smoker. This would generally not be considered re-underwriting. Facts and circumstances should be carefully reviewed to determine whether there has been a re-underwriting as part of the analysis in ASC 944-30-25-37(a). However, it is also important to note that the lack of underwriting is not, by itself, sufficient to conclude that the change is not substantial.

3.7.5.2 Changes in the nature of investment return rights

The guidance in ASC 944-30-35-37(b) is principles based and, as such, requires qualitative considerations to assess changes in the nature of investment returns. We believe that entities should use their best judgment when developing an approach for making this assessment, and consistently apply the approach for similar types of internal replacements.

In many cases, the evaluation of the nature of investment return rights is straightforward. The guidance is clear that changing the investment crediting rate from one type of return to another (e.g., from a pass through return to a formulaic return or to a return based on the discretion of the insurance entity) represents a change in the nature of the investment return rights. Therefore, replacing a fixed or general account product with a variable product will result in a substantially changed contract. In addition, adding an investment return floor, such as a GMIB, GMAB, or GMWB, to a variable annuity without any existing minimum guarantees, or capping of the return such that actual returns are not passed along to the contract holder, would result in a substantially changed contract.

Another example of a change in the nature of investment return rights would be a change in contract holder liquidity rights. For example, a variable annuity product may have different types of guarantees: a GMIB (payable in installments over a specified annuitization period; a GMAB (payable at the end of a specified period); or a GMWB (payable during the accumulation phase of the contract). Because each of these features provides for different timing of cash flow accessibility to the contract holder, the change in contract holder liquidity rights is a change in the nature of the investment rights.

In other cases, the determination as to whether a change to investment return rights constitutes a change in its nature will be less straightforward. These include situations when a component of an investment return formula has changed, such as a change in the strike price formula or strike price amount of an investment return floor. Changing the strike price of a guarantee in a variable annuity with a GMAB ratchet that is currently out of the money (i.e., the guarantee is below the current variable annuity account balance) to a next generation of the GMAB ratchet, with the guaranteed floor reset at the modification date to the current account balance (i.e., at the money) is one example. This example, and other situations requiring analysis of changes in the nature of investment return rights, require careful consideration of the facts and circumstances in order to determine if the revision fundamentally changes the nature of the investment return rights. Changes to formulaic inputs may be of such a degree that they change the fundamental nature of the investment return rights.

Question IG 3-16 addresses whether changes in investment management fees are a substantial change.

Question IG 3-16

Are changes to investment management fees and other administrative charges considered under paragraph ASC 944-30-35-37 when determining whether a contract is substantially unchanged?

PwC response

Changes to investment management fees and other administrative charges in accordance with terms and within ranges specified in the original contract, without any other change in benefits or coverages, are not considered modifications. For changes in administrative fees not meeting those criteria (e.g., a change from a flat fee plus percentage of assets to a pure percentage of assets fee), the change should be evaluated under ASC 944-30-35-37(b) in conjunction with investment return rights. ASC 944-30-35-37(a) and ASC 944-30-35-37(c) are not applicable to changes in administrative fees, but instead were meant to apply to changes in insurance risk or charges relating to insurance risk.

3.7.5.3 *Changes in deposits, premiums or other charges*

The purpose of the criterion in ASC 944-30-35-37(c) is to prevent a change in the deposits, premiums, or other charges relating to the original coverage, which would be indicative that the economics of the replaced contract have changed. A change in the deposit, premium, or other charges are not prohibited as long as the change relates to the new change in the benefit or coverage and is not in excess of the amount that is commensurate with the change in benefit provided.

3.7.5.4 *Change to policyholder account value or cash surrender value*

Under the criterion in ASC 944-30-25-27(d), there can be no net reduction in the contract holder's account value or no reduction in the cash surrender value for contracts not having an explicit or implicit account value, other than distributions to the contract holder or contract designee or charges related to newly purchased or elected benefits or coverage.

If there is a net reduction in account value or similar feature, this would be equivalent to a surrender charge and thus indicative of a change in the substance of the original contract. For a universal life-type, limited payment, or investment contract that has an explicit account balance, changing the surrender charge amount or surrender charge period would not be considered a modification until surrender occurs. This is consistent with the concept inherent in ASC 944-30-35-24 that a change is not a change until elected by the contract holder.

3.7.5.5 *Change in the participation or dividend features*

In accordance with ASC 944-30-35-37(e), changing the participation or dividend features of a contract would be considered a substantial change. Changing dividend scales, by themselves, is not considered a violation of this provision. However, the addition of a dividend feature to an individual life contract, or the addition of an experience refund provision to a group contract, are examples of changes in the participation or dividend feature that would cause the modification to fail this provision and thus be considered a substantial change.

3.7.5.6 *Change to the amortization method or revenue classification*

If the contract modification causes the accounting model to change, for example, from a contract accounted for as a traditional life-insurance contract to a contract accounted as a universal life-type contract, the modification would result in a substantially changed contract under ASC 944-30-35-37(f).

3.7.6 *Accounting for a substantially unchanged contract*

When an internal replacement results in a replacement contract that is substantially unchanged from the replaced contract, any unamortized deferred acquisition costs (DAC), unearned revenue liabilities, and deferred sales inducement assets associated with the replaced contract should continue to be deferred and amortized or earned in connection with the replacement contract (i.e., the internal replacement should be accounted for as a continuation of the replaced contract). Other balances associated with the replaced contract, such as any liability for GMDBs or GMIBs, should continue to be recognized as if the replacement contract is a continuation of the replaced contract. Attributed fees for MRBs would remain unchanged if the MRB is unchanged. However, if an MRB feature was changed but determined not to be a substantial change (as in the example in ASC 944-30-55-66), there may be an incremental insignificant change to the attributed fee. For example, if the fair value of the new incremental MRB costs was equal to fifteen basis points of account balance, then fifteen basis points might be added to the existing attributed fee going forward.

Additionally, if the replaced contract was acquired in a business combination, any present value of future profits (PVFP) or value of business acquired (VOBA) established in accordance with ASC 944-805-25-3 would be accounted for in a similar manner. See IG 12 for accounting considerations related to contracts acquired in conjunction with a business combination.

3.7.6.1 *Substantially unchanged short-duration contracts*

As required by ASC 944-30-35-52, for short-duration contracts, the replacement contract is viewed as a prospective revision to the replaced contract. The unamortized DAC is unchanged at the time of the replacement with the future recognition of unearned premium and amortization of DAC adjusted accordingly on a prospective basis based on the revised terms. In accordance with ASC 944-30-35-54, when the modification is a reduction in benefits with a directly proportionate reduction in premiums, the modification should result in an immediate proportionate reduction in unamortized DAC rather than a prospective revision.

3.7.6.2 *Substantially unchanged long-duration contracts*

For long-duration contracts, other than certain investment contracts noted in IG 3.5.3, the replacement contract that is substantially unchanged is viewed as a prospective revision to the

replaced contract in accordance with ASC 944-30-35-46. The unamortized DAC is unchanged at the time of the replacement with the future amortization adjusted on a prospective basis for any change in the expected life of the replacement contract. In accordance with ASC 944-30-35-50 and ASC 944-30-35-51, any related liability for future policy benefits or market risk benefits is required to be updated as described in ASC 944-40-35 and other balances that are determined based on activity over the life of the contract, such as an additional liability for death or other insurance benefits, is calculated considering the term of the replacement contract and activity during the term of the replaced contract.

3.7.6.3 *Substantially unchanged investment contracts*

ASC 944-30-25-48 requires that for certain investment contracts accounted for as interest-bearing or other financial instruments for which DAC is amortized using the interest method under ASC 310-20, the replacement contract represents revisions to the cash flows of the replaced contract. As such, the unamortized DAC and deferred sales inducement assets are adjusted accordingly. See IG 3.5.3 for information about investments contracts accounted for as interest-bearing or other financial instruments.

3.7.6.4 *Costs – substantially unchanged internal replacements*

Costs incurred on internal replacements that result in a substantially unchanged contract should be accounted for as policy maintenance costs and expensed as incurred (i.e., the costs should not be deferred) in accordance with ASC 944-30-35-55.

ASC 944-30-35-56 requires any portion of renewal commissions paid on the replacement contract that meet the criteria for deferral in accordance with ASC 944-30 continue to be deferrable if they do not exceed the amount of deferrable renewal commissions on the replaced contract. See IG 3.4 for further guidance on the criteria for deferral of acquisition costs. The guidance is intended to prevent the deferral of additional costs incurred related to substantially unchanged contract modifications that do not result in additional insurance coverage or incremental deposits. For example, if a contract were exchanged for a new generation of the contract, and the agent was paid a commission on the rollover of the existing account balance, the commission would not be deferrable. Additionally, to the extent a commission is paid at a rate in excess of the rate provided at the replaced contract's inception, the excess commission would not be deferrable. The guidance does not prevent the deferral of commissions paid on premiums attributable to an increase in insurance coverage or incremental deposits not previously provided for in the contract.

3.7.6.5 *Sales inducements – substantially unchanged internal replacements*

ASC 944-30-35-57 through ASC 944-30-55-60 indicates that if a surrender charge assessed on the replaced contract is offset by an immediate sales inducement on the replacement contract, insurance entities should offset the immediate sales inducement against the surrender charge to determine whether there has been a net reduction in the contract holder's account in accordance with ASC 944-30-35-37(d). The sales inducement liability will be recorded as part of the liability for policy benefits over the period in which the contract must remain in force to qualify for the inducement or at the crediting date, if earlier. The criteria in ASC 944-30-25-6 through ASC 944-30-25-7 for recognition of a related sales inducement asset cannot be satisfied in these circumstances because the sales inducement was not specifically identified in the original contract. See IG 3.6 for the criteria for deferring sale inducement assets.

Example IG 3-10 illustrates the accounting for a sales inducement offered with an internal replacement of an investment contract.

EXAMPLE IG 3-10

Sales inducement offered with an internal replacement of an investment contract

Insurance Company offers a sales inducement in conjunction with the conversion of an investment contract to a universal life contract. The account balance of the replaced contract immediately prior to the internal replacement was \$10,000. Upon termination of the replaced contract, a surrender charge of \$500 was applied and a \$500 sale inducement bonus was offered in conjunction with the new internal replacement contract.

How would Insurance Company apply the guidance in ASC 944-30-35-57 and what would be the resulting accounting?

Analysis

The account balance of the investment contract prior to surrender charges is \$10,000 and a \$500 surrender charge is imposed. The resulting \$9,500 credited to the replacement contract account value (prior to consideration of the sales inducement) would result in a substantial change to the contract. However, since an immediate bonus of \$500 was credited to the replacement contract, there would be no net reduction to the balance available to the contract holder and the internal replacement would result in a contract that is substantially unchanged provided the other conditions of ASC 944-30-25-37 are satisfied. Additionally, there would be no net impact on earnings as the \$500 surrender charge would be directly offset by the \$500 immediate sales inducement bonus that is expensed as incurred.

3.7.7 Contract assessments

ASC 944-30-35-61 indicates that front-end fees assessed in connection with an internal replacement of a long-duration contract are evaluated for deferral in accordance with ASC 944-605.

3.7.8 Substantially changed contract (extinguishment of replaced contract)

ASC 944-30-40-1 through ASC 944-30-40-4 requires a replacement contract that is substantially changed from the replaced contract to be accounted for as an extinguishment. Under the guidance, any balances associated with the original replaced contract are derecognized. These balances may include unamortized DAC, PVFP, unearned revenue liabilities, deferred sales inducement assets, liability for future policy benefits, or market risk benefits. The replacement contract is accounted for as if it were a newly issued contract. As such, acquisition costs related to the replacement contract should be evaluated for deferral in accordance with the provisions of ASC 944-30. See IG 3.4 for further guidance on the criteria for deferral of acquisition costs.

ASC 944-30-40-1 through ASC 944-30-40-4 does not provide explicit guidance on the amount of non-cash consideration used to calculate the gain or loss on extinguishment of the replaced contract and the initial premium for the newly issued contract when an internal replacement results in a substantially changed contract.

One way practice has viewed this non-cash transaction is that the consideration for the extinguishment and the premium for the replacement contract would be the same amount adjusted for

any cash exchanged, such as additional premiums or deposits paid by the policyholder for the replacement contract. The non-cash consideration could be the sum of the account balance carried over to the replacement contract from the replaced contract and the fair value of any off-market terms, including benefits, guarantees, premiums, or deposits. Off-market terms are those that are different from terms offered to a new contract holder for the same or similar contract.

An example of an off-market feature on a variable annuity replacement contract would be a GMDB, GMIB, GMAB, or GMWB that has a starting floor guarantee amount above the new account balance (i.e., in the money) but has related policy fees comparable to the fees for a similar guarantee that has a starting floor guarantee equal to the new account balance (i.e., at the money).

Example IG 3-11 illustrates the considerations when determining whether the lapse and reinstatement of a long-duration life insurance contract results in a contract extinguishment

EXAMPLE IG 3-11

Determining whether the lapse and reinstatement of a long-duration life insurance contract results in a contract extinguishment

Insurance Company issued a long-duration life insurance contract that lapsed due to nonpayment of premium. As a result, Insurance Company has no obligation to pay claims during the lapse period. Under the terms of the contract, the policyholder can reinstate the contract within a specified period from the lapse date with no ability of Insurance Company to re-underwrite this risk. In the period between lapse and reinstatement, if the insured dies, there is no death benefit paid. Should the lapse and reinstatement be treated as a contract extinguishment?

Analysis

An extinguishment occurs when an insurance enterprise has no further obligation to pay claims due to the lapse of a contract. However, in the fact pattern above, the policyholder has the unilateral right to reinstate the contract without any underwriting or other qualifying criteria. Therefore, although Insurance Company has no obligation to pay a death benefit claim during the period between lapse and reinstatement, its obligation to the policyholder has not been totally extinguished. Insurance Company may have future death benefit exposure under the current contract if the policyholder decides to reinstate the policy by paying a premium, and thus the contract would not be considered extinguished. In addition, the lapse in coverage would not be considered a contract modification because it was part of the original contract provisions that such a lapse could occur without necessarily terminating the contract. Therefore, neither a contract extinguishment nor a modification has occurred.

In other fact patterns, a policyholder may not have the unilateral right to reinstate the contract (either through the contract terms or a past practice that makes it legally enforceable), or the insurer may have an administrative practice of reinstating lapsed contracts at its discretion while retaining the right to deny reinstatement. In such cases, a lapsed contract would result in an extinguishment for accounting purposes.

3.8 *DAC for reinsurance contracts*

There is DAC-related accounting for reinsurance contracts that is applicable for both the ceding company and the assuming reinsurer.

3.8.1 *Ceding company accounting of DAC*

In many reinsurance transactions, the ceding company will pay the reinsurer a reinsurance premium for reinsurance coverage, and receive a ceding commission from the reinsurer. The ceding commission represents the results of a negotiation for reimbursement to the cedant for both direct and indirect acquisition costs as well as other expenses and any transfer of profit in the premiums. ASC 944-30-35-64 addresses the ceding company's accounting for these proceeds.

ASC 944-30-35-64

Proceeds from reinsurance transactions that represent recovery of acquisition costs shall reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in accordance with the amortization guidance in this Section that applies to those unamortized acquisition costs.

Consistent with the guidance in ASC 944-30-35-64, the ceding allowance DAC offset is limited to the amount that represents recovery of acquisition costs deferred by the cedant. Any remaining amount (i.e., the portion of ceding commission above the amount representing recovery of DAC) should be deferred and amortized rather than recognized in income immediately. The net DAC balance is subject to the simplified DAC amortization model.

For long-duration contracts, the remaining amount should be included as a component of the cost of reinsurance. For short-duration contracts, we believe it would be appropriate to record any remaining commission (i.e., the "excess ceding commission") as an adjustment to unearned ceded premium. The rationale for this view is that reinsurance guidance explicitly acknowledges only two captions for recognition of consideration between the ceding company and the reinsurer: reduction in DAC and unearned ceded premium. However, due to the lack of specific guidance on this issue, we are aware of diversity in practice with regard to balance sheet and income statement classification for this deferred amount and its subsequent amortization. For example, the SEC staff has accepted the amortization of excess ceding commission as ceding commission income or as a reduction to other underwriting expenses.

3.8.2 *Assuming reinsurer accounting of DAC*

The assuming entity in a reinsurance transaction is in substance providing the same type of protection as a direct insurer. As a result, a reinsurer would follow the applicable direct insurance model for DAC deferral, recoverability, and amortization purposes per ASC 944-30-25-13.

3.9 *Other DAC considerations*

Other areas related to DAC that need specific consideration include the classification of DAC as a monetary or nonmonetary item and the translation implications for DAC denominated in a foreign currency.

3.9.1 *Foreign currency implications of DAC*

The classification of deferred acquisition costs (DAC) as monetary or nonmonetary items is dependent on the classification of the contract as either short duration or long duration. See IG 2 for a description of the various classification models. ASC 830-10-45-18 and ASC 255-10-55-1 require that DAC and related amortization for property and casualty contracts (short duration) be classified as nonmonetary items. DAC and related amortization for life insurance contracts (long-duration), on the other hand, would be classified as monetary items.

Nonmonetary assets and liabilities are initially measured using historical exchange rates with all aspects of the ongoing accounting for these items (e.g., amortization, impairment) measured in terms of the entity's functional currency. Monetary assets and liabilities are measured at the end of each reporting period based on the then-current exchange rates. This measurement gives rise to foreign currency gains and losses recorded in current period net income. See our *Foreign currency* guide (FX 5.4) for further information.

Question IG 3-17 addresses the exchange rate to be used to remeasure DAC.

Question IG 3-17

What is the appropriate exchange rate required for remeasurement of foreign currency transactions related to DAC on long-duration insurance contracts?

PwC response

ASC 830-10-45-18 dealing with foreign currency matters or ASC 255-10-55-1 dealing with changing prices require that DAC and related amortization for life insurance companies be classified as monetary amounts. Although BC 84 in the Basis for Conclusions of ASU 2018-12 observes that “deferred acquisition costs are not, in themselves, monetary items,” ASC 830 and ASC 255 note that classification as a monetary item is a practical solution given the close relationship of DAC for life insurers to related monetary items (the insurance liabilities).

Monetary assets and liabilities are measured at the end of each reporting period based on the then-current exchange rates. This measurement gives rise to foreign currency gains and losses, which are recorded in current period net income.

Chapter 4:
Short-duration contract
liabilities

4.1 Short-duration contract liabilities – chapter overview

This chapter provides guidance relating to the recognition and measurement of revenue and related contract liabilities for short-duration insurance contracts, including:

- Premium revenue recognition and unearned premium liability
- Liability for unpaid claim and claim adjustment expenses, including incurred but not reported (IBNR) claims (often called insurance reserves)
- Discounting of claim liabilities
- The differentiation between loss occurrence or claims-made insurance coverage
- Consideration of embedded derivatives under ASC 815
- Residual value insurance contracts
- Deposit contracts that do not transfer insurance risk

4.2 Premium recognition and unearned premium liability

Insurance entities charge premiums as compensation for providing insurance protection over the contract period. Written premium is the total amount that a policyholder is required to pay under the insurance contract absent a cancellation. Earned premium is the amount an insurance entity has recognized as revenue for the coverage provided under the insurance contract to date. Premium revenue is typically earned over the contract period in proportion to the amount of insurance protection provided, with an unearned premium liability recognized representing the unexpired portion of premiums in force as of a particular financial statement date.

In certain commercial lines policies, the amount of premiums can change during the contract period due to endorsements, audit premiums, retrospective premium adjustments, and cancellations. The same principle of recognizing premium revenue in proportion to the amount of insurance protection provided applies to the premium adjustments.

- Endorsements are amendments to existing insurance contracts that change the scope or terms of the original insurance policy. Endorsements may include lowering or raising the coverage limits and/or deductibles as well as the addition or removal of insured risks (e.g., adding a new insured vehicle to an automobile policy), which will typically affect the policy premiums. Endorsements may also be needed for certain administrative changes (e.g., changing the insured's mailing address), which would typically not affect the policy premiums.
- Audit premiums are adjustments to the policy premium to accurately reflect the insurance exposure under the contract. Periodic premium audits are performed on policyholders' records (e.g., employee payroll data for a workers' compensation insurance policy or vehicle count for a commercial automobile insurance policy) in order to update the existing premium estimate to reflect the premiums for the actual exposures under the contract.

- Retrospective premium adjustments are adjustments to the premiums subsequent to the effective date of the contract, and typically subsequent to the coverage period, based on the actual claims experience of the contract.
- Cancellation is the termination of an existing policy prior to the expiration date of the contract. Cancellations may be initiated by the insurance entity because of nonpayment by the insured or may be requested by the insured when insurance protection is no longer needed. Policy premiums refunds upon a cancellation will typically be based on the number of days the insurance policy was effective, subject to a cancellation penalty if applicable.

4.2.1 Written premium and unearned premium

Although not explicitly required by ASC 944, many insurance entities present written premium as an income statement line item reflecting the sales effort in the period along with the change in unearned premium in order to reconcile to premium revenue earned.

4.2.1.1 Premiums payable in installments

When premiums are paid at the inception of a contract, an unearned premium liability is recognized. There is no specific authoritative guidance on the timing of balance sheet recognition for uncollected written premiums or unearned premiums for contracts with premiums payable in installments. In practice, many insurers writing annual contracts with periodic installment payments present all contractual premiums, regardless of whether earned or due as of the balance sheet, as a premium receivable with a corresponding written premium and unearned premium liability. An alternative view is that because the premium receivable is conditional (the policyholder has the right to cancel the policy and discontinue future payments), written premium and unearned premium should not be recorded until each installment payment is due. Based on existing diversity in practice and the lack of specific authoritative guidance, either view is acceptable as long as the policy decision is applied consistently.

Example IG 4-1 demonstrates the two alternatives for the recognition of written premium and unearned premiums for contracts with premiums payable in installments.

EXAMPLE IG 4-1

Recognition of written premium and unearned premium liability for contracts with premiums payable in installments

Insurance Company enters into a one-year automobile insurance policy effective on January 1, 20X1 with an annual premium amount of \$1,600 that is payable in quarterly installments of \$400 starting at contract inception with no finance charge.

How may the written premium and unearned premium liability be recognized at contract inception and at March 31, 20X1?

*Analysis**Method 1: Premium receivable recorded with offsetting unearned premium liability for total written premium*

At contract inception (January 1, 20X1), Insurance Company would record the following journal entries.

Dr. Cash	\$400	
Dr. Premium receivable	\$1,200	
Cr. Unearned premium liability		\$1,600

Dr. Change in unearned premium*	\$1,600	
Cr. Written premium*		\$1,600

* Optional income statement entry to record written premium as a separate financial statement line item, which nets to zero

At March 31, 20X1, Insurance Company would record the following journal entry.

Dr. Unearned premium liability	\$400	
Cr. Earned premium (or Change in unearned premium*)		\$400

* Optional financial statement line item utilized when recording written premium

On the balance sheet as of March 31, 20X1, Insurance Company would have cash or investments of \$400, premium receivable of \$1,200 and unearned premium liability of \$1,200 related to this policy (ignoring any claim activity). On the income statement for the period ending March 31, 20X1, Insurance Company would have earned premium of \$400.

Method 2: Record unearned premium liability as premium is due

Alternatively, at contract inception (January 1, 20X1), Insurance Company would record the following journal entry.

Dr. Cash	\$400	
Cr. Unearned premium liability		\$400

At March 31, 20X1, Insurance Company would record the following journal entry.

Dr. Unearned premium liability	\$400	
Cr. Earned premium		\$400

On the balance sheet as of March 31, 20X1, Insurance Company would have only cash or investments of \$400 related to this policy (ignoring any claim activity). No premium receivable or unearned premium liability would be recorded until the next installment payment is due on April 1, 20X1. On the income statement for the period ending March 31, 20X1, Insurance Company would have earned the same \$400 premium as under the written premium method.

4.2.2 *Short-duration contracts — premium revenue recognition*

ASC 944-605-25-1 provides guidance on the recognition of premium revenue.

ASC 944-605-25-1

Premiums from short-duration contracts shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

As required by ASC 944-605-25-1, premiums are recognized as revenue evenly over the contract period or the period of risk, if significantly different, in proportion to the amount of insurance protection provided. Straight-line recognition over the coverage period is the primary practice. However, in certain seasonal and aggregate excess of loss coverages (i.e., coverage of total claims that exceed a certain threshold in a period), an uneven pattern of insurance protection can be supported, which would result in a different pattern of premium recognition. For example, wind storm protection can be considered seasonal even though most coverage is for the full year. There are two schools of thought on aggregate excess of loss contracts. Some consider the coverage to have risk over the whole period for a yet to be determined portion of each claim in the period and thus recognize premium evenly over the entire period. Others consider the risk covered to be concentrated in the later part of the period when the threshold for coverage is more likely to be exceeded.

Question IG 4-1 addresses premium revenue recognition on a multi-year contract as coverage is partially used by incurred claims.

Question IG 4-1

How is premium revenue recognized for a multi-year short duration contract, when coverage is depleted as losses are incurred? For example, how would premium revenue be recognized for a three-year contract with an annual premium of \$500,000, and an aggregate coverage limit of \$3,000,000 over the three years?

PwC response

It depends. If no losses occur, premiums should be recognized as revenue on a pro rata basis as the coverage expires (e.g., on a straight-line basis over the three-year period with \$500,000 premium revenue recognized in year one). If losses are incurred and the coverage is diminished, premiums should be recognized as revenue proportionate to the coverage used. For example, if a loss of \$2,000,000 occurs in year one, two-thirds of total contractual premiums (\$1,000,000) should be recognized as revenue in year one.

ASC 944-605-25-2 provides premium revenue recognition guidance for policies in which premiums are subject to adjustment based on claim experience or based on the value of the insured property (e.g., retrospectively rated or other experience-rated insurance contracts). If the ultimate premium can

be reasonably estimated, the estimated ultimate premium is recognized as revenue over the contract period. Conversely, if the ultimate premium cannot be reasonably estimated, the cost recovery method or the deposit method is utilized until the ultimate premium becomes reasonably estimable. Under the cost recovery method, premiums are recognized as revenue in an amount equal to estimated claim costs as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time. Under the deposit method, the portion of premiums subject to adjustment is not recognized as revenue and claim costs are not charged to expense until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time. At each reporting period, the estimated ultimate premium is updated to reflect current experience.

4.2.3 Short-duration contracts – premium deficiency

ASC 944-60 requires the recognition of a loss when an entity expects a loss on insurance policies based on current cash flow assumptions in excess of recorded amounts. For short-duration contracts, a loss is recognized when expected claim and claim adjustment costs, expected dividends, unamortized acquisition costs, and maintenance costs for the unexpired portion of the contract exceed unearned premium. See IG 7.2 for further information on premium deficiencies for short-duration contracts.

4.3 Short-duration claim costs

For short-duration contracts, both a liability for unpaid claims and a liability for claim adjustment expenses is established when insured events occur. ASC 944-40-25-2 requires that the liability for unpaid claims include both costs associated with reported claims, commonly referred to as “case reserves,” and costs associated with claims that have occurred but have not yet been reported to the insurance entity, commonly referred to as “incurred but not reported (IBNR) claims.” In practice, the IBNR liability component may also include an estimate for expected increases in case reserves but not yet allocated to case reserves (sometimes called incurred but not enough reserves, IBNER). When accounting for a claims-made insurance policy, the insurer should accrue claims as they are reported, with no provision for IBNR (see IG 4.4).

The liability for claim adjustment expenses, commonly referred to as “loss adjustment expense (LAE) reserves,” represents the expected costs to be incurred in conjunction with the adjudication and settlement of unpaid claims. Claims adjustment expenses directly related to a claim are called “allocated loss adjustment expenses” (ALAE) and include legal fees, claims adjusters’ fees, and other costs to record, process, adjust, and pay claims. Claim adjustment expenses also include other costs related to claims processing that cannot be associated with specific claims. These are commonly referred to as “unallocated loss adjustment expenses” (ULAE).

The liability for unpaid claims is based on the estimated ultimate cost of settling the claims, including the effects of both inflationary and socio-economic factors, as detailed in ASC 944-40-30-1. The ultimate cost is estimated using past experience adjusted for current trends and factors and most often involve the use of actuaries. In accordance with ASC 944-40-35-1, changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims are recognized in income in the period in which the estimates are changed or payments are made.

4.3.1 Short-duration claim cost recoveries

Salvage and subrogation are defined in ASC 944.

Definitions from ASC 944-40-20

Salvage: The amount received by an insurer from the sale of property (usually damaged) on which the insurer has paid a total claim to the insured and has obtained title to the property.

Subrogation: The right of an insurer to pursue any course of recovery of damages, in its name or in the name of the policyholder, against a third party who is liable for costs relating to an insured event that have been paid by the insurer.

When an automobile insurance policyholder gets in an accident that results in a total loss of the insured vehicle, the insurance entity pays the policyholder for the total claim and obtains title to the insured vehicle. The amount received by the insurance entity for the vehicle upon sale is salvage. If it is determined another party was at fault for the accident, the insurance entity may seek to recover damages from that other party and the insurance entity of the other party, if applicable. The amount received by the insurance entity from the other party is subrogation.

Estimated recoveries on unsettled claims, such as salvage and subrogation, and which could include a potential ownership interest in real estate, are recorded based on their estimated realizable value and are deducted from the liability for unpaid claims in accordance with ASC 944-40-30-2. ASC 944-40-30-3 requires estimated recoveries on settled claims to also be deducted from the liability for unpaid claims, except for claims arising from mortgage guaranty insurance and title insurance. Subsequent adjustments in the reported amounts of recoveries or realized gains and losses on the sale of real estate acquired in settling claims are recognized as an adjustment to claim costs incurred.

4.3.2 Short-duration reinsurance

Reinsurance is the purchase of insurance coverage by an insurance entity to mitigate the risks of the underlying insurance contracts issued to policyholders. Reinsurance contracts rarely achieve offset accounting on the balance sheet and therefore result in recording a separate reinsurance recoverable asset (i.e., the reinsurance balance does not offset the liability for unpaid claims). However, from an income statement perspective, the impact of the reinsurance will offset the claims expenses. Refer to IG 8 for further information on the reinsurance of short-duration contracts.

4.3.3 Discounting of short-duration claim costs

Discounting claim liabilities allows the insurance entity to incorporate the time value of money into estimates of expected future cash flows by recording the present value of the claim liabilities in the financial statements. Typical lines of business that may be discounted include workers' compensation and other short-duration insurance policies with claim payment patterns that are expected to occur over a longer period.

ASC 944 does not provide any specific guidance on scope and measurement for the discounting of liabilities for unpaid claims and claim adjustment expenses related to short-duration insurance contracts. However, the SEC issued SAB Topic 5.N, *Discounting by Property-Casualty Insurance Companies* (codified in ASC 944-20-S99-1), stipulating the circumstances under which the SEC staff would not object to discounting.

Excerpt from ASC 944-20-S99-1

The following is the text of SAB Topic 5.N, Discounting by Property-Casualty Insurance Companies.

Facts: A registrant which is an insurance company discounts certain unpaid claims liabilities related to short-duration FN9 insurance contracts for purposes of reporting to state regulatory authorities, using discount rates permitted or prescribed by those authorities ("statutory rates") which approximate 3 1/2 percent. The registrant follows the same practice in preparing its financial statements in accordance with GAAP. It proposes to change for GAAP purposes, to using a discount rate related to the historical yield on its investment portfolio ("investment related rate") which is represented to approximate 7 percent, and to account for the change as a change in accounting estimate, applying the investment related rate to claims settled in the current and subsequent years while the statutory rate would continue to be applied to claims settled in all prior years.

FN9 The term "short-duration" refers to the period of coverage (see FASB ASC paragraph 944-20-15-7 (Financial Services—Insurance Topic), not the period that the liabilities are expected to be outstanding.

Question 1: What is the staff's position with respect to discounting claims liabilities related to short-duration insurance contracts?

Interpretive Response: The staff is aware of efforts by the accounting profession to assess the circumstances under which discounting may be appropriate in financial statements. Pending authoritative guidance resulting from those efforts however, the staff will raise no objection if a registrant follows a policy for GAAP reporting purposes of:

Discounting liabilities for unpaid claims and claim adjustment expenses at the same rates that it uses for reporting to state regulatory authorities with respect to the same claims liabilities, or

Discounting liabilities with respect to settled claims under the following circumstances:

- (1) The payment pattern and ultimate cost are fixed and determinable on an individual claim basis, and
- (2) The discount rate used is reasonable on the facts and circumstances applicable to the registrant at the time the claims are settled.

Although, the guidance in ASC 944-20-S99-1 is specifically applicable to SEC registrants, non-public insurance entities also follow the guidance in practice. Short-duration claim costs are an accounting estimate and, similar to other accounting estimates, there is the potential that actual future loss payment experience for existing incurred losses will be different from what is expected at the time the estimate is made. Discounting of short-duration claim costs is appropriate only when the amount and timing of future claim payments for a line of business can be estimated by management with a relatively high level of confidence and relatively low variability. Generally, management must demonstrate that past claims experience demonstrates a low variability and that the past claims experiences is a faithful representation of the current and expected future claims experience (i.e., no significant changes from the past claims experience). Additionally, the expected level of variability that would be acceptable (i.e., would be considered "relatively low") is, in part, a function of an entity's stockholders' equity. As the amount of the discount increases in relation to equity, the expected

variability would need to decrease for discounting to be acceptable. Only in rare circumstances will management be able to demonstrate the required expectation of low variability for new insurance entities, new lines of business, existing lines of business with significantly increased volume, or existing lines of business with significant changes expected from relevant past claims experience.

In all circumstances, other than structured settlements when ASC 835-30-15-2 requires discounting, claim costs that are eligible for discounting are not required to be discounted. As a result, reporting the undiscounted ultimate claim cost is an acceptable approach under US GAAP. Reporting undiscounted reserves is required when management is unable to support an expectation of relatively low variability in future loss payments. The decision to discount or not is an accounting policy election that should be consistently applied and disclosed.

See ASC 944-40-50-5 for the disclosure requirements when discounting claim liabilities.

In order for an insurance entity to change its policy from nondiscounting to discounting, it would need to justify the change as being preferable, as required by ASC 250, *Accounting Changes and Error Corrections*. ASC 250 requires that a change in accounting principle be reported through retrospective application to all prior periods, unless impracticable.

4.3.3.1 *Discounting of settled claims*

Under ASC 944-20-S99-1, the first criteria for the discounting of settled claims is that the payment pattern and ultimate cost are fixed and determinable on an individual claim basis. An “individual claim basis” refers to those claims for which the claimant has agreed to the amount and frequency of payments, along with the period over which those payments are to be made. However, under certain circumstances, it would be appropriate to include as settled claims those based on actuarial estimates of the aggregate amount expected to be paid to a large number of individuals with similar claims. For example, personal liability settlements may be based on life expectancy. If the insurance entity has information that provides reliable estimates of the aggregate claims expected to be paid to a large number of claimants, as well as the timing of the payments, these claims may be discounted as settled claims.

4.3.3.2 *Determination of the discount rate*

Diversity exists regarding the discount rate used to discount liabilities for unpaid claims and claim-adjustment expenses. In practice, short-duration insurance entities apply the guidance in ASC 944-20-S99-1 (SAB Topic 5.N) or ASC 450-20-S99-1 (SAB Topic 5.Y).

ASC 944-20-S99-1 provides that liabilities for unpaid claims and claim adjustment expenses can be discounted at the same rates used for reporting such claims liabilities to state regulatory authorities. The reference to “state regulatory authorities” is applied by analogy to geographic locations outside of the United States with significantly robust insurance regulations.

SAB Topic 5.Y, *Accounting and Disclosures Relating to Loss Contingencies* (codified in ASC 450-20-S99-1), which is applicable to environmental and product liabilities, and ASC 410-30, *Environmental obligations*, which is explicitly applicable to environmental liabilities, provide guidance on discounting. We believe this guidance can be applied to all types of short-duration insurance liabilities, not just environmental and product liabilities. ASC 450-20-S99-1 specifies that the discount rate used to discount the cash payments should be “the rate that will produce an amount at which the environmental or product liability could be settled in an arm's-length transaction with a third party.”

ASC 450-20-S99-1 further states that the discount rate used to discount the cash payments should “not exceed the interest rate on monetary assets that are essentially risk free and have maturities comparable to that of the environmental or product liability.” This rate is referred to as a “settlement rate,” even though it conceptually involves the transfer of the obligation to a third party instead of settlement with the claim counterparty. It is generally difficult to determine the settlement discount rate. As a result, in practice, a risk-free rate for monetary assets with comparable maturities is typically utilized even though the settlement/transfer rate would include a risk margin to compensate for the risk being assumed so would generally be less than the risk-free rate.

Conceptually, the discount rate applied to a liability should not change from period to period if the liability is not recorded at fair value. The effective rate on debt obligations and loans is not changed once established in an amortized cost model. Many liabilities recorded for contingencies consist of numerous claims that are being established and settled from period to period and keeping track of the period for which estimates for liabilities were recorded and later revised adds additional complexity when locking in discount rates. In practice, some insurance entities have discounted all estimated cash flows in the liability at a single current or blended rate (i.e., a blending of the rates at which the liabilities were initially established).

Changing the basis of the discount rate (e.g., statutory rate to risk free rate) would be considered a change in policy and would require preferability.

4.3.4 ***Fair value option***

Short-duration insurance contracts are eligible for the fair value option election at inception of the contract. Claims incurred are not a separate contract and would not be eligible for the fair value option. ASC 825-10-15-4 allows the fair value election for financial instruments, including insurance contracts that meet the definition of a financial instrument. Additionally, in accordance with ASC 825-10-15-4(d), the fair value option is available for insurance contracts that are not financial instruments (because the contract requires or permits the insurer to provide goods or services rather than a cash settlement) if the contract terms permit the insurer to settle by paying a third party to provide those goods or services. In effect, the guidance allows the fair value option election when the insurer itself is not *required* to provide a good or service and can instead expend cash. If the insurer is required to provide the goods or services, it would not be eligible for the fair value election. In practice, it is unusual for an insurance entity to elect the fair value option.

If the fair value option is elected, the guidance in ASC 825-10 should be followed.

Excerpt from ASC 825-10-25-7

The fair value option may be elected for a single eligible item without electing it for other identical items with the following four exceptions:

- a. ...
- b. ...
- c. If the fair value option is applied to an eligible insurance or reinsurance contract, it shall be applied to all claims and obligations under the contract.

- d. If the fair value option is elected for an insurance contract (base contract) for which integrated or nonintegrated contract features or coverages (some of which are called riders) are issued either concurrently or subsequently, the fair value option also must be applied to those features or coverages. The fair value option cannot be elected for only the nonintegrated contract features or coverages, even though those features or coverages are accounted for separately under Subtopic 944-30. Paragraph 944-30-35-30 defines a nonintegrated contract feature in an insurance contract. For purposes of applying this Subtopic, neither an integrated contract feature or coverage nor a nonintegrated contract feature or coverage qualifies as a separate instrument.

See PwC's *Guide to Fair Value Measurements* for further discussion of fair value measurements.

4.4 **Loss occurrence and claims-made insurance coverages**

Short-duration insurance contracts are issued on either a loss occurrence or claims-made basis. Under a loss occurrence insurance policy, a loss event that occurs during the contract period will be covered by the insurance contract, regardless of the length of time between the date of loss and the date reported to the insurance entity. Conversely, in a pure claims-made insurance policy, a loss event that is reported to the insurance entity during the contract period will be covered by the insurance contract, regardless of the date of loss. Typically, a retroactive date is established in the insurance contract, whereby loss events occurring prior to the retroactive date are not covered. All subsequent renewal policies will use the same initial retroactive date.

Insurance contracts are generally issued on a claims-made basis when the date of loss may be difficult to determine or when the loss may span over a long period. A claims-made policy mitigates potential coverage disputes because the date of loss is generally not relevant to the determination of coverage. Typically, professional liability insurance contracts (e.g., directors' and officers' liability insurance and medical malpractice insurance) are issued on a claims-made basis.

In practice, many claims-made policies have endorsements (e.g., extended reporting period provisions or extension of the policy in force period – commonly referred to as “tail coverages”) that allow for varying occurrence characteristics to be introduced into the policy. The tail coverage may be for a definite or an indefinite period. The effect of adding tail coverage to a claims-made policy may, in substance, create an occurrence insurance policy. Furthermore, if a policy gives the insured a unilateral option to purchase tail coverage at a premium not to exceed a specified fixed maximum, we believe the entity should record liabilities as if it was an occurrence-based policy.

4.5 **Short-duration contracts – embedded derivatives**

Derivatives can be components of other contractual arrangements, including short-duration insurance policies. Embedded derivatives can affect the cash flows or value of other exchanges required by the contract in a manner similar to that of a derivative.

4.5.1 **Insurance scope exception**

Insurance contracts meet the definition of a derivative in ASC 815. However, ASC 815-10-15-52 includes an insurance scope exception for certain insurance contracts. Generally, traditional insurance

contracts that are within the scope of ASC 944 would qualify for the scope exception, including traditional property and casualty contracts. A contract is eligible for this scope exception if the holder is only compensated as a result of an identifiable insurable event (e.g., damage to insured property). ASC 815-10-15-52 provides guidance for assessing whether an insurance contract meets this scope exception.

ASC 815-10-15-52

A contract is not subject to the requirements of this Subtopic if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. Only those contracts for which payment of a claim is triggered only by a bona fide insurable exposure (that is, contracts comprising either solely insurance or both an insurance component and a derivative instrument) may qualify for this scope exception. To qualify, the contract must provide for a legitimate transfer of risk, not simply constitute a deposit or form of self-insurance.

An example of an insurance contract that would not meet the insurance scope exclusion is hurricane catastrophe coverage that provides for payment based solely on industry loss experience and not on specific losses incurred by the policyholder.

A property and casualty contract that compensates the holder as a result of both an identifiable insurable event *and* changes in a variable (e.g., a dual-trigger property and casualty insurance contracts) is in its entirety exempt from the requirements of ASC 815, provided that all of the following conditions in ASC 815-10-15-55 are met:

- Benefits or claims are paid only if an identifiable insurable event occurs (e.g., theft or fire)
- The amount of the payment is limited to the amount of the policyholder's incurred insured loss
- The contract does not involve essentially assured amounts of cash flows (regardless of the timing of those cash flows) based on insurable events highly probable of occurring because the insured would nearly always receive the benefits (or suffer the detriment) of changes in the variable.

Under a dual-trigger policy, the payment of a claim is triggered by the occurrence of two events (an insurable event and changes in a separate pre-identified variable). Because the likelihood of both events occurring is less than the likelihood of only one of the events occurring, the dual-trigger policy premiums are lower than traditional policies that insure only one of the risks. One common example of a dual-trigger that often meets the criteria for exemption is hurricane catastrophe coverage that insures a policyholder against actual losses incurred by the policyholder due to a hurricane, but establishes a limit on the loss amount based on the dollar amount of hurricane losses incurred by others in a particular region. ASC 815-10-55-40 provides additional examples.

With regard to the requirement not to involve essentially assured amounts of cash flows, if a contract includes an actuarially-determined minimum amount of expected claim payments from insurable events that are highly probable of occurring under the contract and the minimum claim payment amounts are both (1) indexed to or altered by changes in a non-insurance variable (e.g., changes in an equity index) and (2) expected to be paid each policy year (or on another predictable basis), that "portion" of the contract does not qualify for the insurance exception. Effectively, the minimum claim

amount is the contract's minimum notional amount in determining the embedded derivative under ASC 815-15-25.

Features that meet the definition of an embedded derivative are required to be accounted for at fair value. See PwC's *Guide to Derivatives and Hedging*, for further information on the accounting and reporting of derivative instruments under ASC 815.

4.6 *Residual value insurance contracts*

Residual value insurance guarantees that a properly maintained asset will not be worth less than a specified amount on a specified date, such as upon expiration of a lease. The insurance protects the insured from losses due to greater than expected declines in the market value of an asset. Premiums are typically paid at inception of the policy.

Settlement is usually based on comparing the insured value agreed upon at the inception of the policy to the amount determined by one of the following common settlement provisions:

- Specific asset appraisals or actual proceeds from the sale of the asset
- The higher of the specific asset appraisal, actual proceeds from a sale, or value established by reference to an asset valuation guide (such as Blue Book)
- The asset value as indicated by an agreed-upon asset valuation guide (such as Blue Book)

Residual value insurance guarantee contracts are most likely accounted for as derivatives unless they qualify for the exception in ASC 815-10-15-59. Residual value contracts that meet the derivatives scope exception are typically accounted for using a short-duration insurance model by analogy because residual value guarantees do not meet the definition of either an insurance contract or a financial guarantee contract.

Excerpt from ASC 815-10-15-59

Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following:

...

- b. The price or value of a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash. This scope exception applies only if both of the following are true:
 1. The nonfinancial assets are unique.
 2. The nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset. (If the contract is a call option, the scope exception applies only if that nonfinancial asset is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset above the option's strike price.)

When payment under the residual value insurance contract is based on an index (e.g., the Blue Book value for automobiles), instead of the value of a specific nonfinancial asset, the contract would not qualify for the scope exception under ASC 815-10-15-59 and would be accounted for as a derivative. Conversely, settlement based on using the appraisal value or the sales proceeds of the specified asset owned by the party would meet the scope exception in ASC 815-10-15-59 and the contract would be accounted for as issued insurance. In situations when the appraisal value, sales proceeds, or the insured value is adjusted to reduce the amount of the required payment for factors such as the actual excess wear and tear and excess mileage of the asset, the contracts would still meet the exception as long as the price or value of the asset that is being referenced in the calculation is that of the actual specific asset. In that situation, the underlying on which settlement is based is still the sales price or appraisal value of the unique asset. The excess wear and tear provisions and similar adjustments only serve to reduce the amount of the claim payment when the asset is returned in a condition other than that specified in the contract.

In instances when settlement is based on the higher of multiple amounts (e.g., the higher of actual proceeds from sales or values established by referencing an asset valuation guide), the contract is considered to have multiple underlyings. The contract is subject to ASC 815 if all of the underlyings behave in a manner that is highly correlated with any of the underlyings that do not qualify for the scope exception. For example, a Blue Book value for automobiles and actual sales proceeds are deemed to be highly correlated as the Blue Book values are based on actual sales and transactions or new manufacturer price information. If a contract settles based on a comparison of the insured value with the higher of sales proceeds or asset valuation guide, the reporting entity would compare the results under the contract using the combined underlyings with the result using only the asset valuation guide. If the two underlyings are highly correlated, the contracts would not meet the ASC 815-10-15-59 scope exception and would be accounted for as a derivative and follow mark to market accounting.

See PwC's *Guide to Derivatives and Hedging*, for further information on the accounting and reporting of derivative instruments under ASC 815.

4.7 **Deposit accounting contracts**

Contracts that are written as insurance but fail the significant insurance risk test are accounted for as deposits. ASC 340-30, *Other Assets and Deferred Costs*, provides guidance on deposit accounting for short-duration insurance contracts that fail risk transfer. ASC 340-30-05-2 requires the transfer of significant insurance risk to include both timing risk and underwriting risk. As a result, there are four possible categories used to classify deposit contracts.

- A contract that transfers only significant timing risk (see IG 8.7.1)
- A contract that transfers only significant underwriting risk (see IG 8.7.2)
- A contract that transfers neither significant timing nor significant underwriting risk (see IG 8.7.1)
- A contract with indeterminate risk (see IG 8.7.3)

At inception, a deposit asset or liability is recognized based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract.

Deposit contracts that lack underwriting risk follow a financial instrument effective yield model, with the effective yield being a function of the deposit and future projected cash flows. Those contracts that have underwriting risk, but lack timing risk, require a discounted claim estimation measurement. For contracts with indeterminate risk, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. See IG 8.7 for further information on the accounting for deposit insurance and reinsurance contracts.

***Chapter 5:
Long-duration contract
liabilities—updated May 2022***

5.1 Long-duration contract liabilities – chapter overview

A long-duration insurance contract is one that generally is not subject to unilateral changes in its provisions and either provides insurance coverage or a return for an extended period. Long-duration insurance contracts are principally life, annuity, non-cancellable or guaranteed renewable accident and health, and disability.

This chapter focuses on the accounting for long-duration contracts that in whole or in part fall within the following classifications:

- Non-participating traditional life insurance contracts
- Limited payment contracts
- Universal life-type contracts
- Investment contracts
- Market risk benefits
- Derivatives and embedded derivatives in insurance and investment contracts
- Additional liabilities for annuitization, death or other insurance benefits

Refer to IG 2.4 for the framework for determining the classification of long-duration contracts.

This chapter also addresses policyholder dividends and the concept of “shadow” adjustments. See IG 5.9 and IG 5.10 for further information, respectively.

5.2 Measurement – nonparticipating traditional life insurance

Traditional long-duration contracts provide a specified, fixed amount of insurance benefit in exchange for a fixed premium, paid either upfront, over a fixed number of years, or payable each year the policy is kept in force (e.g., whole-life insurance, guaranteed renewable term-life insurance, or long-term disability insurance).

Premiums on nonparticipating traditional long-duration insurance contracts are recognized in revenue when due. The liability for future policyholder benefits is recognized on the balance sheet using a net premium measurement approach whereby the liability is accrued as a proportion of premium revenue recognized. The change in the accrued liability in each period is reported as benefit expense. If actual experience unfolds exactly as projected, reported underwriting profit in each year will be a constant percentage of premiums. The aggregate liability for future policy benefits reflects the insurance entity’s contractual obligations under insurance policies in force as of the balance sheet date using current assumptions. This calculation is performed by grouping similar contracts into cohorts using projected cash flows to determine the net premium ratio.

5.2.1 Estimating the liability for future policy benefits

ASC 944-40-25-8 describes an income statement margin approach, which requires the liability for future policy benefits for nonparticipating traditional life insurance and limited-payment contracts to be determined such that expected policyholder benefit payments are accrued in proportion to premium revenue recognized. This is accomplished through a method referred to as the “net premium” approach.

The liability is determined as the present value of future policyholder benefits and related expenses less the present value of future net premiums, where net premiums are gross premiums for the contracts in the cohort multiplied by the net premium ratio. As noted in ASC 944-40-35-7B, in no event should the liability for future policy benefits be less than zero at the level of aggregation at which liabilities are measured.

Figure IG 5-1 outlines the formula for determining the net premium ratio.

Figure IG 5-1

Formula for the net premium ratio

$$\text{Net premium ratio} = \frac{\text{Present value of benefits and related expenses}}{\text{Present value of gross premiums}}$$

The net premium ratio is capped at 100% (i.e., net premiums cannot exceed gross premiums). The liability can also be thought of as premium revenue recognized from the inception of the contract multiplied by the net premium ratio, less benefits and expenses already paid as long as the net premium ratio is updated for actual experience and stays below the 100% cap. See IG 5.2.5 for further details on the measurement of loss contracts.

Related expenses include termination and settlement costs and exclude acquisition costs and non-claim related costs, such as costs relating to investments, general administration, policy maintenance, product development, market research, and general overhead or any other costs that are required to be expensed under ASC 944-720-25-2.

The premiums, benefits, and related expenses cash flows are estimated using methods that include assumptions, such as estimates of mortality, morbidity, terminations, and claim-related expenses, and the possible impact of inflation on those expenses. Benefits include all guaranteed cash flows to the policyholder, including coupons, annual endowments, and conversion privileges. See IG 5.2.2 for additional details surrounding reserve assumptions utilized in the net premium ratio.

Example IG 5-1 illustrates the calculation of the net premium ratio at issue date for a cohort of policies and the resulting liability of future policy benefits.

EXAMPLE IG 5-1

Calculation of initial net premium ratio and liability of future policy benefits

Insurance Company A has a cohort of traditional life insurance contracts with estimated cash flows as detailed in the chart below. The example is based on Example 6 in ASC 944-40-55, *Updating of*

Assumptions Used in the Measurement of the Liability for Future Policy Benefits.

How is the initial net premium ratio calculated and what journal entries should be recognized in Year 1?

Analysis

The net premium ratio is calculated based on the following cash flows, and then multiplied by the gross premium to yield the net premium in each period. Discounting of cash flows to derive the net premium ratio uses the original contract issuance discount rate, which for simplicity of illustration, is assumed to be 0%.

Year	Benefits	Gross premiums (A)	Net premiums (A*71.1%)
1	\$200.0	\$500.0	\$355.4
2	208.8	474.5	337.2
3	216.1	450.3	320.0
4	222.2	427.3	303.6
5	227.0	405.4	288.1
6	230.7	384.6	273.3
7	233.5	364.8	259.2
8	235.3	346.0	245.9
9	236.3	328.1	233.2
10	236.5	311.2	221.1
11	236.0	295.1	209.7
12	235.0	279.7	198.8
13	233.4	265.2	188.5
14	231.3	251.4	178.6
15	228.7	238.3	169.3
16	225.8	225.8	160.5
17	222.5	214.0	152.1
18	219.0	202.8	144.1
19	215.1	192.1	136.5

Year	Benefits	Gross premiums (A)	Net premiums (A*71.1%)
20	211.1	182.0	129.3
Total	\$4,504.4	\$6,338.4	\$4,504.4
Present value (0%)	\$4,504.4	\$6,338.4	\$4,504.4

Net premium ratio

Present value of total benefits and expenses (for Years 1-20)	(B)	\$4,504.4
Present value of total gross premiums (for Years 1-20)	(A)	\$6,338.4
Net premium ratio (B)/(A)		71.1%

The Year 1 ending balance for the liability for future policy benefits would be as follows:

Year 1 calculation

Present value of future benefits and expenses (for Years 2-20)	\$4,304.4
Less: Present value of future net premiums (for Years 2-20)	4,149.0
Liability for future policy benefits	\$155.4

At the end of year 1, Insurance Company A would record the following journal entries to reflect the liability calculation and cash flows from premiums received (\$500) and benefits paid (\$200). In this example, actual amounts are equal to expected, and therefore benefit expense is equal to gross premiums of \$500 multiplied by the net premium ratio of 71.1%.

Dr. Cash ¹	\$300.0	
Dr. Benefit expense ²	355.4	
Cr. Premium income		\$500.0
Cr. Liability for future policy benefits		155.4

¹ Premiums collected of \$500, less benefits paid of \$200

² Benefits paid of \$200, plus change in reserve of \$155.4

See IG 5.3 for additional consideration for limited-payment contracts.

5.2.2 *Liability assumptions in the net premium ratio*

ASC 944-40-30-8 includes the assumptions required to be incorporated into the calculation of the net premium ratio used for the liability for future policy benefits:

- Discount rate
- Mortality
- Morbidity
- Termination
- Expense

The discount rate is required to be an upper-medium grade (low credit risk) fixed-income corporate instrument yield (“single A”) that reflects the duration characteristics of the liability. See IG 5.2.3 for further information on the discount rate.

Mortality represents the likelihood of a policyholder dying at various ages. Mortality assumptions comprise an integral component of the calculation of long-duration life and annuity contract liabilities and should be based on estimates of expected mortality. Morbidity represents the likelihood of illness or sickness occurring, and thus morbidity assumptions are incorporated into coverages such as disability, long-term care, and accident and health. ASC 944-40-30-13 notes that expected incidences of disability and claim costs for various types of insurance and other factors, such as occupational class, waiting period, sex, age, and benefit period, should be considered in making morbidity assumptions, as well as the risk of antiselection or adverse selection, which is the risk of having a disproportionately higher number of higher risk policyholders. ASC 944-40-30-12 notes that morbidity assumptions should be based on estimates of expected incidences of disability and claim costs. The expected benefit cash payments for disability claims and not the incurred lump sum amount should be used in the expected benefits.

ASC 944-40-30-14 provides that termination assumptions should be based on estimates of expected terminations and nonforfeiture benefits, using expected termination rates and contractual nonforfeiture benefits (e.g., cash value, paid-up insurance value, or extended-term insurance value). Termination rates may vary by plan of insurance, age at issue, year of issue, frequency of premium payment, and other factors. Composite rates may be used, but only if the rates are representative of the entity's actual mix of business.

Expense assumptions represent the estimated costs to be incurred by the insurer to settle a claim of an in-force policy, considering the possible effect of inflation, and include such costs as termination or settlement costs. These estimates are generally expressed as a percent of premium or per policy, surrender, or claim processed. ASC 944-40-30-15 notes that non-claim related costs, including policy maintenance costs, are excluded from the net premium ratio and expensed as incurred.

Excerpt ASC 944-40-30-15

However, expense assumptions shall not include acquisition costs or any costs that are required to be charged to expense as incurred, such as those relating to investments, general administration, policy maintenance costs, product development, market research, and general overhead (see paragraph 944-720-25-2).

Annual or more frequent updating of insurance assumptions is required, with the impact on the liability recognized on a retrospective catch up basis as a separate component of benefit expense. See IG 5.2.4 for details on the frequency of when the assumptions must be updated in the net premium ratio.

5.2.3 Discount rate assumption

Future cash flows used to estimate the liability for future policy benefits for nonparticipating traditional insurance contracts and limited-payment contracts must be discounted using an upper-medium grade (low credit risk) fixed-income instrument yield (interpreted as a “single A” interest yield) that reflects the duration characteristics of the contracts. The discount rate is required to be updated at each reporting date, with the effect of the discount rate changes on the liability recognized in OCI. The contract inception date discount rate is locked in for benefit expense purposes. See IG 5.2.3.1 for additional details.

The discount rate selection should maximize the use of current market observable inputs. The FASB chose the “single A” interest yield as being an objective standardized representation of a liability yield that reflects the characteristics of the liability.

An entity should not substitute its own estimates for observable market data unless the market data reflects transactions that are not orderly, as defined in the guidance on fair value measurement (ASC 820). For points on the yield curve with no or limited market observable data, an entity should use an estimate consistent with existing guidance on fair value measurements.

Question IG 5-1

How is the upper-medium grade (low credit risk) fixed-income instrument yield determined?

PwC response

When available, observable market data should be used. For example, banks and rating agencies publish rates for corporate fixed-income debt instruments in various rating categories, one of which is characterized as the “upper-medium grade,” which corresponds to what is commonly referred to as a “single A” rating. Although these ratings are available for various classes of instruments (e.g., public debt, private placements, municipal debt, asset-backed securities), we believe the FASB’s intention is that the upper-medium grade rate be that of a public corporate debt security.

The concept of using a standardized rate in calculating a specific class of liability is consistent with the accounting for pension obligations, which requires discounting using a high-quality fixed-income yield. Therefore, although the yield required for insurance liabilities is upper-medium grade rather than the high-quality rate required for pensions, entities can use similar principles in developing the yield curve. For example, when determining an upper-medium grade yield from an available rating

agency, considerations should include assessing whether they incorporate appropriate bonds and bond pricing, effectively match the expected cash flow stream, and incorporate reasonable assumptions about reinvestment of excess bond cash flows and yields for bond maturities in years when no bonds exist (e.g., beyond 30 years).

Question IG 5-2

May an entity adjust the single A yield if it believes the cash flows in its contracts differ in certain respects from a typical single A corporate credit. For example, if the insurer believes the cash flows in its contracts are less liquid than those of a single A-rated public debt of a non-insurance corporate entity, can the yield be adjusted?

PwC response

No. The FASB's intention in requiring the use of an upper-medium grade (low credit risk) fixed-income instrument yield is to promote consistency and comparability between entities as well as to make it operationally easier for entities to apply. Therefore, the only adjustment from a single A-rated corporate debt instrument that would be permitted would be to adjust for differences in duration. The rate is a prescribed rate, unlike the discount rate required by other insurance models, such as IFRS 17, *Insurance Contracts*, under which a debt instrument yield can be the starting point to which further adjustments are made.

Question IG 5-3

An entity has contracts with cash flows expected to occur over the next 70 years. How would an entity develop a single A interest yield for points beyond the observable period?

PwC response

For points on the yield curve for which there is limited or no observable market data (e.g., when cash flows are expected to occur beyond the date when observable single A corporate rates are available), an entity should use estimates determined using techniques consistent with those that would be used for level 3 estimates of fair value under ASC 820. Under that guidance, points on the yield curve may need to be derived through extrapolation or interpolation consistent with what a market participant would use.

Question IG 5-4

What is a single A rate in a non-US territory, such as Japan or Brazil?

PwC response

We believe the FASB's intention is the rate used would be equivalent to a single A interest yield (low credit risk) from a global rating agency for a corporate bond issued in the same currency in which the insurance contract is written.

Question IG 5-5

In foreign economies without an active market of public single A rated securities, how should an upper-medium grade (low credit risk) fixed-income instrument yield be determined?

PwC response

ASC 944-40-30-9 requires the liability for future policy benefits to be discounted using an upper-medium grade (low credit risk) fixed-income instrument yield (interpreted as a single A interest yield for corporate bonds) that reflects the duration characteristics of the contracts/cohorts. In situations when there is not an active market of public single A rated securities in a foreign jurisdiction, insurance entities should estimate a single A rate consistent with existing guidance on fair value measurement in ASC 820 and by maximizing observable data (as noted in ASC 944-40-15-13E). For example, if the foreign jurisdiction has government bonds that are rated above or below single A, it may be possible to derive a hypothetical single A rate corporate bond yield using the sovereign yield as an input to the curve and adjusting it (positive or negative adjustment) as appropriate.

Question IG 5-6

Cohorts may be established that represent particular contracts that are issued over a particular period. For example, a cohort may be defined to be certain term life insurance policies that originate during a particular calendar quarter. How should the curve be developed for this cohort given that interest rates will change over the quarter? For example, should the rate at the beginning of the quarter, end of the quarter or an average of the quarter be used?

PwC response

The objective of ASC 944-40-35-6A (b)(2) is to employ an interest accretion rate on the liability for future policy benefits that represents “the original discount rate used at contract issue date.” ASC 944-40-30-7 permits contracts to be aggregated into cohorts for purposes of measurement, and in so doing, implicitly permits entities to use judgment in developing an aggregate discount rate assumption appropriate at the cohort level. The ultimate rate selected should be representative of the cohort as a whole. For example, a reporting entity may determine that a curve as of a particular date in the quarter may best represent the cohort (e.g., beginning curve, mid period curve, or end of period curve) depending on the pattern of issuance, general trend in interest rates, and market availability. A weighted average of the daily curves could also be used.

It may be inappropriate to use a beginning of the period rate/curve without adjustment if there have been significant changes in the yield curve during the period and a significant portion of policies included in such cohort were issued during the latter half of this period.

Variability in yield curve and timing of issuance of policies may therefore be factors that reporting entities consider in determining the length of a cohort (i.e., how long of a period a cohort will cover).

If a cohort spans multiple reporting periods, for instance an annual cohort spanning quarters, a weighted average rate (or weighted average spot or forward curve, if a curve is used) could be developed and updated as each subsequent quarter’s activity is added until the annual period is closed. If done appropriately, the changes will be weighted by the new cash flows each quarter and be the approximate equivalent to locking each quarter. The disclosure of the weighted average rate will

change each quarter as new insurance contracts are added to the cohort and the interest environment changes.

Question IG 5-7

May an entity apply different discount rates to individual contracts within a cohort?

PwC response

The objective of ASC 944-40-35-6A (b)(2) is to employ an interest accretion rate on the liability for future policy benefits that represents “the original discount rate used at contract issue date.” Although in many instances, entities may decide that use of an aggregate rate or curve for the cohort is appropriate (as illustrated in Question IG 5-6), in other instances, they may decide that it is not. For example, entities may write certain types of products for which large premium payments are received at inception, such as pension risk transfer business. For these products, entities may decide that measuring the liability at the cohort level using discount rates appropriate for each contract within the cohort better meets the objective set out in ASC 944-40-35-6A (b)(2).

Under this approach, a single net premium ratio would be determined for the cohort and would be subject to the 100% net premium ratio cap. The numerator would be the present value of benefits and the denominator would be the present value of premiums for the entire cohort, with each contract’s cash flows discounted using the yield curve or rate applicable for the issue date of each contract within the cohort. Similarly, when calculating benefit expense for each period, the ending liability would be calculated from the present value of benefits and present value of net premiums with each contract’s cash flows discounted using the yield curve or rate applicable for the issue date of each contract within the cohort.

5.2.3.1 Impact of discounting in the income statement and OCI

The liability for future policy benefits involves two separate present value of cash flows calculations. A locked-in discount rate is used for the purposes of generating the liability for future policy benefits for purposes of income statement interest accretion and updating the net premium ratio, while the liability for future policy benefits is remeasured to reflect current single A yields for purposes of balance sheet measurement, with the corresponding change recognized through other comprehensive income.

Locked-in discount rate – income statement interest accretion and updating the net premium ratio

When a contract (or cohort) is first issued, a net premium ratio is calculated that represents the present value of benefits and related claims expense divided by the present value of gross premiums. The discount rate used to derive the net premium ratio is representative of a single A yield curve at contract (or cohort, if applicable) issuance date. This present valuing calculation incorporates the time value of money concept into the determination of the contract margin (i.e., the difference between future premiums less benefits and claims expense) to be recognized over time. The cumulative income statement interest accretion at contract maturity will be equal to the difference in the net premiums and benefits on a discounted and undiscounted basis. Each period, the net premium ratio will be updated using new policyholder assumptions, but the discount rate/curve will be the locked-in rate, as described in ASC 944-40-35-6A.

Excerpt from ASC 944-40-35-6A (b)(2)

The interest accretion rate shall remain the original discount rate used at contract issue date.

Several approaches can be applied to calculate this accretion to the income statement over time. See IG 5.2.3.2 for further details.

Remeasurement of the liability for future policy benefits due to changes in discount rates recognized in OCI

A remeasurement of the liability for future policy benefits is required each period using the current single A discount curve. Updated future benefits and related claim expense cash flows and the updated future net premiums (using the revised net premium ratio) are discounted to the current reporting date using current discount rates (i.e., not the locked-in income statement interest accretion rate determined upon issuance of the contract, but rather the period end single A discount rate curve). The difference between the updated liability measured using the locked-in discount rate curve and the liability measured at the current discount rate curve is presented in accumulated other comprehensive income (AOCI), and the change in AOCI for the period is presented in OCI and not as an expense of the period. The liability for future policy benefits is required to be remeasured each reporting period using the current discount rate curve, even if the net premium ratio is not recalculated in the period.

Question IG 5-8

In discounting cash flows, does the guidance require the locking in of a yield curve or an equivalent level rate?

For purposes of calculating the balance sheet remeasurement and related OCI adjustment, should one apply a consistent methodology?

PwC response

The guidance does not specify whether an insurer should lock in a yield curve (i.e., use a different rate for each cash flow based upon the curve) or use an equivalent level rate that reflects the duration-specific spot rates from each point on the yield curve. At contract inception, a spot rate yield curve should be used to reflect the expected timing of the cash flows. A different rate on the curve would be used to discount cash flows expected to occur at each point on the yield curve.

The results of using the yield curve could potentially be translated to an equivalent level rate. As the guidance is silent, this equivalent level rate could be locked in and used for discounting all cash flows in future net premium ratio calculations and the income statement benefit expense for the cohort or the curve itself could be locked in with each future year's cash flows using the applicable year rate on the curve.

At each reporting date, a new curve will be needed to remeasure the present value of the cash flows for purposes of calculating the AOCI adjustment (using current rates).

As the objective of discounting is to estimate the time value of money, the estimation techniques selected for a cohort should be used consistently throughout the life of a cohort. Use of a different

technique for subsequent cohorts of the same product may be acceptable if a better estimate is achieved using another technique.

There may be different acceptable techniques for using a locked-in curve in subsequent periods that achieve the objective of isolating changes in market interest rates from the changes in locked-in time value of money. See IG 5.2.3.2 for further details.

Question IG 5-9

Are there any AOCI impacts which require disclosure associated with the LFPB discount rate remeasurement, or any reclassifications out of AOCI that would require disclosure in line with ASC 220-10-45-14A?

PwC response

Generally, no. ASC 944-40-35-6A(b)1 requires the difference between the liability for future policy benefits measured at the current discount rate and locked-in discount rate to be recognized immediately in AOCI. Transactions between the insurer and the policyholder, whether it be maturities, terminations/lapses, or death will not result in any remeasurement of the amounts in AOCI through net income - that is, amounts that have been accumulated related to the discount rate changes in AOCI will only be released through comprehensive income. Therefore, the reclassification disclosures are not applicable to transactions with the policyholder.

There may be instances where the liability for future policy benefits is transferred to a third party, for example through a sale or novation. In these situations, the amounts in AOCI related to the current discount rate may be realized through net income, in which case, the reclassification disclosures required by ASC 220-10-45-14A would be required to reflect the remeasurement.

5.2.3.2 Determining the income statement accretion discount rate

In practice, there are three approaches to determining the income statement accretion discount rate that could be utilized by insurance entities. They are the spot rate, forward rate, and equivalent level rate approaches. Given that the guidance is silent on the specific approach to be used, we believe that each is acceptable given their economic equivalency. If an insurance entity had perfect information, each of these approaches should theoretically produce substantially similar present values at inception of a contract (or cohort). However, the income statement accretion pattern for each subsequent period would be different.

Question IG 5-10

In choosing among the spot, forward and equivalent level rate approaches in determining the discount rate for benefit expense recognition for traditional and limited-payment long-duration contracts, is a reporting entity required to use a similar approach entity wide, or can a different approach be used based upon specific cohorts or products (i.e., can you use a spot rate approach for some products or cohorts and a forward or equivalent level rate for others)?

PwC response

The same approach is not required entity wide. However, we generally expect that the same approach will be used for groups of contracts (cohorts) with similar contract terms and characteristics. A reporting entity may use different approaches when, for example, the timing of cash flows varies between different products or different contracts (e.g., single pay premium versus installment premium life insurance contracts). Once an approach is selected, it should be applied consistently throughout the life of a cohort. Use of a different technique for subsequent cohorts of the same product may be acceptable if a better estimate is achieved using another technique.

Spot rate approach

Under a spot rate approach, each future cash flow used to calculate the net premium ratio is considered akin to a zero-coupon single A rated bond. As a result, each cash flow should be discounted at the rate on the spot rate curve equal to its respective expected payment date.

Under this approach, a spot interest rate curve would be constructed based on a zero-coupon single A corporate bond rate for each duration-specific cash flow, maximizing the use of market observable information. Since corporate bonds typically are not zero coupon instruments, but instead bear a coupon interest rate, the zero-coupon single A corporate bond rate for each duration-specific cash flow would first need to be derived from corporate interest bearing single A corporate bond rates. Once the spot rate curve is derived, each distinct future cash flow would be discounted at the rate specific to its duration point on the spot curve. As a result, each cash flow would be discounted using an individual, duration-specific spot discount rate for single A rated zero coupon bonds.

Forward rate approach

Under a forward rate approach, each future cash flow is considered to be represented by different rates for each period as if a zero coupon bond is being reinvested each period until its maturity. This approach acknowledges that market participants would be indifferent to purchasing (a) a zero coupon bond with a maturity that matches the future cash flow (i.e., the spot rate approach) or (b) a bond with a shorter term than the future cash flow and reinvesting it at today's view of future rates. A forward curve represents a yield to maturity that would be demanded to purchase a zero coupon bond at some point in the future (for example, a cash flow in year 2 could be discounted at the 1 year spot rate for year 1 and for year 2 at the 1 year forward rate). The year 2 forward rate represents the rate at inception at which a market participant would expect to reinvest at the end of year 1 for a bond maturing in year 2 (i.e., the rate that the market would demand today for a one year bond issued one year from now).

Under the forward rate approach, the interest rate curve could be derived based on the spot yield curve. Each cash flow would be discounted at each period's distinct forward rate on the curve. For example, a cash flow being discounted from year 3 would be discounted at a different rate for year 3, year 2, and year 1, whereas the spot rate approach would discount the cash flow expected at the end of year 3 back to inception using the 3-year spot rate.

Equivalent level rate approach (single rate approach)

Under an equivalent level rate approach, the single equivalent level rate would be determined that reflects the duration-specific spot rates from each point on the yield curve at policy inception. This approach determines a single effective yield considering the timing and amounts of the cash flows using the results of the spot curve approach. This single rate would be utilized for each cash flow

regardless of changes in expected cash flow timing or amount in future cohort liability calculations. The single effective yield is determined by solving for the discount rate that produces the same net premium ratio as what would be produced if a curve were utilized (to avoid an immediate OCI impact). Note that solving for the same net premium ratio may result in different present values of net premiums and benefits than would be produced if a curve were utilized.

Each of the three approaches will begin with developing a yield curve for a single A rated corporate bond. Example IG 5-2 illustrates the economic concepts of using each of the three approaches for the purpose of calculating income statement interest accretion.

EXAMPLE IG 5-2

Illustration of different approaches for income statement accretion discount rates

Insurance Company has two cash flows. The first is a \$1,000 cash outflow expected to occur at the end of year 2 and the second is a \$1,000 cash outflow expected to occur at the end of year 3.

The yield curves for zero-coupon single A rated corporate bonds for years one to three are as follows:

Zero coupon curves	Year 1	Year 2	Year 3
Spot	1%	2%	3%
Forward (derived)	1%	3.01%	5.03%

The forward rates were derived from the spot rates. For example, the year 2 forward rate was determined based on the rate a zero coupon bond maturing after the initial year 1 period (which earned 1% in year 1) would need to earn in year 2 in order to get an overall 2% yield (the year 2 spot rate) over a two-year period. The year 3 forward rate was determined based on the rate a zero coupon bond maturing after the initial year 1 period (which earned 1%) and then reinvested at 3.01% in year 2 would need to earn in year 3 in order to get to an overall yield of 3% (the 3-year spot rate) over a 3-year period.

How would Insurance Company calculate each of the acceptable approaches (i.e., spot rate, forward rate and equivalent level rate) for the purposes of income statement interest accretion?

Analysis

As illustrated in the following tables, each of the approaches results in the same present value at inception ($\$961.17 + 915.14 = \$1,876.31$). Additionally, each one results in the same amount of total interest accretion ($\$123.69$), although the annual amount varies. However, the amount of accretion each period can vary considerably amongst these approaches. This example illustrates the economic concepts of each approach rather than the actual net premium ratio calculation.

Spot rate approach

	Cash flow at end of year 2	Cash flow at end of year 3	Annual interest accretion
Present value at issuance	\$961.17 ⁽¹⁾	\$915.14 ⁽²⁾	
End of year 1	980.39	942.59	\$46.67 ⁽³⁾
End of year 2	1,000.00	970.87	47.89
End of year 3		1,000.00	29.13

⁽¹⁾ Calculated by discounting the cash flow at the end of the year 2 based on the 2-year spot rate of 2% for 2 years ($\$1,000/(1.02)^2$)

⁽²⁾ Calculated by discounting the cash flow at the end of year 3 based on the 3-year spot rate of 3% for 3 years ($\$1,000/(1.03)^3$)

⁽³⁾ Represents the interest accretion resulting from applying the respective spot rate to each cash flow for the period ($(\$961.17*2\%) + (\$915.14*3\%)$)

Forward rate approach

	Cash flow at end of year 2	Cash flow at end of year 3	Annual interest accretion
Present value at issuance	\$961.17 ⁽⁴⁾	\$915.14 ⁽⁵⁾	
End of year 1	970.78	924.29	\$18.76 ⁽⁶⁾
End of year 2	1,000.00	952.11	57.04 ⁽⁷⁾
End of year 3		1,000.00	47.89 ⁽⁸⁾

⁽⁴⁾ Calculated by discounting the cash flow at the end of year 2 to the end of year 1 using the 2-year forward rate of 3.01% and then discounting that total to issuance using the 1% forward rate ($(\$1,000/1.0301)/1.01$)

⁽⁵⁾ Calculated by discounting the cash flow at the end of year 3 to the end of year 2 using the 3-year forward rate of 5.03%, and then discounting the total to the end of year 1 using the 2-year forward rate of 3.01%, and then discounting the total to issuance using the 1% forward rate ($(\$1,000/1.0503)/1.0301/1.01$)

⁽⁶⁾ Represents the interest accretion resulting from applying the forward rate to each cash flow for the period ($(\$961.17*1\%) + (\$915.14*1\%)$)

⁽⁷⁾ Represents the interest accretion resulting from applying the forward rate to each cash flow for the period. In year 2, the forward rate used for accretion would be 3.01%. Year 2 interest is $(\$970.78*3.01\%) + (\$924.29*3.01\%)$

⁽⁸⁾ Represents the interest accretion resulting from applying the forward rate to each cash flow for the period. In year 3, the forward rate used for accretion would be 5.03%. Year 3 interest is $(\$952.11*5.03\%)$

Equivalent level rate approach

	Cash flow at end of year 2	Cash flow at end of year 3	Annual interest accretion
Present value at issuance	\$ 961.17 ⁽⁹⁾	\$ 915.14 ⁽¹⁰⁾	
End of year 1			\$ 48.59 ⁽¹¹⁾
End of year 2	1,000.00		49.85
End of year 3		1,000.00	25.25

⁽⁹⁾ Calculated by discounting the cash flow at the end of the year 2 based on the 2-year spot rate of 2% for 2 years ($\$1,000/(1.02)^2$)

⁽¹⁰⁾ Calculated by discounting the cash flow at the end of year 3 based on the 3-year spot rate of 3% for 3 years ($\$1,000/(1.03)^3$)

⁽¹¹⁾ Represents the interest accretion resulting from discounting each cash flow for the period at the equivalent level rate based upon the spot curve. This rate was determined by calculating the internal rate of return for a bond with an inflow of \$1,876.31 (the sum of the present values of each cash flow at issuance, $(\$961.17 + \$915.14)$) and an outflow of \$1,000 at the end of year 2 and year 3. This rate is 2.59%. The calculation of the interest accretion for year 1 is $(\$961.17 + \$915.14) * 2.59\%$. This is a simplified example. As noted in IG 5.2.3.2, the equivalent level rate for the liability for future policy benefits is determined by solving for the discount rate that produces the same net premium ratio as would be produced if a curve were utilized.

When subsequently recalculating the net premium ratio and the liability for future policy benefits under the spot rate approach, the cash flows in years 2 and 3 should continue to be discounted at the same rate utilized at inception (i.e., 2% for year 2 and 3% for year 3 cash flow). Insurance Company should not move along/walk up/walk down the curve when calculating interest accretion (i.e., it should not discount the \$1,000 cash flow at the end of year 2 at 1% (the 1-year zero coupon single A bond rate) given this cash flow is now only one year away). The zero-coupon yield curve applies a blended yield to maturity for each cash flow based upon a single A bond rate. Adjusting this rate to move along/walk down the curve would result in amounts that run counter to amortized cost accounting as it would assume reinvestment at the end of each period at an amount that is different from what has been accrued.

For example, the present value of the year 2 cash flow at inception was \$961.17. At the end of year 1, this cash flow accreted by 2% based on the 2-year curve to \$980.39. If at the end of year 1, the cash flow at the end of year 2 was discounted based on the 1% 1-year zero coupon rate, the present value of the \$1,000 would be \$990.10. As a result, the present value would not equal what had been accreted - a nonsensical result.

Alternatively, if Insurance Company had used the forward rate approach, it would accrete the present value amount of \$961.17 (representing the present value of the \$1,000 cash flow payable at the end of year 2) by 1% in the first year, and by 3.01% in the second year. Similarly, it would accrete the present value of the \$915.14 (representing the present value of the \$1,000 cash flow payable at the end of year 3) by 1% in the first year, by 3.01% in the second year, and by 5.03% in the third year.

Some might refer to this as “walking along” or “moving up the curve.” However, as noted in the spot rate approach, an insurance entity would not “move along/walk down the curve” as time goes on (i.e., at the end of year 1, an entity would not use the 2-year forward rate of 3.01% in place of the 3-year

forward rate of 5.03% to discount the \$1,000 payable in two years). The forward rate approach already takes into account market expectations of reinvestment at inception rates and market charges for the risk inherent in long term commitments. The same anomaly described above under the spot rate approach would also result if an entity walked down the curve.

Question IG 5-11

Which discounting approach should be used in the remeasurement of the liability for future policy benefits to reflect current discount rates and the corresponding amount to be recognized in OCI?

PwC response

In deriving the remeasurement of the liability for future policy benefits each period, a new interest rate yield curve representing yields at period end will need to be compiled to remeasure the cash flows for purposes of calculating the AOCI adjustment (using current rates). Such yield curve could be either the single A corporate bond zero coupon spot curve or forward curve. The method used to derive the discount rate for balance sheet remeasurement purposes should be consistent with the method used for interest accretion purposes.

While some insurance entities may want to discount the cash flows for balance sheet remeasurement purposes using an equivalent level rate approach, which mechanically achieves the same result as using a curve, we do not believe there is a practical benefit. This is because the equivalent level rate derived will change each period as the duration of the cash flow changes, and thus the equivalent level rate at the balance sheet date would need to be derived using an updated curve anyway. The measurement of the liability will be based on the projected cash flows and the curve at the measurement date.

5.2.3.3 Discount rate on claims liabilities

In certain product lines, such as disability and long-term care, claim payments may have a “long tail” (i.e., the payout of claims may be expected to occur over a number of years). Claim payments also exist for other traditional long-duration insurance contracts, such as life insurance, but the time period between the incurral and payment of a claim is typically short and results only from lags in reporting and processing of the claim. (Once such a claim is incurred, the benefit is immediately payable and does not depend on any further contingencies.) Based on established practice prior to ASU 2018-12, some entities implicitly think of the long-duration liability as being comprised of cash flows relating to potential future claims (the future benefits component of the liability) as well as cash flows relating to claims that have already been incurred (the claim liability component).

ASC 944-40-30-9 requires actual historical benefits to be included in the updated net premium ratio and discounted using the single A rate at contract (or cohort) inception, implicitly requiring that the claim liability amounts, from which the actual historical benefits will be derived, also be discounted at the inception single A rate. As a result, under the post ASU 2018-12 ASC 944-40 requirements, the “present value of estimated future benefits to be paid to or on behalf of policyholders and certain related expenses” referred to in ASC 944-40-25-8 represent all payments under the contract, including future expected claims and claims for which the disability, morbidity, or other insurance event has occurred but for which claims have not yet been paid. This obviates the need for a separate claim liability measurement. The total liability for measurement purposes includes future benefits, claim

liabilities, claims in the course of settlement liabilities, and liabilities for incurred but not reported claims.

Under ASU 2018-12, based on the above changes to the measurement model, entities may present a single liability for future benefits in the statement of financial position. Alternatively, entities may continue their existing practice of presenting a claim liability separate from the future policy benefits liability in the statement of financial position or note disclosures to the extent they believe financial statement users would benefit from this separate presentation, however, the measurement of the liability is the same whether presented in total or in components. See the claim liability guidance in the AICPA Life and Health Insurance Entities Audit and Accounting Guide, Appendix G.

5.2.4 *Updating assumptions — liability for future policy benefits*

All assumptions (except for the expense assumptions) utilized in the calculation of the liability for future benefits are required to be reviewed (and updated, as necessary) on an annual basis (at the same time each year by product or by cohort) or more frequently if evidence suggests that assumptions should be revised. To ease the operational burden of allocating and updating expense assumptions on a periodic basis, insurance entities can make an entity-wide accounting policy election to lock-in that assumption.

A revised net premium ratio is calculated using historical experience and the new assumptions for the future, as outlined in Figure IG 5-2. The revised net premium ratio is calculated as of contract inception, using the discount rate at inception.

Figure IG 5-2

Formula for the revised net premium ratio

$$\text{Revised net premium ratio} = \frac{\text{Present value of actual historical benefits and related claim expenses} + \text{present value of future benefits and related expenses}}{\text{Present value of actual gross premiums} + \text{present value of updated future gross premiums}}$$

The revised net premium ratio is used to update the liability for future policy benefits as of the beginning of the current reporting period, which is then compared to the liability for future policy benefits calculated as of the beginning of the current reporting period using the previous period's cash flow assumptions.

For traditional insurance contracts, the difference between the updated and previous liabilities is the “remeasurement gain/loss” (cumulative catch-up adjustment), which is presented as a separate line item (or parenthetically) in the current period statement of operations. See IG 5.3 for additional considerations for limited-payment contracts.

The revised net premium ratio applied as of the beginning of the current reporting period is also used to calculate the current period benefit expense based on current premium revenue. In subsequent periods, the revised net premium ratio will be used to accrue the liability for future policy benefits, absent future changes in the cash flow assumptions.

Question IG 5-12

What is meant by “beginning of the current reporting period” for purposes of the remeasurement of the liability for future policy benefits for entities that report on an interim as well as an annual basis (e.g., SEC registrants with interim reporting)?

PwC response

In determining the remeasurement gain or loss to be reported when the net premium ratio is revised, the updated liability for future policy benefits must be compared to the carrying value before updating “as of the beginning of the current reporting period” (ASC 944-40-35-6A). For SEC registrants that issue interim financial statements, the “beginning of the current reporting period” is the beginning of the reporting period for which the financial reporting close process is being performed. In accordance with ASC 270-10-45-17, there is no restatement of previously reported interim financial information related to a change in an accounting estimate. That is, the remeasurement gain or loss would be calculated for the interim period as of the beginning of the interim period. This concept follows through to the annual financial statements (i.e., the beginning of the reporting period does not change to the beginning of the year in the annual financial statements). As a result, annual and year to date remeasurement gains or losses will be the sum of each interim (e.g., quarter) remeasurement gains or losses. This interpretation is consistent with the views expressed by the FASB staff on their November 2018 webcast, *IN FOCUS: FASB Accounting Standards Update on Insurance* and the guidance in the AICPA Life and Health Insurance Entities Audit and Accounting Guide, Appendix G. As an example, if the liability for future policy benefits is remeasured in conjunction with the third quarter Form 10-Q filing for a calendar year-end SEC registrant, the remeasurement is calculated as of July 1 for the quarter-to-date financial information. The year-to-date remeasurement would be the sum of the Q1, Q2, and Q3 quarterly remeasurement gains or losses.

Example IG 5-3 illustrates the calculation of the revised net premium ratio for a cohort of policies and the resulting liability of future policy benefits.

EXAMPLE IG 5-3

Calculation of the revised net premium ratio and liability of future policy benefits

Insurance Company has a cohort of traditional life insurance contracts. At the end of Year 6, Insurance Company updated its mortality assumption to reflect unfavorable experience in that year and its effect on estimated cash flows. The net premium ratio was revised from 71.1% to 71.8%. (See Example IG 5-1 for the calculation of the initial net premium ratio.)

At the end of Year 9, Insurance Company reviewed and updated its mortality assumption to reflect the unfavorable experience in that year and an increase in expected mortality in Years 10-20.

Under the retrospective catch up approach required by ASC 944-40-35-6A, actual historical cash flows received (gross premiums) and paid (benefits) are included from contract inception (Years 1-9) along with updated future cash flow assumptions for Years 10-20 to derive the revised net premium ratio. Refer to the following table for the updated cash flow estimate. Discounting of cash flows to derive the net premium ratio uses the original contract issuance discount rate, which for simplicity of illustration, is assumed to be 0%.

Year	Benefits	Gross premiums
1 (historical)	\$200.0	\$500.0
2 (historical)	208.8	474.5
3 (historical)	216.1	450.3
4 (historical)	222.2	427.3
5 (historical)	227.0	405.4
6 (historical)	276.9	384.6
7 (historical)	280.1	364.7
8 (historical)	282.2	345.8
9 (historical)	283.2	327.8
10	283.4	310.8
11	282.8	294.6
12	281.4	279.2
13	279.3	264.5
14	276.7	250.6
15	273.5	237.4
16	269.9	224.9
17	265.9	213.0
18	261.5	201.8
19	256.8	191.0
20	251.8	180.9
Total	5,179.5	6,329.1
Present value (0%)	\$5,179.5	\$6,329.1

How should the revised net premium ratio be calculated and what journal entries should be recognized in Year 9?

Analysis

The revised net premium ratio of 81.8% would be used to calculate revised net premiums.

Revised net premium ratio

Present value of total benefits and expenses (for Years 1-20)	(A)	\$5,179.5
Present value of total gross premiums (for Years 1-20)	(B)	6,329.1
Net premium ratio (A)/(B)	(C)	81.8%

The remeasurement gain or loss (i.e., the retrospective catch up adjustment to the beginning of the period liability) is a loss in this case of \$287.4, which is calculated by comparing the carrying amount of the liability at the beginning of the period (\$542.9) with the updated liability calculated using revised cash flow assumptions (\$830.3). The discount rate used in these computations is the original (contract issuance) discount rate. The following table illustrates the calculation of these amounts.

Updated estimate

Year	Benefits	Gross premiums (A)	Net premiums (A*81.8%)
9	\$283.2	\$327.8	\$268.3
10	283.4	310.8	254.3
11	282.8	294.6	241.1
12	281.4	279.2	228.4
13	279.3	264.5	216.5
14	276.7	250.6	205.1
15	273.5	237.4	194.3
16	269.9	224.9	184.1
17	265.9	213.0	174.3
18	261.5	201.8	165.1
19	256.8	191.0	156.3
20	251.8	180.9	148.0
Total	3,266.2	2,976.6	2,435.9
Present value (0%)	\$3,266.2	\$2,976.6	\$2,435.9

Year 9 calculations (beginning of year)

	Prior estimate	Updated estimate	Change
Present value of future benefits (for Years 9-20)	\$2,728.1	\$3,266.2	\$538.1
Less: Present value of future net premiums (for Years 9-20)	2,185.2	2,435.9	250.7
Liability for future policy benefits	\$542.9	\$830.3	\$287.4

The Year 9 ending liability for future policy benefits (\$815.4) is computed as the present value of future benefits minus the present value of future net premiums, in this case using the revised amounts for Years 10-20.

Year 9 calculation (end of year)

Present value of future benefits (for Years 10-20)	\$2,983.0
Less: Present value of future net premiums (for Years 10-20)	2,167.6
Liability for future policy benefits	\$815.4

The amount of benefit expense for the period is recognized separate from the remeasurement loss. In this example, actual amounts are equal to expected, and therefore benefit expense (\$268.3) is equal to gross premiums of \$327.8 multiplied by the net premium ratio of 81.8%. The following entries would be recorded for Year 9.

Dr. Cash ¹	\$44.6	
Dr. Benefit expense ²	268.3	
Dr. Liability remeasurement loss	287.4	
Cr. Premium income		\$327.8
Cr. Liability for future policy benefits ³		272.5

¹ Premiums collected of \$327.8, less benefits paid of \$283.2

² Benefits paid of \$283.2, less change in reserve of \$14.9 using current net premium ratio of 81.8%

³ Liability remeasurement of \$287.4, less current period change in reserve of \$14.9

The \$272.5 is the sum of the benefit expense (\$268.3) and liability remeasurement loss (\$287.4) minus benefit payments of \$283.2. From a liability perspective, the \$272.5 is the difference between the prior estimate and revised estimate of the liability as of the beginning of the year (\$287.4) plus the change in the liability for current year activity of \$14.9 (\$830.3 - \$815.4).

5.2.4.1 Frequency of updating cash flow assumptions and updating for actual experience

As noted in IG 5.2.4, cash flow assumptions are required to be reviewed (and updated, as necessary) on an annual basis (at the same time each year by product or by cohort) or more frequently in interim reporting if evidence suggests that earlier cash flow assumptions should be revised. The liability for future policy benefits is also required to be updated for actual experience on an annual basis, but is only required to be updated between annual assessments if the cash flow assumptions are updated.

Question IG 5-13

May an insurer update the net premium ratio more frequently than annually?

PwC response

The FASB's intent in requiring an annual review (with more frequent updating if evidence suggests the need) was to ease the administrative burden of having to perform frequent revisions. However, an entity is not prohibited from updating the net premium ratio cash flows more frequently in the absence of a trigger. For example, some entities may have the capability to calculate the net premium ratio on a quarterly basis, and may even find it operationally easier and less costly than developing and monitoring triggers for reassessment. Updating the net premium ratio more frequently than annually for actual cash flow changes and changes to insurance in force will result in a better matching of experience variances in the periods in which they occur.

Whenever an entity performs an update, the entity should update all cash flow components, including actual cash flows, updated insurance in force, and potential future cash flow assumptions to produce a revised net premium ratio that uses the best information available at the measurement date. That is, an entity cannot choose to simply update the historical cash flows and the insurance in force. It should consider all information available in the interim period and have a reasonable basis to conclude that all applicable assumptions are still the entity's best estimate, even though more detailed experience studies and a review of future assumptions may be scheduled for later in the year. Similarly, ASC 944-40-35-6 requires updating for actual experience whenever cash flow assumptions are changed.

Question IG 5-14

When updating cash flow assumptions in the net premium ratio calculation outside of the annual process, should all assumptions be assessed or can one assumption be updated without reviewing others? Similarly, when updating actual historical benefit and premium cash flows in the net premium ratio more frequently than annually, should remaining expected future benefit and premium cash flows also be assessed?

PwC response

Yes. All assumptions should be assessed. Whenever an insurance entity performs an update (either annually or more frequently), the entity should update all cash flow components (consisting of actual historical cash flows, updated insurance in force, and future cash flow assumptions) to produce a revised net premium ratio and revised liability for future policy benefits that uses the best information available at the measurement date. That is, an insurance entity cannot choose to simply update the historical cash flows and the insurance in force without considering the need to review its future projections, even though more detailed experience studies and detailed review of future assumptions

may be scheduled for later in the year. Similarly, ASC 944-40-35-6 requires updating for actual experience whenever cash flow assumptions are changed. Additionally, when a cash flow assumption is updated for one cohort, consideration should be given to whether other cohorts require an update, including those normally subject to review at a different time of year.

This interpretation is consistent with the views expressed by the FASB staff on their November 2018 webcast, *IN FOCUS: FASB Accounting Standards Update on Insurance*, in which they stated that if an insurance entity concludes that one assumption needs to be updated or actual cash flows must be adjusted, the entity is unlocking the net premium ratio and needs to revalidate that all other assumptions are still appropriate. It is also consistent with the AICPA Life and Health Insurance Entities Audit and Accounting Guide, Appendix G.

Question IG 5-15

Assuming a reporting entity has determined that an update to the net premium ratio for the interim period is unnecessary (i.e., there is no evidence to suggest that cash flow assumptions should be revised under ASC 944-40-35-5 and ASC 944-40-35-6), does the guidance require an entity to update the insurance in force at the interim date?

PwC response

This fact pattern assumes that a reporting entity has determined that experience to date with the cash flow components (consisting of actual historical cash flows, updated insurance in force, and future cash flow assumptions) does not suggest a need to revise the net premium ratio for the interim period. That is, calculating the liability for future policy benefits using updated cash flow components would not result in a significant change from keeping the existing cash flow components.

Based on that determination, and the objective of reporting the best estimate of the liability for future policy benefits, an entity would not be prohibited from updating the actual insurance in force in a period in which it had not been required to update the net premium ratio based on actual experience, as it will result in a measurement of the liability that more closely approximates the measurement if all three cash flow components had been updated. It would therefore be assumed to not result in a significant impact to the liability for future policy benefits.

5.2.4.2 Updating the discount rate - liability for future policy benefits

When calculating the revised net premium ratio, the updated cash flows are discounted using the original contract issue date discount rate (See IG 5.2.3.1). The revised net premium ratio will be used to measure benefit expense based on recognized premium revenue in the period.

A remeasurement of the liability is also required using the current discount rate. The same updated cash flows are discounted to the current reporting date using the current liability discount rate. The difference between the liability measured using the locked-in discount rate and the liability measured at the current rate is reflected in AOCI, and the change for the period is presented in OCI and not as an expense of the period. The remeasurement of the liability for future policy benefits using the current discount rate is required each reporting period even if the net premium ratio is not recalculated in the period. Interest is accreted to the statement of operations using the original discount rate on the

contract issue date. As the disabled claim liability is considered part of the liability for future benefits, the impact of remeasuring at current rates will also be reflected in AOCI.

Example IG 5-4 illustrates the calculation and impact of remeasuring the liability for future policy benefits at the current discount rate.

EXAMPLE IG 5-4

Remeasurement of the liability for future policy benefits at the current discount rate

Insurance Company has a locked-in (original issue date) discount rate of 3% and the current rate at the subsequent balance sheet date is 3.2%.

What is the balance sheet remeasurement adjustment for the liability for future policy benefits?

Analysis

Insurance Company would remeasure the liability for future policy benefits as follows:

Present value of updated future benefits and related claim expenses @ 3%	\$1,200
Less: Present value of updated future net premiums @ 3%	(1,050)
Liability for future policy benefits @ 3%	\$150 (A)
Present value of updated future benefits and related claim expenses @ 3.2%	\$1,170
Less: Present value of updated future net premiums @ 3.2%	(1,030)
Liability for future policy benefits @ 3.2%	\$140 (B)
Difference (A) - (B)	\$10

Insurance Company A would record the following entry to recognize the remeasurement of the liability for future policy benefits. Company A has reversed the previous period AOCI adjustment, so the end of the period adjustment would be as follows:

Dr. Liability for future policy benefits	\$10
Cr. AOCI	\$10

Updating the discount rate through OCI will often mitigate the volatility in stockholders' equity if the insurance entity invests in available-for-sale debt securities to fund the group of contracts at the inception of the contract. For example, when interest rates decline after contract issuance, there would be a charge to OCI for the related change in the liability for future policy benefits. This charge would potentially offset the OCI impact from the available-for-sale debt securities funding the product. Decreases in interest rates do not result in loss recognition through the income statement.

In certain increasing interest rate environments, a change in the interest rates could result in the remeasurement producing a liability for future policy benefits that is negative (present value of future benefits less present value of net premiums). However, ASC 944-40-35-7B states that the liability for future policy benefits on a cohort basis cannot be negative. This guidance applies both for balance sheet remeasurement and for measurement of the liability at the locked in discount rate.

ASC 944-40-35-7B

In no event shall the liability for future policy benefits balance be less than zero at the level of aggregation at which the reserves are calculated.

5.2.5 Loss contracts – future policy benefits

As cash flow assumptions are required to be updated regularly and the net premium ratio is capped at 100% (i.e., net premiums cannot exceed gross premiums), a premium deficiency test is not required for nonparticipating traditional insurance and limited-payment contracts. Expected benefits and claim-related costs in excess of premiums are expensed immediately. As the liability assumptions are updated at least annually, if conditions improve whereby the contracts are no longer expected to have net premiums in excess of gross premiums, the improvement would be captured in the remeasurement process and reflected in earnings in the period of improvement.

5.2.6 Level of aggregation – future policy benefits

ASC 944-40-30-7 prescribes that a group cannot contain contracts with different issue years, but does not provide any more specific guidance on grouping.

Excerpt ASC 944-40-30-7

In determining the level of aggregation at which reserves are calculated, an insurance entity shall not group contracts together from different issue years but shall group contracts into quarterly or annual groups.

Factors to consider in grouping contracts within issue years include the type of insurance benefit, the type of insurance risk, and how the contract is priced. The retrospective calculation for a cohort requires using historical information for contracts that have terminated as well as those in force.

Question IG 5-16

Can an insurance entity group different products issued within the same year (e.g., a whole life contract and a term insurance contract, or a disability contract and a long-term care contract) for purposes of calculating the net premium ratio and the liability for future policy benefits?

PwC response

It is expected that these each grouping would be within a particular product line or a level below the product level. Grouping of a whole life product with disability or long-term care products usually would not meet this objective.

Question IG 5-17

Can an insurance entity have different cohorts for two term insurance contracts issued within the same quarter (e.g., a 10-year term insurance contract issued to a 20-year old male and 65-year old woman), for purposes of calculating the net premium ratio and the liability for future policy benefits?

PwC response

Potentially. As noted in Question IG 5-16, it is expected that cohort groupings be within a particular product line or a level below the product level. ASC 944-40-30-7 only specifies an upper bound to the cohort groupings, but does not provide more specific guidance. Judgment will have to be applied to determine whether contracts written within the same quarter or year have similar risks and should be within the same cohort. Factors to consider in grouping contracts within issue years include the type of insurance benefit, the type of insurance risk, and how the contract is priced. An insurance entity may argue that the two different term products were priced differently or that some aspect of their expected performance or risks warrants separate measurement.

Question IG 5-18

Can an annual contract grouping for measuring the liability for future policy benefits for nonparticipating traditional and limited-payment contracts be determined on something other than a calendar year basis (e.g., can it be the 12 months ending June 30 if the annual assumption update is done in the second quarter)? Can an insurance entity use different annual periods for different products, geographic locations, or foreign subsidiaries?

PwC response

The new guidance requires that contracts be grouped into quarterly or annual groups and prohibits grouping contracts with different issue years; however, it does not provide any more specific guidance. As a result, there is nothing that prohibits an entity from defining annual cohorts on other than a calendar-year basis, nor is there anything that requires an entity to make the grouping decision on an entity-wide basis.

Question IG 5-19

Can contracts denominated in different currencies be aggregated within the same cohort?

PwC response

No. ASC 830-20-35-2 requires that, at each balance sheet date, recorded balances that are denominated in a currency other than the functional currency be adjusted to reflect the current exchange rate, with the related foreign currency transaction gain or loss recognized in net income in the period in which the exchange rate changes.

Therefore, when calculating the liability for future policy benefits, insurers should project cash flows, calculate the net premium ratio, and determine the liability for future policy benefits in the currency in which the contract is denominated, and then remeasure that balance into the functional currency. Establishing separate cohorts for different currencies ensures that changes in exchange rates are recognized immediately in income as required by ASC 830 rather than being included in the revised

cash flows used in the net premium ratio and recognized in future periods through the constant margin calculation.

Question IG 5-20

Can the cohort used to measure the liability for future policy benefits change subsequent to initial measurement?

No. ASC 944-40-30-7 requires the selection of cohorts at initial measurement. ASC 944-40-35 does not contemplate changes in cohorts in periods subsequent to the period in which a cohort is established. The selection of a cohort is an irrevocable decision made at initial measurement rather than an accounting policy choice. A cohort is also not a cash flow or discount rate assumption as described in ASC 944-40-35-6A, where updates are required at least annually with a retrospective catch up. Therefore, an entity also cannot change cohorts as if it were a change in estimate.

Question IG 5-21

If an entity changes segments for segment reporting purposes, should it change its cohorts to reflect the segment change?

No. ASC 944-40-55-13H states that for the purposes of the rollforward disclosures, “an insurance entity should not aggregate amounts from different reportable segments according to ASC 280, if applicable.” However, subsequently, if a re-segmentation occurs, in accordance with ASC 280, and an existing cohort or cohorts now span multiple segments, the cohorts established at initial measurement must be maintained for consolidated reporting.

An additional consideration related to determining contract groupings for calculating the liability for future policy benefits is the appropriate cohorting of riders, conversion features, or policyholder election options (“features”) that are not under separate measurement in ASC 815 or ASC 944. If the pricing of these features is contractually established at inception of the base contract, the cash flows of the features should be included in the liability for future policy benefits from inception of the base contract; however, determining the cohorting of the features will require judgment. An entity should consider whether in substance, there is one contract or separate contracts for measurement purposes, especially if the risk covered by the features are different from the base contract (e.g., a disability rider on a whole life contract). If the price of the feature is determined upon election, those features would be considered new contracts when elected, whereby they must be recognized at election and aggregated in cohorts separately from the base contract. Finally, some features may extinguish the base contract and create a new contract, which must be aggregated in cohorts upon recognition of the new contract. Figure IG 5-3 outlines some considerations for determining the cohort of these contract features and whether they represent contract modifications.

Figure IG 5-3

Cohort considerations for additional contract features.

Feature	Timing of Pricing	Considerations
Feature elected at inception	At inception	An entity must use judgment to determine, whether in substance, the feature is part of the base contract or separate accounting unit. An entity may consider the availability and pricing of a similar, standalone contract in making this determination.
Feature included in original contract	At inception	Since the pricing of the feature is set at inception of the contract, election of the feature subsequent to issuance is not an internal replacement; it is the continuation of an existing contract. The inception date of the feature is the date of issuance of the original contract, even if the feature was not elected at the date of issuance of the original contract. Cash flow assumptions for the liability for future policy benefits should include assumptions about the timing and incidence of feature elections from inception of the base contract. An entity should consider the substance of the feature in its determination of cohorts.
Feature included in original contract	Upon election of the feature	As the pricing of the feature was not set at inception, the election of the feature is a modification that is generally a non-integrated internal replacement (considered a new contract separate from the original contract) that should be recognized and aggregated in cohorts separately from the original base contract. The issue date of the feature (used for cohorting and inception discount rate establishment) is the date of election. However, if there is no underwriting required at election, an entity should consider whether the lack of underwriting causes it to be part of the base contract (i.e., is underwriting significant to the determination of it being a new contract).

Certain conversion options, such as nonforfeiture options, are part of the liability for future policy benefit assumptions in the base contract. This means that cash flow assumptions from contract inception would include, in the same cohort as the base contract, assumptions about the timing and incidence of option election, and about subsequent reinstatement if permitted by the contract. Utilization of these options is a continuation of the existing contract; the present value of future cash flows and net premium ratio would be updated to reflect actual experience. An entity would need to determine whether the contract should be treated as limited pay, such that a portion of the margin would be deferred in a DPL.

5.3 Measurement – limited-payment insurance contracts

Limited-payment contracts provide a specified, fixed amount of insurance benefit that extends beyond the period or periods in which premiums are collected (e.g., single pay life insurance contract, five-year pay whole life insurance, single premium life-contingent payout annuity). GAAP guidance requires that the liability for future policy benefits attributable to limited-payment contracts be calculated consistent with the accounting for nonparticipating long-duration contracts if the terms of

the contract are fixed and determinable. See IG 5.2 for additional information on the measurement of nonparticipating traditional insurance contracts.

Under the accounting for nonparticipating long-duration contracts with premiums received over the entire life of the contract (traditional life insurance), any gross premium received in excess of the net premium is recognized in income when received. However, in the limited-payment model, the collection of premium does not represent the completion of the earnings process, so any gross premium received in excess of net premium must be deferred initially. The deferred revenue amount is known as the deferred profit liability (DPL). ASC 944-605-35-1A requires the DPL to be amortized in relation to the discounted amount of the insurance in force (for life insurance contracts) or expected future benefit payments (for annuity contracts). As the calculation of the DPL is based on discounted cash flows, interest accrues on the unamortized DPL balance.

The guidance does not specify where to present the DPL and subsequent amortization of the DPL within the balance sheet or income statement. Refer to IG 10.2.1 for further information. The liability for future policy benefits attributable to limited-payment contracts is consistent with the accounting for nonparticipating traditional insurance contracts. Refer to the table in Figure IG 5-4 for additional references to guidance within this guide.

Figure IG 5-4

Guidance on measuring the liability for future policy benefits

Reference	Topic
IG 5.2.1	□ Estimating the liability for future policy benefits
IG 5.2.2	□ Liability assumptions in the net premium ratio
IG 5.2.3	□ Discount rate assumption
IG 5.2.4	□ Updating assumptions in the liability for future policy benefits
IG 5.2.5	□ Loss contracts – future policy benefits
IG 5.2.6	□ Level of aggregation – future policy benefits

5.3.1 Changes to the liability for future policy benefits and DPL

For limited-payment contracts, the updating of cash flow assumptions and resulting retrospective updating of the net premium ratio impacts not only the liability for future policyholder benefits, but also the amount of the DPL. The DPL will also be adjusted on a retrospective catch up basis, contemporaneous with any updating of the liability for future policy benefits.

The remeasurement gain or loss in net income for the current reporting period as a result of updating cash flow assumptions is described in ASC 944-605-35-1C.

Excerpt ASC 944-605-35-1C

- a. Cash flow assumptions used to calculate the deferred profit liability at contract issuance shall be updated in subsequent periods using actual historical experience and updated future cash flow assumptions.
- b. The recalculated deferred profit liability as of the contract issue date shall be subsequently amortized in accordance with paragraph 944-605-35-1A to derive the revised deferred profit liability estimate as of the beginning of the reporting period.
- c. The revised deferred profit liability estimate calculated in (b) shall be compared with the carrying amount of the deferred profit liability as of the beginning of the current reporting period to determine the change in the estimate adjustment to be recognized in net income of the current reporting period (see paragraph 944-40-45-4).

Insurance entities should complete the following steps in order to reflect the updating of cash flow assumptions within the liability for future policy benefits and DPL for limited-payment contracts in subsequent periods:

- Update cash flow assumptions used to calculate the liability for future benefits and the DPL at contract issuance using actual historical experience and updated future cash flow assumptions (see IG 5.2.4).
 - Updated insurance in force or expected benefit payments are discounted using the original contract issue date discount rate.
- Using the updated DPL as of the contract issue date, recalculate subsequent amortization based on the updated discounted amount of insurance in force (for life insurance) or expected future benefit payments (for annuity contracts) to derive the revised DPL estimate as of the beginning of the current reporting period.
- Compare the revised DPL to the carrying amount of the DPL as of the beginning of the current reporting period to determine the remeasurement gain or loss.

The guidance does not specify the categorization of the remeasurement gain/loss in net income other than requiring presentation separately in net income, either parenthetically or as a separate line item (see IG 10.2.1.1). If an insurance entity chooses to present the remeasurement gain/loss parenthetically, we expect it to be in the same revenue or expense category where DPL amortization is recognized. See IG 10.2.1 for further details on the presentation of DPL amortization.

Interest will accrue on the unamortized DPL at the original contract issue date discount rate.

5.4 Measurement – universal life-type insurance contracts

Universal life-type contracts have charges or provide benefits that are not fixed or guaranteed. A principal component of most universal life-type contracts is an account balance on which interest is credited to policyholders and from which fees are deducted (assessed) for mortality (or other insurance) risk and contract administration.

The revenue recognized on a universal life-type contract consists of mortality (or other insurance) fees and contract administration assessments. Such revenue is generally recognized when due as policy charges and fee income. Unlike traditional insurance contracts, the premiums collected are considered deposits and are not recognized as revenue. The premiums received are part of the policyholder's account balance and recognized on the balance sheet as a liability.

Under ASC 944-40-30-16, the liability for policy benefits for universal life-type contracts is equal to the sum of the following four elements:

- Balance that accrued to the benefit of the policyholder at the balance sheet date (e.g., stated account balance or similar internal explicit or implicit contract value). The accounting method that measures the liability for policy benefits based on policyholder balances is known as the "retrospective deposit method." See IG 5.4.1.
- Amounts previously assessed against policyholders for services to be performed in the future (i.e., deferred revenue, including front-end or initiation fees). See IG 5.4.3.
- Amounts previously assessed against policyholders that are refundable on contract termination
- Any amounts provided for premium deficiencies. The liability for premium deficiency should be calculated in accordance with the premium deficiency provisions of the accounting for long-duration contracts. See IG 7.3 for further information on initial and subsequent measurement.

The most significant component of a universal life-type contract is the policyholder account balance, as the other elements may not always be present. In addition to the four components of the liability for all universal life-type contracts, ASC 944-40-25-25B requires an "additional liability" for some universal life-type contracts. These liabilities are accrued for contracts or contract features that provide potential benefits in addition to the account balance that accrues to the benefit of the policyholder. See IG 5.4.5.

5.4.1 Policyholders' account balances and other contract elements

The account balance is analogous to a deposit placed with a financial institution. It is the accumulated gross amount accruing to the policyholder under the terms and conditions of the policy assuming the contract will continue in force. As described in ASC 944-40-25-14 through ASC 944-40-25-15, the accrued account balance for universal life-type contracts is the sum of:

- a) deposits (i.e., premiums) net of withdrawals,
- b) plus amounts credited pursuant to the contract,
- c) less fees and charges assessed,
- d) plus additional interest (i.e., an amount that is required to be accrued under the liability valuation model that has not yet been credited to the contract holder account balance - see IG 5.4.2),
- e) plus or minus other adjustments (for example, appreciation or depreciation relating to variable annuity, variable life, and certain group pension participating contracts to the extent not already credited and included in (b) above).

Surrender and other similar charges not assessed against the account balance absent any action by the policyholder (i.e., termination of the contract through surrender) should not be accrued. This includes contracts referred to as market value annuities, which provide for a return of principal plus a fixed rate of return if held to maturity (book value) or a market-adjusted value if surrendered before maturity. See IG 5.4.4 for additional information.

Contracts that have features resulting in more than one potential account balance should base the accrued account balance on the highest contractually-determinable balance that will be available in cash or its equivalent without reduction for future fees and charges expected to be assessed. An example is a contract that provides a return based on a contractually-referenced pool of real estate assets owned by the insurance entity but also provides for minimum investment return guarantees.

For a contract not accounted for as a derivative that provides a return based on the total return of a referenced pool of assets, the accrued account balance should be based on the fair value of the referenced pool of assets, in accordance with ASC 944-40-25-19.

For certain universal life-type contracts, an explicit account balance will not be reported to the policyholder. However, in many instances, an internally generated explicit account balance or an implicit account balance will be maintained or calculated for each policyholder. Typically, these balances are generated by the insurance entity for purposes of calculating the amount of "excess interest" to be credited to each policy (i.e., there must be a determinable balance against which the "excess interest" crediting rate can be applied).

In the absence of a stated account balance or a similar explicit or implicit contract value, the cash surrender value measured as of the balance sheet date should be accrued. However, in the event it is determined that only the cash surrender value should be accrued, it may be appropriate to reconsider the product classification. Generally, a significant and flexible investment component is incorporated into each universal life-type product, and it is unlikely that a universal life-type policy could provide such a function or service without the maintenance of at least an implicit account balance. See IG 2.4 for more information on the framework for appropriate classification of long-duration insurance contracts.

5.4.2 Sales inducements - universal life-type contracts

Sales inducements (including "Day 1 bonuses," persistency bonuses, and enhanced interest crediting) should be accrued as part of the liability for policy benefits over the period for which the contracts must remain in force for the contract holder to qualify for the inducement or at the crediting date, if earlier, in accordance with ASC 944-40-25-12. See IG 5.4.1.

Guidance in ASC 944-30-25-6 and ASC 944-30-25-7 requires an entity to establish a sales inducement asset for such amounts credited to account balances if certain criteria are met. The sales inducement asset is required to be amortized and recognized as a component of benefit expense using the same methodology and assumptions as DAC. See IG 3.6 and IG 3.6.1 for additional guidance on the recognition of sales inducement assets and subsequent accounting.

An example of additional interest is a persistency bonus that is determined as a percentage of a specified future year's account balance (e.g., 1% of the account balance that exists at the end of year five). ASC 944-40-55-12 requires a persistency bonus to be accrued ratably over the five-year vesting period. Accruing using an interest rate method or at a level amount each period is appropriate. Other methods, such as using estimated gross profits, would not be appropriate as consideration of

anticipated surrenders and deaths is prohibited. Separately, a sales inducement asset would be established and amortized as a component of benefit expense on a basis consistent with DAC amortization.

Question IG 5-22

How should the amount of persistency bonus to be accrued over the vesting period be estimated for a persistency bonus that is determined as a percentage of a specific future year's account balance (e.g., 1% of the account balance that exists at the end of year five for a contract that receives a discretionary crediting rate each period)?

PwC response

An acceptable approach would be to use the account balance at the end of the current reporting period as an estimate of the future account balance, and multiply that amount by 1% to estimate the persistency bonus to be paid at the end of year five. This amount would be recognized ratably over the five-year period. Cumulative adjustments would be made each period for the impact of changes in the current balance.

Question IG 5-23

How should the liability for a recurring persistency bonus (e.g., crediting a bonus every 5 years) be accrued?

PwC response

Several potential methods could be used. One method would be to accrue each bonus during each separate five-year vesting period.

Another method would be to calculate the total amount of bonus interest that would be paid at contract maturity and recognize the additional interest over the life of the contract using the effective interest rate method. Alternatively, each persistency bonus can be considered separately and individually recognized ratably over the period from inception of the policy to its individual crediting date.

Question IG 5-24

What is the accounting for the accrued additional interest liability upon a policy lapse?

PwC response

The liability is reversed and the forfeited persistency bonus treated as an additional surrender charge.

Question IG 5-25

Assume a product for which a "Day one" bonus is offered upon each deposit, not just the initial premium deposit, and additional deposits are at the policyholder's discretion and not expected to be level. Would the bonus qualify as a capitalizable sales inducement?

PwC response

Yes. Bonuses on discretionary non-level deposits can be considered incremental and thus are potentially eligible for capitalization if all of the ASC 944-30-25-6 criteria are met. On the other hand, if premium deposits were scheduled and required, and if the "Day one" bonus was being offered on each premium deposit, it may be difficult for the company to clearly demonstrate that bonuses on such amounts are incremental.

Question IG 5-26

If "bonus interest" is offered to policyholders as a trade-off with other contract features, e.g., a higher bonus applies if an increased surrender charge schedule is elected, would that bonus be eligible for deferral as a sales inducement?

PwC response

If the crediting is predicated on the features that are elected, the contracts can never be similar, and thus the bonus would not be eligible for deferral.

The sales inducement asset and liability represent contract cash flows and therefore should be included in universal life insurance premium deficiency tests. Refer to IG 7.3 for further information.

5.4.3 *Deferred revenue – universal life-type contracts*

Guidance related to accounting for long-duration contracts in ASC 944-605-25-6 through ASC 944-605-25-7 requires that amounts assessed against the policyholder during a period for services to be provided in future periods should be deferred. Thus, any front-end or initiation fees assessed at the inception of a contract or during the earlier years should be deferred. The recognition of revenue when front-end fees are assessed would be inappropriate as no service has yet been provided. Unearned revenue should be amortized into revenue in the same manner, and using the same assumptions, as are utilized to amortize DAC in accordance with ASC 944-605-35-2. See IG 3.5 for additional information on the amortization of DAC.

ASC 944-605-25-9 through ASC 944-605-25-10 clarify that the unearned revenue liability is separate from any additional liability for death or other insurance benefits that may be required to be established. See IG 5.8 for further information.

Unearned revenue, along with sales inducement assets and liabilities, represent contract cash flows and therefore should be included in universal life insurance premium deficiency tests. See IG 7.3 for further information.

5.4.4 *Surrender charges – universal life-type contracts*

A surrender charge is collected when the relationship between the policyholder and the insurer has been severed at the specific election of the policyholder.

Surrender charges are designed to provide for the recovery of contract origination costs that may not be fully recovered from policy profits if the policy is terminated early or to allow the entity to invest in longer term assets without disintermediation risk (i.e., the risk investments will need to be sold early when interest rates have risen). Thus, the level of surrender charges assessed against policyholders

generally decreases on a sliding scale to zero after a specified period of time. Since the insurance entity cannot assess surrender charges until an event is enacted by the policyholder (e.g., termination of the policy), surrender charges (like other policyholder fees) are recognized as earned when assessed by the insurance entity.

5.4.5 Additional liabilities – universal life-type contracts

In addition to the four components of the liability for universal life-type contracts, ASC 944-40-25-25B may require an “additional liability” for some universal life-type contracts. These liabilities are accrued for contracts or contract features that provide potential benefits in addition to the account balance that accrues to the benefit of the policyholder. These contract features protect against a policy lapsing (e.g., no lapse guarantee), offer a return based on the total return of a referenced pool of assets (e.g., indexed crediting rate tied to the S&P 500), or offer guaranteed minimum benefits (e.g., guaranteed minimum death benefit). Insurers must evaluate whether these features meet the criteria of market risk benefits (MRBs), embedded derivatives, or represent additional liabilities for annuitization, death, or other insurance benefits. See IG 2.4 for additional details of the analysis to determine appropriate classification and IG 5.6, IG 5.7, and IG 5.8 for the accounting considerations for MRBs, embedded derivatives, and additional liabilities for annuitization, death, or other insurance benefits, respectively.

5.5 Measurement – investment contracts

Investment contracts are those contracts written by an insurer that do not subject the insurer to significant mortality or morbidity risk (e.g., a guaranteed investment contract (GIC)). Certain annuities may qualify as investment contracts (e.g., fixed annuities, fixed (equity) indexed annuities in the accumulation phase). However, the payout phase for a fixed annuity (i.e., the period during which the contract holder is receiving periodic payments) is a separate contract for accounting purposes (a limited-payment contract). See IG 2.4 for additional considerations surrounding long-duration insurance contract classification.

Long-duration insurance contracts that have been classified as investment contracts must be accounted for in a manner consistent with the accounting for interest bearing or other financial instruments in accordance with ASC 944-825-25-1 through ASC 944-825-25-2. The premiums collected are considered deposits and are not recognized as revenue. The premiums are part of the account balance of the policyholder and are recognized on the balance sheet as a liability. Any change in the accrued account balance should be reflected in net income in the period of the change.

The liability for policy benefits is the stated account balance, if applicable. If there is no stated account balance, the liability is recognized as the present value of future payments using the effective yield at inception of the contract.

In accounting for investment contracts in a manner similar to other interest bearing obligations, revenue results from the investment of funds received from the policyholder and from any surrender charges. Expenses are comprised primarily of interest credited to the policyholder's account balance. No provision for future losses (i.e., premium deficiency) is made for investment contracts. In the event that losses are estimated, the losses represent a negative investment spread that should be recognized over the remaining life of the contract, consistent with other industries' treatment of debt instruments.

Investment contracts can have various contract features, including returns based on the total return of a referenced pool of assets (e.g., indexed crediting rate tied to the S&P 500) and guaranteed minimum benefits (e.g., guaranteed minimum withdrawal benefit or GMWB). Insurers must evaluate whether those features meet the criteria of market risk benefits (MRBs), embedded derivatives, or represent additional liabilities for annuitization, death, or other insurance benefits. See IG 2.4 for additional details of the analysis to determine appropriate classification and IG 5.6, IG 5.7, and IG 5.8 for the accounting considerations for MRBs, embedded derivatives, and additional liabilities (annuitization, death, or other insurance benefits), respectively.

5.6 *Measurement – market risk benefits*

ASC 944-40-25-25C introduces the term “market risk benefits” The market risk benefit is an amount that a policyholder would receive in addition to the account balance upon the occurrence of a specific event or circumstance, such as death, annuitization, or periodic withdrawal. See IG 2.4.5 for further information on the assessment of contract features under the MRB guidance.

Features that meet the definition of MRBs are accounted for at fair value. The portion of the fair value change attributable to a change in the instrument-specific credit risk of the issued contract is recognized in other comprehensive income, while the remainder is recognized in net income. MRB balances and changes in their measurement are separately presented in the statement of financial position and the statement of operations.

MRBs can be present in variable and fixed annuity contracts and in certain life insurance contracts. MRB features in contracts include various GMXBs, such as GMDBs and GMIBs. MRB features also include GMABs and GMWBs previously accounted for as embedded derivatives, as well as GMWB for life benefits, for which there was previously diversity in accounting practice. For variable annuity contracts, the host contract will be measured excluding the separated features and may be further separated into different accounting units, consistent with where the policyholder elected the funds to be invested (the variable accounts or the fixed account) and if the contract contains an embedded derivative.

ASC 944-40-25-25D (b) notes that an MRB does not include the death benefit component of a life insurance contract (i.e., the difference between the account balance and the death benefit amount). However, an MRB may be present in a life insurance contract if it provides for protection from capital market risk for other benefits, for example, a GMAB or GMWB on the account balance component of a variable universal life insurance contract. MRBs may also be present in certain universal life insurance contracts that provide for an option to settle the contract upon surrender or death with an annuity determined using guaranteed fixed interest rates.

5.6.1 *Initial measurement of MRBs*

ASC 944-40-30-19C through ASC 944-40-30-19D require that market risk benefits be measured at fair value and provide further guidance on initial measurement of the MRB features, incorporating guidance from ASC 815-15, which relates to identifying and measuring embedded derivatives.

ASC 944-40-30-19C

A market risk benefit shall be measured at fair value. Total attributed fees used to calculate the fair value of the market risk benefit shall not be negative or exceed total contract fees and assessments collectible from the contract holder.

ASC 944-40-30-19D

In determining the terms of the market risk benefit, the insurance entity shall consider guidance on determining the terms of an embedded derivative that is required to be accounted for separately under Subtopic 815-15 on embedded derivatives, including the following:

- a. Consistent with paragraph 815-15-30-4, if a nonoption valuation approach is used, the terms of the market risk benefit shall be determined in a manner that results in its fair value generally being equal to zero at the inception of the contract.
- b. Consistent with paragraph 815-15-30-6, if an option-based valuation approach is used, the terms of the market risk benefit shall not be adjusted to result in the market risk benefit being equal to zero at the inception of the contract.
- c. Consistent with paragraph 815-15-25-7, if a contract contains multiple market risk benefits, those market risk benefits shall be bundled together as a single compound market risk benefit.

ASC 944-40-30-19D notes that in determining the terms of the market risk benefit, the guidance on determining the terms of the embedded derivative in ASC 815-15 should be considered. ASC 815-15-30-2 provides guidance on allocating the value of a hybrid instrument between the embedded derivative and the host contract. The market risk benefit is measured on the balance sheet at its fair value, and the remaining initial consideration is allocated to the host contract (net of any embedded derivatives also measured at fair value).

Question IG 5-27

What is the unit of measurement for determining the attributed fee for an MRB? How does it compare to the unit of measurement for fair value under the ASC 820 fair value framework?

PwC response

The unit of measurement for determining the attributed fee for an MRB is the individual contract. An entity is limited to fees and assessments collectible from “the contract holder,” meaning each individual contract holder. In principle, fees and assessments collectible from one contract holder cannot be attributed to another contract.

The unit of account may differ from the unit of measurement. The fair value of an MRB feature may, under ASC 820 fair value guidance, be determined for a group of MRBs (i.e., the group may be the unit of measurement). However, ASC 820 does not change the unit of account prescribed by ASC 944. To the extent components of the fair value of an MRB are measured at a higher level than the individual contract (e.g., risk margin), that component of the fair value would need to be allocated to the individual contracts in a systematic and rational manner. Additionally, certain insurance assumptions such as mortality rates and lapse rates may be determined based on the average experience of a group of policies. These averages will be applied at the contract level. For example, male attained age mortality assumptions may be set in aggregate but would apply to each policyholder based on their attained age. The attributed fee determined at inception of the contract is then calculated and set at the contract level based on the specific application of assumptions to that contract.

In practice, in determining the attributed fee at contract inception, it may be possible to group homogeneous contracts issued in the same period. For example, homogeneous groups of contracts could be accumulated for each product (such as all variable annuities with guaranteed minimum death benefits), by category of additional benefit (such as a return of premiums, premiums plus interest, or highest anniversary value), by type of fund offered, and for each issue age within these categories. When grouping contracts, entities should consider the likelihood and materiality of any potential misclassification due to insufficient fees of one group being made up with allocation of fees from another group of contracts.

In practice, the “attributed fee” method is a common approach for determining the terms of an MRB by defining how much of the contractual fees are attributable to the MRB. The attributed fee for a GMXB feature is typically determined at contract inception by estimating the fair value of expected future benefits and allocating a portion of the total fees expected to be assessed against the contract holder equal to the fair value of the expected benefits. The attributed fee may differ from the fee specified in the contract for the GMXB benefit. This approach generally results in a zero value for the feature at inception. However, ASC 944-40-30-19C provides that the attributed fee cannot exceed the total contract fees and assessments collectible from the contract holder and cannot be less than zero. Assessments collectible from the contract holder typically include explicit rider fees as well as those for administration, mortality, and expense. Investment spread/margin is excluded from the attributed fee determination as these amounts are not collected from contract holders.

Question IG 5-28

Can mutual fund fees or other fees that are received in conjunction with a contract (but are not directly collectible from the contract holder) be considered part of total contract fees and assessments collectible from the contract holder?

PwC response

No. Fees or assessments collectible under separate contracts that are not directly executed between the insurance entity and the contract holder do not qualify as “contract fees and assessments collectible from the contract holder.” Examples of fees that do not meet the description include mutual fund fees earned by an affiliate mutual fund provider and “revenue sharing” fees received from third-party mutual funds relating to an insurer’s separate account mutual fund investments. If these fees are contingently collectible from the policyholder (e.g., in the event the policyholder may have to pay a fee in the event the mutual fund option changes and fees are no longer collected), insurers could consider the probability of collecting the fees contingently collectible from the contract holder as part of the total contractual fees available to be attributed to the MRB.

The required attributed fee determined at contract inception is typically converted to a percentage of total fees, which is then applied to the total fees collectible from the contract holder. The percentage of the total fees is considered a fixed term of the MRB feature for accounting purposes and does not change over the life of the contract. At subsequent reporting dates, the fair value of the GMXB is determined based on the present value of future benefits to be paid to contract holders minus the present value of the future attributed fees (which are calculated using the inception attributed fee percentage).

For products without a fee stream or where fees are not attributed to the MRB, an option-based approach may be used. Under the option-based approach, the initial consideration allocated to the

MRB is the initial fair value of expected future benefits, and the remaining consideration (assuming no embedded derivatives) is allocated to the host insurance or investment contract. This results in a discount on the host equal to the MRB consideration.

For products that only provide separate account investment options and have a fee stream, we would expect that an attributed fee method would be used, and if fees are insufficient, a day 1 loss would be incurred. For products that only provide general account investment options and do not have a fee stream, we expect that an option-based method would be used. If products offer both general and separate account investment options and the fund allocation determines the fee stream, companies should consider the relevant product features and policyholder behavior assumptions when developing their valuation approach. We believe that in keeping with the principle that in an arms-length transaction, there should not be a loss at inception of a contract. If fees are insufficient, to the extent there are available funds in the general account investment option, a host adjustment could generally be made as compensation for the fee insufficiency.

Example IG 5-5 and Example IG 5-6 illustrate the recognition and measurement of certain market risk benefits.

EXAMPLE IG 5-5

Recognition and measurement of an MRB in a variable annuity

A contract holder deposits \$100,000 in a deferred variable annuity with GMAB and GMDB riders that provide that the contract holder's benefit upon the year 5 anniversary date or upon death will be the greater of the account balance or the deposits less withdrawals accumulated at 3% interest compounded annually. The policy terms provide that fees equal to 200 basis points of the account balance will be deducted from the account balance each year. The insurance entity uses the attributed fee method to determine the fair value of the MRB. The insurance entity determines that the fair value of the total benefits for the GMAB and GMDB riders to be paid in excess of the account balance is \$7,500 and the estimated total amount of fees is \$20,000.

Under the attributed fee method (non-option method), how would the MRB and host contract be recognized and measured?

Analysis

The attributed fees for the compound MRB would be 37.5% (MRB attributed fee of \$7,500/ total expected fees of \$20,000), or 75 basis points of the annual fees of 200 basis points. These ascribed fees are less than the contractual fee. Going forward, the MRB fair value will be determined as the current fair value of the future excess benefits to be paid minus the current fair value of 75 basis points of the account balance. The remaining 125 basis points of contractual fees will be considered variable annuity host fees and recognized when deducted.

EXAMPLE IG 5-6

Recognition and measurement of an MRB in an equity indexed annuity

A contract holder deposits \$100,000 in an equity indexed annuity with a GMDB rider that provides that the contract holder death benefit be credited an additional 25% of the S&P 500 positive returns beyond those credited to the account balance. At contract inception, the entity determines that the fair

value of the benefits to be paid in excess of the account balance is \$5,000 and the fair value of the embedded derivative for index crediting is \$10,000.

Under the option method, how would the MRB, embedded derivative, and host contract be recognized and measured?

Analysis

In using the option method of identifying the MRB cash flows in determining its fair value, the insurance entity would recognize an MRB liability of \$5,000, an embedded derivative of \$10,000, and an account balance, less discount, host contract of \$85,000. The host discount of \$15,000 would be accreted through interest crediting expense over the life of the host contract to \$100,000. The MRB and embedded derivative would be revalued each period to fair value.

5.6.2 Multiple market risk benefit features

ASC 944-40-30-19D(c) provides guidance on the accounting for multiple market risk benefits within a single long-duration contract.

ASC 944-40-30-19D(c)

Consistent with paragraph 815-15-25-7, if a contract contains multiple market risk benefits, those market risk benefits shall be bundled together as a single compound market risk benefit.

Accounting for market risk benefits within an insurance contract often becomes more complex when there are multiple MRBs. Each potential MRB should be analyzed separately to determine if it meets the scope criteria.

Once a conclusion is reached that multiple MRB features must be separated from the host contract, the value of the compound MRB is based on one unit of account rather than determining separate fair value measurements for each market risk benefit component and adding them together. A separate unit of account method is inconsistent with ASC 944-40-30-19D(c) and may produce an inappropriate valuation result since multiple MRBs within a single insurance contract will likely affect each other's fair values.

In theory, the requirement to value the components together could yield different results than if each of the components was valued separately. For example, we expect that the volatility of the combined MRBs would be lower than the volatility when valuing the components separately, potentially resulting in a lower risk margin for the combined MRBs. Additionally, the interdependency of certain assumptions emphasizes the requirement to perform a combined valuation. Lapse assumptions for variable annuity products tend to be more dependent on the extent to which the guaranteed minimum living benefits are "in-the-money" than the factors affecting the GMDBs if the GMDB were valued separately.

5.6.3 MRB – instrument-specific credit risk

ASC 944-40-35-8A requires that changes in the fair value of market risk benefits be recognized in net income, except that fair value changes in MRBs (issued or purchased) attributable to a change in the instrument-specific credit risk of the reporting entity are required to be recognized in other

comprehensive income. The requirement to report changes attributable to the instrument-specific credit risk in other comprehensive income rather than in earnings is consistent with the accounting for a change in fair value of a liability caused by a change in credit risk when the fair value option is elected under ASC 825, *Financial Instruments*. The FASB also understands that insurance entities typically exclude the risk of non-performance in the development of their hedging strategies.

Question IG 5-29

ASC 944-40-35-8A states “...The portion of a fair value change attributable to a change in the instrument-specific credit risk of market risk benefits in a liability position shall be recognized in other comprehensive income.” Does this imply that a reporting entity cannot include the portion of the change in fair value relating to its own credit risk (instrument-specific credit risk) in other comprehensive income if the market risk benefit fair value is in an asset position?

PwC response

No. Any changes in instrument-specific credit risk of the reporting entity included in the fair value of its market risk benefit, whether in an asset or liability position, and whether related to an issued or purchased MRB, should be recognized in OCI. The FASB included the word “liability” to emphasize that the only changes due to instrument specific credit risk recognized in other comprehensive income should be that of the reporting entity and should exclude nonperformance risk of a reinsurance entity or other counterparty to a market risk benefit.

Consistent with the liability fair value option guidance in ASC 825, instrument-specific credit risk for MRBs is measured as the portion of the periodic change in fair value that is not due to changes in a base market rate, such as a risk-free interest rate (the “base rate method”). There is no guidance provided in terms of what portion of the spread above risk-free constitutes “instrument-specific.” An alternative method may be used if it is considered to faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. Other potential choices may include the portion of the periodic change in fair value that is not due to changes in the risk-free rate plus or minus any combination of the following: (1) industry sector spread, (2) overall individual company credit standing, or (3) individual company credit standing for a specific product. The selected methodology is a policy election and will need to be disclosed, if material, and consistently applied to each financial liability from period to period.

5.6.4 Nonperformance risk – components of hybrid instruments

Determining the nonperformance risk relating to the components of an insurance contract containing an MRB that is bifurcated for financial reporting purposes (e.g., a variable annuity with a guaranteed minimum accumulation benefit) requires consideration of the nature of the hybrid instrument's contractual terms and whether payments under each of the contractual components (i.e., the host contract and the market risk benefit) have the same or different credit standings. Essentially, the individual components should be treated as separate liabilities of a single entity that may have different levels of nonperformance risk. For example, in the case of a variable annuity with a GMAB, the variable annuity host liability may be fully collateralized by related separate account assets, while the bifurcated minimum guarantee is not. In such a case, the nonperformance risk of the bifurcated market risk benefit would need to be considered separately based on its specific attributes. Additional data points in determining nonperformance risk may include credit spreads or credit default swaps

spreads and should consider the issuing entity credit data when determining the nonperformance risk of regulated subsidiaries.

5.6.5 *Guarantees related to future contract deposits*

An insurance or investment contract, such as a variable annuity with a guarantee feature, may provide a guaranteed return on future potential deposits, in addition to existing deposits, for a specified fee that is other than a current market fee.

The guarantee, and the right to make future deposits that will be subject to the guarantee, are attributes of the existing contract. Therefore, such guarantees need to be incorporated into the valuation if a market participant would incorporate these attributes into the price at which it would be willing to execute the transaction.

5.6.6 *MRB annuitization benefits*

For contracts with guaranteed minimum annuitization or withdrawal benefits accounted for at fair value as MRBs, ASC 944-40-35-8B provides guidance on the accounting at the date of annuitization or extinguishment of the account balance. That date marks the end of one accounting contract (the deferred annuity contract with an MRB recognized at fair value) and the beginning of a new contract (the payout annuity). This is because the payout phase is viewed as a separate contract and is not combined with the accumulation phase, as noted in ASC 944-30-35-3. At the date of annuitization or account balance extinguishment (for withdrawal benefits), the MRB would be derecognized, and any amount in AOCI relating to changes in instrument-specific credit risk would be reversed through OCI. The derecognized MRB amount, along with the derecognized contract holder account balance (if any), would be the “in substance” single pay premium used to derive the deferred profit liability recognized at inception of the payout annuity when the “in substance” premium exceeds the liability for future policy benefits. The payout annuity is a new contract for accounting purposes, the liability for which is subject to limited payment accounting, as described in IG 5.3.

Example IG 5-7 and Example IG 5-8 illustrate the accounting upon the election of the annuitization option for a GMIB feature and upon the extinguishment of the account balance (i.e., when the account balance goes to zero) for a GMWB feature accounted for as an MRB, in accordance with ASC 944-40-35-8B.

EXAMPLE IG 5-7

Accounting upon the election of the annuitization option for a GMIB feature accounted for as an MRB, resulting in a deferred profit liability

Insurance Company issues a deferred annuity contract with a GMIB feature that is accounted for as an MRB. At the annuitization date, the contract holder account balance (\$50) plus the MRB fair value (\$49) is equal to \$99, and a cumulative decrease in the MRB’s instrument-specific credit risk since the inception of the contract of \$1 has resulted in an existing credit balance in AOCI. Upon annuitization, the liability for future policy benefits for the payout annuity is \$90 (measured in accordance with the initial recognition guidance for limited payment contracts in ASC 944-40-30-7).

What is the accounting upon the election of the annuitization option for a GMIB feature accounted for as an MRB?

Analysis

In accordance with ASC 944-40-35-8B, Insurance Company would record the following journal entry to derecognize the unrealized instrument-specific credit risk through OCI. Insurance Company would not record a gain or loss in net income because there is no settlement of an obligation for an amount less than the contractual obligation amount (i.e., no realization of Insurance Company's previously estimated nonperformance).

Dr. OCI	\$1
Cr. MRB liability	\$1

Insurance Company would record the following journal entry to reflect the annuitization using the derecognized contract holder account balance and the MRB liability as the "in substance" premium for the payout annuity.

Dr. Contract holder account balance	liability	\$ 50
Dr. MRB liability		\$50
Cr. Liability for future policy benefits		\$90
Cr. Deferred profit liability		\$10

In this entry, a deferred profit liability is recognized at the inception of the payout annuity because the "in substance" premium exceeds the liability for future policy benefits. There is diversity in practice as to whether premium revenue and claims expense are separately recognized in the statement of operations in the period of annuitization or, since the transaction is not a new sale, the amounts are netted. This result would be the same for a GMWB where the account value is extinguished, except there is no debit to contract holder account balance as it has been reduced to zero.

EXAMPLE IG 5-8

Accounting upon the election of the annuitization option for a GMIB feature accounted for as an MRB, resulting in a loss

Insurance Company issues a deferred annuity contract with a GMIB feature that is accounted for as an MRB. At the date of extinguishment of the account balance, the contract holder account balance is \$50, the MRB fair value is \$34, and a cumulative decrease in the MRB's instrument-specific credit risk since the inception of the contract of \$1 has resulted in an existing credit balance in AOCI. Upon extinguishment, the liability for future policy benefits for the payout annuity is \$90 (measured in accordance with the initial recognition guidance for limited payment contracts in ASC 944-40-30-7).

What is the accounting upon the election of the annuitization option for a GMIB feature accounted for as an MRB?

Analysis

In accordance with ASC 944-40-35-8B, Insurance Company would record the following journal entry to derecognize the unrealized instrument-specific credit risk through OCI. Insurance Company would not record a gain or loss in net income because there is no settlement of an obligation for an amount less than the contractual obligation amount (i.e., no realization of Insurance Company's previously estimated nonperformance).

Dr. OCI	\$1	
Cr. MRB liability		\$1

Insurance Company would record the following journal entry to reflect the extinguishment using the derecognized MRB liability as the "in substance" premium for the payout annuity.

Dr. Contract holder account balance liability	\$50	
Dr. MRB liability	\$35	
Dr. Loss	\$5	
Cr. Liability for future policy benefits		\$90

5.7 Measurement – derivatives in insurance/investment contracts

Insurance entities issue various types of insurance and investment contracts, and reinsurance contracts, with embedded derivatives. These include certain equity indexed life and annuity contracts and reinsurance contracts with returns based on referenced investment portfolios.

The derivative accounting guidance in ASC 815-10-15-13 provides a scope exception from derivative accounting for certain insurance contracts and market risk benefits. Contract features need to be assessed to determine if the scope exemption applies or if accounting as an embedded derivative is required. ASC 815-15-55-66 through ASC 815-15-55-69 notes that the equity-indexed return portion of the contract will generally be required to be separated from the host and accounted for as a derivative. See IG 2.4 for additional considerations surrounding long-duration insurance contract classification. Refer to IG 9.9 for additional details on reinsurance contracts that contain embedded derivatives.

Features that meet the definition of an embedded derivative are required to be accounted for at fair value. Unlike market risk benefits, the entire change in fair value of the embedded derivative is

recognized through income. Consideration should be given to the measurement of the embedded derivatives and related guidance, including the issues identified in IG 5.7.1 through IG 5.7.3.

5.7.1 Insurance contracts with embedded derivatives

ASC 820 requires that a fair value measurement reflect the price the transferor would pay to transfer the liability in an orderly transaction between market participants at the measurement date, even if there is no active market in which to transfer insurance and investment contract liabilities and the embedded derivatives in such contracts, and even if transfer is not permitted under the terms of the contract. Therefore, an entity valuing a contract or embedded derivative component of a contract in the absence of an observable market would need to determine the hypothetical market in which the transfer would occur.

Some insurance entities have suggested that reinsurance is the exit market for insurance contracts, investment contracts, and embedded derivative components of such contracts. While the typical indemnity reinsurance transaction may be a viable way to economically transfer the risks related to these contracts, the ceding entity is still primarily obligated to the insured parties, and, thus, indemnity reinsurance is not equivalent to a complete transfer of the obligation as contemplated in ASC 820. While actual or hypothetical reinsurance transactions may offer data points and inputs into the fair value measurement, they would not necessarily be representative of an exit price. Accordingly, if reinsurance transactions (either actual or hypothetical) are used as inputs, how those inputs might differ from an actual transfer would need to be considered, including reinsurance contract terms, such as termination provisions, loss limits, potential premium adjustment provisions, remaining services provided by the cedant (such as policy administration and claims handling), and compliance (primary obligor risks, such as market conduct and reputational risks).

As an alternative to reinsurance, another direct insurance entity may provide a hypothetical market, possibly viewed in the context of a business acquisition. Such an approach would require consideration of what type of acquirer is involved in the business acquisition. That is, whether the buyer would be a strategic buyer or a financial buyer, the size of the buyer and size of the portfolio that would be purchased, the efficiencies in administrative systems of a typical market participant, and other factors.

Because of their unique features and lack of an established active market for transfers of the obligations, determining the fair value of many, if not all insurance and investment contracts or embedded derivative components of such instruments will require significant unobservable inputs. As a result, the fair value measurements are likely to be Level 3 measurements for fair value hierarchy disclosure purposes. Such unobservable inputs will reflect the insurance entity's assumptions about the assumptions market participants would use in pricing the specific portfolio, using the best information available, which might include the entity's own data. The insurance entity's own data should be adjusted if information indicating that market participants would use different assumptions is reasonably available without undue cost and effort. However, in many cases, there may be no reason to believe that the insurance entity's own assumptions are not consistent with those of a typical market participant.

5.7.2 Nonperformance risk – embedded derivatives

ASC 820 requires that the fair value of a liability reflect the nonperformance risk (including credit risk) relating to that liability. In the debt market, changes in either an entity's specific credit rating or general credit spreads will typically have a direct and immediate impact on the fair value of the

instrument. However, for certain insurance and investment contracts, premium pricing can be relatively insensitive to changes in ratings that relate to an insurer's claim paying ability or overall financial strength (at least within the upper levels of credit). For example, for retail products, consumers often do not distinguish a difference in claim paying ability above some level that is deemed acceptable. The commercial insurance and reinsurance markets may be somewhat more sensitive to credit rating changes.

The existence of state or other governmental guaranty funds and collateralization may also serve to reduce the significance of nonperformance risk in these measurements. As discussed in FV 8.1.1, credit risk may differ among liabilities of the same entity for a number of reasons. In addition to the items highlighted within that section, insurance contract liabilities may have other features that may be considered when measuring fair value. For example, variable annuity, variable life, and certain pension contracts may be collateralized by insurance entity separate account assets. Funds in a separate account are not commingled with other assets of the insurance entity for investment purposes. In the US, certain separate account assets are legally insulated from the general account liabilities of an insurance entity, such that the separate account contract holder is not subject to an insurer's default risk to the extent of assets held in the separate account. While separate account liabilities are generally collateralized by the related separate account assets, the extent of the legal insulation provided by the separate account arrangement may vary from jurisdiction to jurisdiction.

Another unique aspect of insurance entity operations is state guaranty funds, which help to pay claims of insolvent insurance entities. State laws specify the lines of insurance covered by these funds and the dollar limits payable. Although ASC 820-10-35-18A states that guarantees of liabilities should not be considered by the issuing entity in determining the fair value of the liability, ASC 825-10-25-13b exempts government guarantees from this exclusion.

In order to consider collateralization, a third-party, or a governmental guarantee in valuing a liability, such a feature must be an attribute of the instrument and inseparable from it. For example, with regard to state guaranty funds, it may be appropriate to consider their impact in the assessment of nonperformance risk if the guarantee would apply to the contract in the event the liability were transferred (i.e., if the guaranty fund remains obligated to provide its guarantee on the contract liability). This fact should be verified with appropriate legal or regulatory experts, as laws may vary by state and by type of insurance contract. Other restrictions may also exist, such as limitations on the amount of coverage provided by the guaranty fund for specific types of contracts.

See IG 5.6.3 and IG 5.6.4 for additional considerations around nonperformance risk.

5.7.3 Identification of risk margins for significant assumptions

ASC 820 requires that inputs to valuation techniques include the assumptions that market participants would use in pricing the asset and liability, including assumptions about risk. This includes the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. However, ASC 820 does not require that a separate risk margin be explicitly estimated for each input into a fair value estimate.

For fair value measurements that use a present value technique, ASC 820-10-55 provides guidance on how assumptions about risk can be factored into the present value calculation, describing three different methods that adjust the cash flows for risk. One method, the discount rate adjustment technique, uses a single set of cash flows (contractual, promised, or most likely) and a risk-adjusted

discount rate to capture all the risk and uncertainty of that single set of cash flows. However, this method assumes that the release of all risks is purely time based, which will not always be the case. The other two methods are variations of the expected cash flow technique. The first uses risk-adjusted expected cash flows discounted using a risk-free rate, so that the entire risk premium is captured in the cash flows. The second uses expected cash flows and a risk-adjusted discount rate (but different from the risk-adjusted rate used in the discount rate adjustment technique). This method thereby captures the risk and uncertainty through use of both expected cash flows and the discount rate. In addition, market participants might apply industry-based risk assumptions, such as risk-neutral or policyholder behavior assumptions with risk margins. If specific risk measurement methodologies are used for certain types of policies or contracts by market participants, they should be considered in the measurement of fair value under ASC 820.

5.8 Measurement – additional liability for insurance benefits

Many nontraditional contract features have market risk, and would most likely be classified as MRBs or embedded derivatives. However, there are certain features that lack market risk or otherwise fail the criteria for MRB and embedded derivative classification but provide additional benefit beyond the account balance or base insurance coverage. Contract features that do not meet the criteria of market risk benefits (MRBs) or embedded derivatives are required to be accounted for under the guidance relating to death or other insurance benefits or annuitization benefits (see IG 2.4.5.2). These include certain two-tiered annuities, no-lapse guarantees on universal life-type insurance contracts, and waiver of premium policies.

A two-tiered annuity has two crediting rates: one used to calculate the account balance available for surrender and the other, typically higher, used to calculate the balance available to the contract holders if they elect to annuitize. A "no-lapse guarantee" is a contract provision whereby the life insurance protection is kept in force, even when the account balance is not sufficient to pay the cost of insurance or other charges. A waiver of premium benefit provides that in the event of disability, a contract holder's premium (the cost of insurance or COI charge) will be waived but the policy will remain in force.

5.8.1 Additional liability for death or other insurance benefit

For contracts with death or other insurance benefits, ASC 944-40-25-27A requires that if amounts assessed against the contract holder each period for an insurance benefit feature are assessed in a manner that is expected to result in profits in earlier years and losses in later years from the insurance benefit function, an insurer is required to establish an additional liability. The liability represents the portion of assessments that compensates the insurer for benefits to be provided in future periods (commonly referred to as an "SOP 03-1 liability" or "SOP 03-1 reserve"). The test for profits followed by losses is required to be performed on a contract-by-contract basis, at contract inception, and is not revisited.

Although ASC 944-40-25-27A uses the words "profits in earlier years and losses in subsequent years" ("profits followed by losses"), we believe the requirement also applies to situations when the feature creates losses followed by losses (i.e., situations in which charges that are attributable to an insurance-benefit feature are less than the expected cost of the insurance benefit in all periods.) This is consistent with the concept inherent in ASC 944-40-30-20, that the insurance entity is required to establish a

liability if it provides an insurance benefit in future periods for which it charges amounts in such periods that are less than the expected value of the insurance benefits to be provided.

The profits followed by losses test should be applied separately to the base mortality or morbidity feature and, in addition, applied separately to each other mortality or morbidity feature. This applies when assessing products that have a base mortality feature (e.g., universal life insurance) but also have an additional insurance-benefit feature, such as a no-lapse guarantee or a long-term care benefit acceleration rider.

Question IG 5-30

What is meant by "amounts assessed against the contract holder for the insurance benefit feature" for purposes of the profits-followed-by-losses test in ASC 944-40-25-27A? That is, should such assessments be limited to those explicitly charged for the insurance benefit feature being tested, or, in certain instances, should fees from other contract elements be allocated as additional assessments supporting the insurance benefit feature?

PwC response

There is a rebuttable presumption that the explicit fee should be used for the profits followed by losses test. However, there may be circumstances in which the presumption may be overcome if evidence indicates that the substance of the agreement is not captured in the explicit terms of the contract. For example, in some universal life policies, the product's base mortality function is designed and priced on an integrated basis with the other functions. In other products, there may be no explicit fee; instead, the fee is implicit in the total contract charges. However, it is unlikely that the presumption can be rebutted when a contract has an explicit incremental assessment upon the election of a separate insurance benefit feature that is not payable if the election is not made.

Question IG 5-31

When determining whether "the amounts assessed against the contract holder each period for the insurance benefit feature are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function," what is meant by "expected?"

PwC response

A range of scenarios should be analyzed to determine whether there are any scenarios in which profits are expected in earlier years and losses are expected in later years from the insurance benefit function. A single best estimate, a mean, a median, or a specified percentile of the scenarios should not be used.

When an additional liability is required, the death or other insurance benefit liability should be recognized in accordance with ASC 944-40-30-20 through ASC 944-40-30-25.

ASC 944-40-30-20

The amount of the additional liability recognized under paragraph 944-40-25-27A shall be determined based on the ratio (benefit ratio) of the following:

- a. Numerator. The present value of total expected excess payments over the life of the contract, discounted at the contract rate.

- b. Denominator. The present value of total expected assessments over the life of the contract, discounted at the contract rate.

Total expected assessments are the aggregate of all charges, including those for administration, mortality, expense, and surrender, regardless of how characterized.

The contract rate used to compute present value shall be either the rate in effect at the inception of the book of contracts or the latest revised rate applied to the remaining benefit period. The approach selected to compute the present value of revised estimates shall be applied consistently in subsequent revisions to computations of the benefit ratio.

The benefit ratio determined in ASC 944-40-30-20 may exceed 100%, resulting in a liability that exceeds cumulative assessments. This is different from the accounting for traditional and limited-payment contracts. The additional liability would be a component of the universal life-type contract premium deficiency test, which is typically performed at a higher level, and could yield a premium deficiency loss at that higher grouping level (see IG 7.3.2 for a discussion of premium deficiency).

For contracts in which the assets are reported in the general account, investment margins (i.e., amounts expected to be earned from the investment of policyholder balances less amounts credited to policyholder balances) are included with any other assessments for purposes of calculating total assessments in the ratio. However, ASC 944-40-30-22 clarifies that “policyholder balances” refers to the accrued account balance described in ASC 944-40-25-14, which excludes the death or other insurance benefit liability itself.

Assessments for purposes of the ASC 944-40-30-20 benefit ratio denominator would also include the amount being amortized through income in each period relating to any unearned revenue liability (see IG 5.4.3 for a discussion of deferred revenue amortization) and exclude any fees deferred as an increase in the unearned revenue liability.

Question IG 5-32

What are considered to be the “excess payments” for a no-lapse guarantee contract feature?

PwC response

One interpretation is that the excess payments are the death benefit payments that are made, or are expected to be made, while the no-lapse-guarantee provision is activated (i.e., while the account balance is insufficient to pay the cost of the insurance).

In calculating the present value of expected excess payments and total assessments and investment margins, insurers should use a range of scenarios that consider the volatility inherent in the assumptions rather than a single set of best estimate assumptions. The number of scenarios should be sufficient such that increasing that number would yield a materially similar result. In addition, the scenarios should include the tails of the distribution rather than only reasonably possible and probable scenarios.

As required by ASC 944-40-35-9, these assumptions should be evaluated regularly and, if actual experience or other evidence suggests the need for revision, the liability should be adjusted on a retrospective catch up basis, with a related charge or credit to benefit expense. That is, the revised

estimate of the present value of total expected excess payments and the present value of total expected assessments and investment margins should be calculated as of the balance sheet date using historical experience from the issue date to the balance sheet date and estimated experience thereafter. The revised benefit ratio would be considered the “current benefit ratio” referenced in the guidance in ASC 944-40-35-10 to be used in calculating the additional liability.

ASC 944-40-35-10

The additional liability at the balance sheet date shall be equal to:

- a. The current benefit ratio multiplied by the cumulative assessments (cumulative assessments shall be calculated as actual cumulative assessments, including investment margins, if applicable, recognized from contract inception through the balance sheet date)
- b. Less the cumulative excess payments (including amounts reflected in claims payable liabilities)
- c. Plus accreted interest.

However, in no event shall the additional liability balance be less than zero.

Question IG 5-33

Is the additional liability calculated at an individual contract level, or at some higher group level?

PwC response

Although the accounting for a universal life-type contract is typically done on an individual contract basis, the calculations required by ASC 944-40-35-9 and ASC 944-40-35-10 for the additional insurance benefit liability require analysis of actual experience, implicitly requiring the grouping of a block of similar contracts.

5.8.2 Additional liability for annuitization benefits

Contracts with benefits payable only upon annuitization that do not fall within the scope of accounting as MRBs or derivatives require the recognition of an additional liability for the contract feature if the present value of the expected annuitization payments at the expected annuitization date exceeds the expected account balance at the expected annuitization date. The liability should be recognized in accordance with ASC 944-40-30-26 through ASC 944-40-30-29. ASC 944-40-25-26 notes that examples include certain annuity purchase mortality guarantees and two-tier annuities. The test to determine if an additional liability is required is performed on a contract-by-contract basis, at contract inception, and is not revisited.

ASC 944-40-30-26

The additional liability required under paragraph 944-40-25-27 shall be measured initially based on the benefit ratio determined by the following numerator and denominator:

- a. Numerator. The present value of expected annuitization payments to be made and related incremental claim adjustment expenses, discounted at an upper-medium grade (low-credit-risk) fixed-income instrument yield applicable to the payout phase of the contract, minus the expected

accrued account balance at the expected annuitization date (the excess payments). The excess of the present value payments to be made during the payout phase of the contract over the expected accrued account balance at the expected annuitization date shall be discounted at the contract rate.

- b. Denominator. The present value of total expected assessments during the accumulation phase of the contract, discounted at the contract rate.

Total expected assessments are the aggregate of all charges, including those for administration, mortality, expense, and surrender, regardless of how characterized.

Consistent with the guidance relating to the additional liability for death or other insurance benefits, in calculating the benefit ratio for contracts in which the assets are reported in the general account, investment margins (i.e., amounts expected to be earned from the investment of policyholder balances less amounts credited to policyholder balances) are included with any other assessments for purposes of calculating total assessments in the ratio. However, ASC 944-40-30-22 clarifies that policyholder balances refers to the accrued account balance described in ASC 944-40-25-14, which excludes the annuitization benefit liability itself.

Excess payments are calculated as the present value of the expected annuitization payments to be made and related incremental claim adjustment expenses, less the expected accrued account balance on the expected annuitization date. The calculation should be based on expected experience, over a range of scenarios that considers the volatility inherent in the assumptions rather than a single set of best estimate assumptions. When determining expected excess payments, the expected annuitization rate is one of the assumptions. This annuitization rate should be dynamic, taking into account company and industry experience, as applicable, as well as the value of the benefit.

The periodic future annuitization benefits expected to be paid during the annuitization phase are discounted back to the future expected annuitization date using the upper-medium grade (low credit risk) fixed-income instrument yield to determine the excess benefit upon annuitization. This amount is then discounted to the current period using the contract liability discount rate.

The discount rate is not locked in for expected annuitization benefits subject to ASC 944-40-30-26. The rate is required to be updated each period consistent with other components of the annuitization benefit cash flows. Changes in the discount rate applied to the future annuitization payments will be reflected in the benefit ratio and recognized over time as the benefit ratio is applied to total assessments.

As required by ASC 944-40-35-12 and ASC 944-40-35-13, these assumptions should be evaluated regularly and, if actual experience or other evidence suggests the need for revision, the liability should be adjusted on a retrospective catch up basis, with a related charge or credit to benefit expense. That is, the revised estimate of the present value of total expected excess payments and the present value of total expected assessments and investment margins should be calculated as of the balance sheet date using historical experience from the issue date to the balance sheet date and estimated experience thereafter. The revised benefit ratio would be considered the “current benefit ratio” referred to in the guidance in ASC 944-40-35-14 to be used in calculating the additional liability.

ASC 944-40-35-14

The additional liability at the balance sheet date shall be equal to the sum of the following:

- a. The current benefit ratio multiplied by the cumulative assessments
- b. Accreted interest (an addition)
- c. At time of annuitization, the cumulative excess payments determined at annuitization (a deduction).

However, in no event shall the additional liability balance be less than zero.

At the actual date of annuitization of an individual policyholder, cumulative excess payments for that policyholder are calculated using assumptions specific to that policyholder and are deducted from the additional liability. Any remaining additional liability relating to the policyholder, along with the account balance and any other derecognized liabilities related to the contract upon annuitization, is the “in substance” single premium used in establishing the liability for future policy benefits for the new payout annuity. The payout annuity is a new contract for accounting purposes, the liability for which is subject to limited payment accounting described in IG 5.3. To the extent that the “in substance” premium exceeds the liability for future policy benefits, a deferred profit liability is recognized at the inception of the payout annuity. If the “in substance” premium was less than the liability for future policy benefits, an immediate loss would be recognized through earnings. There is diversity in practice as to whether premium revenue and claims expense are separately recognized in the statement of operations in the period of annuitization or, since the transaction is not a new sale, the amounts are netted.

See Example IG 5-7 for similar journal entries.

5.9 Policyholder dividends

Both long-duration life insurance contracts and short-duration property and casualty insurance contracts may include provisions for policyholder dividends. Policies with dividend features may be sold by both mutual and stock life insurance entities.

5.9.1 Dividend features based on the contribution principle

Policyholder dividend features in certain long-duration participating contracts that meet the definition outlined in ASC 944-20-15-3 (referred to as the contribution principle) are recognized over the life of the contracts.

ASC 944-20-15-3

Consistent guidance in the Long-Duration Subsections in this Subtopic (and other Subtopics within the Financial Services—Insurance Topic) applies only to certain long-duration participating life insurance contracts of mutual life insurance entities and certain stock life insurance entities. For purposes of that guidance:

- a) Mutual life insurance entities include assessment entities, fraternal benefit societies, and stock life insurance subsidiaries of mutual life insurance entities.
- b) Participating life insurance contracts denote those that have both of the following characteristics:
 - 1) They are long-duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurance entity.
 - 2) Annual policyholder dividends are paid in a manner that both:
 - a) Identifies divisible surplus
 - b) Distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the contribution principle).

Annual policyholder dividends on participating contracts are based on actual performance of the insurance enterprise, and the guidance requires that such dividends be reported separately as an expense in the statement of earnings and be based on estimates of amounts incurred for the policies in effect during the period.

ASC 944-40-25-30 and ASC 944-40-35-22 also require that a liability for terminal dividends be accrued in the liability for future policy benefits if payment of the dividend is probable and the amount can be reasonably estimated, which would ordinarily be the case. Because the rights to terminal dividends accumulate to policyholders over a policy's life, the terminal dividends should be recognized as an expense over the life of a book of participating life insurance contracts at a constant rate based on the present value of the base used for the amortization of DAC.

Many mutual entities set up special structures for the dividend participating contracts called “closed blocks” when they demutualize. Guidance on accounting by insurance enterprises for demutualizations and the formation of mutual insurance holding entities and for certain long-duration participating contracts can be found in the demutualizations subsection of ASC 944-805, *Insurance - Business Combinations*.

5.9.2 Dividend features not using the contribution principle

For those participating contracts not using the contribution principle identified in ASC 944-20-15-3, the determination of the amount of the dividend is based upon the policy provision, applicable law, company policy, and the actions of the board of directors in accordance with guidance in ASC 944-50-30-1 through ASC 944-50-30-3.

Participating Contracts

ASC 944-50-30-1

Policyholder dividends accrued under paragraph 944-50-25-1 shall be measured using an estimate of the amount to be paid

Participating Contracts with Income-Based Dividend Limitations

ASC 944-50-30-2

Income-based dividend provisions for participating contracts other than those long-duration participating life insurance contracts that meet the criteria in paragraph 944-20-15-3, shall be based on net income that includes adjustments between general-purpose and statutory financial statements that will reverse and enter into future calculations of the dividend provision.

Participating Contracts Without Income-Based Dividend Limitations**ASC 944-50-30-3**

Policyholder dividends shall be recognized over the premium-paying periods under paragraph 944-50-25-3 based on dividends anticipated or intended in determining gross premiums or as shown in published dividend illustrations at the date insurance contracts are made.

Group contracts may also have dividend provisions based upon the experience of the group or upon the level of investment return that the group's funds have generated. Such payments are not generally considered dividends as that term is defined in ASC 944-50-30-1 through ASC 944-50-30-3, as they are determined on an individual contract basis rather than on a class of contract basis.

Most insurance entities do not pay policyholder dividends. For those entities still paying a dividend, the undeclared dividends should be accrued at the balance sheet date using the best available estimate of the amount of dividends to be paid, as described in ASC 944-50-30-1 through ASC 944-50-30-3.

Policyholder dividends are charged against income. "Dividends" related to the experience of a group contract generally reduce premium income or are recognized as credits to contract holder funds.

5.10 “Shadow” accounting

Most insurance entities classify many of their debt security investments as available for sale (AFS). AFS investment accounting recognizes unrealized gains and losses relating to the securities' remeasurement each period to fair value in OCI. ASC 320-10-S99-2 requires that the carrying amount of certain assets and liabilities be adjusted to the amount that would have been reported if the unrealized holding gains and losses from AFS securities had been realized (often referred to as a “shadow” OCI adjustment). Accounts that could require a shadow adjustment include noncontrolling interests, certain policyholder liabilities, and intangible assets arising from insurance contracts acquired in business combinations that are amortized using the gross-profits method. Shadow adjustments are recognized with a corresponding credit or charge reported directly to other comprehensive income. The accounting prescribed should not affect reported net income.

ASU 2018-12 de-linked invested assets from the valuation of traditional insurance and limited payment contract liabilities and divorced the amortization of certain assets and liabilities from the expected profit emergence pattern. The FASB and SEC have not updated the guidance in ASC 320-10-S99-2 for the provisions of ASU 2018-12. ASC 320-10-S99-2 still cites potential shadow adjustments for deferred acquisition costs and premium deficiency for traditional and limited-payment contracts to the extent that a premium deficiency would have resulted had unrealized holding gains and losses on assets supporting the liabilities been realized. Upon the adoption of ASU 2018-12, these are not instances that would generate a shadow adjustment.

In situations when the contractual liability or asset has already been adjusted through income for the fair value of the related asset (e.g., due to the requirements of derivative accounting or accounting for long-duration contracts), shadow adjustments are not appropriate. While only required for registrants, most insurers follow ASC 320-10-S99-2 in practice.

Figure IG 5-5 summarizes the insurance balances that may require shadow adjustments.

Figure IG 5-5

Insurance balances that may require shadow adjustments

Balance	Contracts impacted	Shadow adjustment required	Explanation
Premium deficiency loss recognition testing	All contracts other than nonparticipating traditional and limited-payment contracts	Depends	A premium deficiency test is required for contracts other than nonparticipating traditional and limited-payment contracts, as described in IG 7.3. To determine if a premium deficiency exists, the expected cash outflows and expected cash inflows relating to the contract should be considered. The significant assumptions outlined in ASC 944-60-25-7 include investment yields. If entities use their updated “book” investment yields to determine any income statement premium deficiency charge, an additional shadow calculation is then performed using current market yields. The impact on the liability of using current market rates rather than updated book investment yields to discount the cash flows in performing the premium deficiency test will result in a corresponding shadow adjustment in OCI.
Recoverability test of PVFP	Nonparticipating traditional and limited-payment contracts	Depends	The net premium ratio used to calculate the liability for future policy benefits for traditional and limited-payment contracts is required to be updated at least annually and is capped at 100%, which represents the premium deficiency test on the liability. However, as noted in IG 7.3, ASC 944-60-25-7 also requires a separate recoverability test of the unamortized PVFP balance and identifies “investment yields” as one of the assumptions that may be used in assessing the recoverability of PVFP. If book investment yields relating to AFS securities are used in performing the PVFP recoverability test for traditional and limited payment contracts, a shadow PVFP recoverability test would also need to be performed using current market yields in place of the book yields.

Balance	Contracts impacted	Shadow adjustment required	Explanation
Additional liability for annuitization, death or other insurance benefits	Universal life-type contracts	Generally yes	<p>ASC 944-40-30-26 and ASC 944-40-30-20 require the additional liability for annuitization, death, or other insurance benefits to be calculated based on a benefit ratio that is calculated as the present value of total expected excess payments divided by the present value of total expected assessments over the life of the contract (as noted in IG 5.8). Total assessments in the benefit ratio include the explicit fees charged to the policyholder for the feature as well as other administrative charges. In addition, for contracts in which the assets are reported in the general account, investment margins are included as part of total expected assessments in accordance with ASC 944-40-30-22. For general account contracts that include investment margins relating to AFS securities as part of total assessments, the hypothetical realization of any unrealized gains and losses on these investments would be included in the shadow assessments calculation for the liability, with a corresponding shadow adjustment in OCI.</p>
Amortization of PVFP	Long-duration insurance contracts	Depends	<p>ASC 944-805 requires any insurance or reinsurance contract intangible asset (or additional liability) to be amortized “on a basis consistent with the related insurance or reinsurance liability,” but does not prescribe specific methods.</p> <p>In some cases, an insurer may choose to amortize PVFP based on profit emergence, and that profit emergence may include consideration of book investment yields on AFS securities. Entities that amortize based on estimated gross profits or other methods that incorporate book investment yields on AFS securities would need to record shadow adjustments in OCI using current market yields in place of the book yields.</p> <p>Other insurers might analogize the balances to DAC as fixed intangible assets or liabilities to be amortized. In these instances, the PVFP is amortized on a straight-line basis consistent with the related DAC amortization method and there would be no shadow PVFP amortization.</p>

Balance	Contracts impacted	Shadow adjustment required	Explanation
Amortization of cost of reinsurance	Long-duration insurance contracts	Depends	<p>ASC 944-605-35-14 requires that the cost of reinsurance be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long duration) or over the contract period of the reinsurance (if the reinsurance contract is short duration). However, ASC 944 is silent as to the pattern of amortization. In some cases, an insurer may choose to amortize the cost of reinsurance based on profit emergence, and that profit emergence may include consideration of book investment yields on AFS securities. Entities that amortize based on estimated gross profits or other methods that incorporate book investment yields on AFS securities would need to record shadow adjustments in OCI using current market yields in place of the book yields.</p> <p>Other insurers might analogize the balances to DAC as fixed intangible assets or liabilities to be amortized. In these instances, the cost of reinsurance would be amortized on a straight-line basis consistent with the related DAC amortization method and there would be no shadow cost of reinsurance amortization.</p>
Policy dividend obligation (PDO)	Closed block participating contracts	Yes	<p>Mutual life insurance entities can convert to stock life insurance entities through a process of demutualization. Upon demutualization, there are assets that are designated to the closed block to preserve reasonable policyholder dividend expectations. These assets cannot subsequently benefit the shareholders of the life insurance entity. The demutualization alone does not constitute an accounting event that would change the historical carrying value of the assets and liabilities attributed in the closed block. However, at the date of demutualization, the assets contributed to the closed block are based upon what is determined to be sufficient expected future earnings to cover the liabilities and policyholder dividend expectations of the closed block (glide path). To the extent that subsequent earnings of the closed block income exceed the glide path, a policyholder dividend obligation is established, as those earnings are not income of the stock life insurance entity but instead are owed to the closed block policyholders. To the extent those excess earnings are due to unrealized</p>

Balance	Contracts impacted	Shadow adjustment required	Explanation
			gains and losses on AFS securities, a corresponding shadow adjustment should be recognized to OCI.

***Chapter 6:
Mortgage insurance, financial
guarantee insurance, and
guaranty funds –updated May
2022***

6.1 *Mortgage insurance*

Mortgage guaranty insurance protects a lender against loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor.

ASC 944 applies to mortgage insurance entities, however, the Subtopics on premium revenue (ASC 944-605-15-2), claim cost recognition (ASC 944-40-15-2), and acquisition costs (ASC 944-30-15-2) do not apply. Regardless, as there is no explicit guidance, mortgage insurers have generally applied the principles in ASC 944 by analogy in recording premium revenue, claim costs, and deferring acquisition costs, and consider ASC 450 in recording claim costs.

6.1.1 *Mortgage insurance premium revenue recognition*

Premiums on mortgage insurance policies are either due upfront, monthly, or annually. The mortgage insurer typically does not have the option to cancel or non-renew the policy unless the insured has violated the terms of the policy, such as non-payment of premium. The policy may also be cancelled or non-renewed if the mortgage is modified. In this respect, mortgage guaranty insurance is similar to a long-duration insurance contract, in that it is not subject to unilateral changes in its provisions and requires performance of various functions and services (including insurance protection) for an extended period of time.

There is no authoritative revenue recognition guidance for mortgage insurers. However, in practice, premiums due on a monthly basis are generally recognized as coverage is provided. For premiums due annually, the premium is typically recognized on a monthly, straight-line basis. Premiums written on a single premium basis are recognized as risk expires, which is typically deemed to be the anticipated claim payment pattern. The anticipated claim payment pattern is developed through historical industry experience; however, recent experience may require adjustments to historical loss trend data.

As part of the claims process, a mortgage insurer may rescind a policy if, for example, there has been a violation of the policy term. If a mortgage insurer rescinds a policy, it may be required to return all of the previously collected premium. Mortgage insurers consider future rescissions in their reserving process, and as such, must accrue a liability for premium that may need to be returned.

6.1.2 *Mortgage insurance deferred acquisition costs*

There is no authoritative guidance for DAC for mortgage insurers. As a result, mortgage insurers analogize to ASC 944 for the definition of what costs are deferrable. For subsequent measurement one acceptable accounting policy that many mortgage insurers adopt is to amortize DAC in proportion to the estimated gross profits expected to be realized over the estimated life of the policies. Under this approach, estimates are updated when necessary to reflect actual experience and changes to assumptions. Typical key assumptions for mortgage insurers include persistency and loss development.

6.1.3 *Mortgage insurance claim liabilities*

Claim liabilities for mortgage insurers are accounted for under ASC 450-20, *Contingencies -- Loss Contingencies*, and ASC 944-40, *Financial Services -- Insurance -- Claim Costs and Liabilities*. While ASC 944-40-15-2 explicitly excludes mortgage insurers from its scope, mortgage insurers use the underlying principles in ASC 944-40, which are consistent with those in ASC 450-20, to establish

claim liabilities. In mortgage insurance, the obligating event is considered to be the mortgage loan default, as defined in the contract. As a result, claim liabilities are established when mortgage insurers receive a notice of default on insured mortgage loans. Mortgage insurers also establish claim liabilities for estimated losses incurred on notices of default not yet reported to the mortgage insurers (i.e., IBNR). While mortgage insurers utilize IBNR, consistent with ASC 450-20, they do not establish liabilities for future claims on insured loans which are not in default at the reporting date.

Real estate classified as held for sale that was acquired in settling mortgage guaranty and title insurance claims should be subsequently measured in accordance with ASC 360-10-35. Subsequent reductions in the reported amount of real estate acquired in settling claims should be recognized as an adjustment to claim costs incurred.

6.1.4 *Mortgage insurance premium deficiency testing*

Mortgage insurers are required to perform a premium deficiency assessment, as noted in ASC 944-10-15-2. Guidance on premium deficiency is found in ASC 944-60-25-1 through ASC 944-60-25-09 and ASC 944-60-35-1 through ASC 944-60-35-6. While mortgage insurers are explicitly exempt from the ASC 944 guidance relating to premium and claims recognition, the recognition of a premium deficiency is required. Although recognizing a premium deficiency for mortgage insurers accelerates the recognition of losses compared to the loss recognition model based on an event of default, it is not dissimilar to recognizing losses through premium deficiencies on other insurance contracts, both long and short duration, or the result of other GAAP impairment models.

To the extent that a mortgage insurer records a premium deficiency, the premium deficiency cannot be reduced in subsequent periods by profits expected from contracts that are written after the original premium deficiency was recognized. The premium deficiency represents an additional liability for the contracts existing at the time of the premium deficiency. Any new premium deficiencies established would in effect create another premium deficiency "layer" that would also be separately analyzed in subsequent periods.

6.2 *Financial guarantee insurance*

Financial guarantee contracts provide protection to a guaranteed party against events of default. Financial guarantee contracts are often written by mono-line financial guarantee insurers in the form of insurance contracts, or they may be written by other types of financial institutions in other forms (e.g., in the form of an ISDA, or International Swap Dealers Association, contract). The scope of the detailed guidance in ASC 944 for financial guarantee contracts is quite restrictive. The scope is limited to financial guarantee insurance contracts written by financial guarantee insurance enterprises (such as guarantees on municipal bonds and asset-backed securities) and is not applicable to non-insurers (such as banks and other financial institutions) who may write similar contracts. It also does not apply to other insurance contracts written by insurance enterprises that are economically similar to financial guarantee insurance contracts in that they provide protection to the insured in the event of the default of a debtor of the insured (e.g., mortgage guaranty insurance and credit insurance on trade receivables).

No matter what its form, a financial guarantee contract should be evaluated to determine if it meets the definition of a derivative under ASC 815 and, if so, if it qualifies for the financial guarantee scope exception under derivative accounting (ASC 815-10-15-58). Financial guarantee contracts are not subject to the derivative guidance if they provide for payments to be made only to reimburse the

guaranteed party for a loss incurred because the debtor fails to pay when payment is due, which is considered analogous to an identifiable insurable event, and if all the other criteria in ASC 815-10-15-58 are met. In contrast, financial guarantee contracts are subject to ASC 815, *Derivatives and Hedging*, if they provide for payments to be made in response to changes in an underlying (for example, a decrease in a specified debtor's creditworthiness) or if they fail any of the other ASC 815-10-15-58 criteria.

To qualify for the ASC 815-10-15-58 scope exception, the contract must meet all of the following requirements:

- The instrument subject to the guarantee must be a non-derivative contract
- The event triggering a payment under the contract must be failure to pay when payment is due, either (a) at pre-specified payment dates (i.e., failure to pay principal and/or interest in accordance with the terms of the instrument) or (b) at accelerated payment dates as a result of the occurrence of an event of default (as defined in the financial obligation covered by the guarantee contract) or notice of acceleration being made to the debtor by the creditor
- The amount paid can be no more than the amount past due, and must be past any contractual extensions or grace periods
- As a precondition for payment, the contract must specify that:
 - the guaranteed party maintain direct legal ownership of the financial asset at inception and throughout the life of the contract, or
 - the guaranteed party maintain a back-to-back arrangement with a third party that has direct legal ownership of the financial asset at inception and throughout the life of the contract.
- The guarantor must receive either:
 - the rights to any payments subsequently advanced to the guaranteed party, or
 - the delivery of the defaulted receivable upon the event of default.

The guaranteed party must relinquish to the guarantor its rights to receive payment from the debtor in order to receive payment from the guarantor. Bankruptcy alone is insufficient to meet the scope exception, and other events of default that do not result in a failure to pay when due are not valid triggering events. Certain invalid events of default common to ISDA contracts include:

- **Obligation Acceleration:** One or more obligations (not necessarily the referenced asset) is accelerated as a result of an event of default other than failure to pay
- **Obligation Default:** An event of default, as specified in the note agreement, other than failure to pay when payment due (e.g., debt covenants, such as failure to maintain certain ratios or cash balances) on any obligation, not just the referenced asset
- **Repudiation / Moratorium:** An entity or government authority disaffirms, disclaims, repudiates or rejects validity of one or more obligations, and not necessarily the referenced asset

- Restructuring: Restructuring of one or more obligations, not necessarily resulting in a failure to pay
- Bankruptcy (unless accompanied by a failure to pay)

Because the default provisions typically do not result in a failure to pay, these default events do not meet the requirements of ASC 815-10-15-58.

6.2.1 *Financial guarantee premiums receivable and unearned premium liability*

A liability for unearned premium revenue is recognized at the inception of a contract. If the entire contractual premium is received at inception (i.e., an "upfront" contract), the initial unearned premium revenue liability is measured as the amount received.

For contracts where premium payments are received over the period of the contract (i.e., an "installment" contract), a receivable for future premiums is established at inception, and the initial unearned premium revenue liability is measured as the amount of the premium receivable. The premium receivable is determined as the present value of contractual premiums due or, if certain criteria are met, as the present value of premiums expected to be collected. Under either method, the discount rate should reflect the risk-free rate at the inception of the contract.

The discount on the premium receivable is accreted through earnings over the contractual period or the expected period that the insured obligation will be outstanding. The unearned revenue liability is not accreted with interest because, unlike the premium receivable, it is not a financial instrument. The liability is instead a stand-ready obligation of the insurer which is measured at the consideration received at inception of the contract. ASC 944 does not prescribe where the accretion of the premium receivable should be recorded in earnings. Accretion may be classified as part of premium revenue, investment income, or a separate line item in the income statement, with disclosure of the company's accounting policy.

In certain instances, the expected period of risk may be less than the contractual risk period due to expected prepayments of the insured obligation. This may occur when insured obligations are contractually prepayable, as is often the case with structured securities including securitizations relating to securitized mortgage loans. An expected contract period may be used to determine the initial receivable and unearned premium revenue liability only if a homogeneous pool of assets underlying the insured financial obligation is contractually prepayable. In that circumstance, prepayment assumptions may be used to determine an expected contract period if prepayments are probable and their timing and amount can be reasonably estimated. Companies should develop and maintain sufficient documentation to support the assertions that an insured obligation has a homogenous pool of underlying assets that are contractually prepayable, and that expected prepayments are probable and their timing and amount are reasonably estimable. The use of prepayment assumptions to determine an expected contract period is an accounting policy decision that must be elected for similar types of contracts. It is not available as a contract-by-contract election.

Use of an expected contractual period is not appropriate for individual callable insured financial obligations because an underlying pool of homogenous assets does not exist. Therefore, incorporating expectations of a future "refunding" of a traditional municipal bond to replace it with a new financial obligation, which is often done to obtain a lower interest rate, is not permitted.

When premiums are received in installments and the period outstanding is estimated based on expected prepayments, the premium receivable asset and unearned premium revenue liability are adjusted when prepayment assumptions change. The premium receivable asset is recalculated based on current prepayment assumptions and the current risk-free rate, and an adjustment is made for the difference between this revised balance and the balance based on original assumptions. An equal adjustment is made to the unearned premium revenue liability, resulting in no effect on earnings at the time of the adjustment. The revised unearned premium revenue liability is recognized in earnings using a newly computed constant rate. ASC 944-310-55-1 provides an example of a change in prepayment assumption.

When premiums are received in installments and contractual, rather than expected, obligation payments are used to measure the unearned premium liability, the premium receivable asset and unearned premium revenue liability are adjusted to reflect any expected reduction in premium receivable because of early principal payments as they occur. The premium receivable asset is recalculated based on remaining contractual principal and the current risk-free rate, and an adjustment is made for the difference between this revised balance and the balance based on original contract terms. An equal adjustment is made to the unearned premium revenue liability, resulting in no effect on earnings at the time of the adjustment.

This guidance applies to early principal payments of insured obligations relating to contracts with installment premium payments, and it equates the adjustment to the unearned premium revenue liability with the adjustment made to the premium receivable asset. ASC 944 does not provide specific guidance on how early principal payments of insured obligations relating to contracts with single premiums paid at inception (and, therefore, no premium receivable asset) should affect the unearned premium revenue liability and related premium revenue recognition. We believe that premium revenue should be recognized in proportion to the amount of insurance protection provided, and insurance protection provided is assumed to be a function of the insured principal amount outstanding. Therefore, if the principal amount outstanding has decreased, an acceptable approach would be to record a credit to earnings for the difference between the existing unearned premium revenue liability and the amount of unearned premium revenue liability that would have existed had the early principal payment been known at inception of the contract (i.e., a retrospective cumulative catch-up type of adjustment). This adjustment to the unearned premium revenue liability would be reflected in premium revenue.

Premiums receivable should be adjusted for uncollectible premiums with a corresponding adjustment to earnings. Uncollectible premiums must also be considered in the recognition and measurement of the claim liability. The guidance assumes that the contract cannot be cancelled because of non-payment of premium. Therefore, adjustment for uncollectible premiums represents a current-period bad debt expense that should not be offset by an adjustment to the unearned premium revenue liability. The unearned premium revenue liability represents the insurer's stand-ready obligation to perform under the contract. As this obligation is not reduced by non-payment of premium, no adjustment should be made to the unearned premium revenue liability. However, in certain limited situations, the contract may provide for a reduction in the claim payment amount to the extent of any uncollectible premium, which would be netted in the claim liability.

6.2.2 *Financial guarantee premium revenue recognition*

Premium revenue is recognized over the period of the contract in proportion to the amount of insurance protection provided, which is assumed to be a function of the insured principal amount outstanding. As premium revenue is recognized, the unearned premium revenue liability is reduced.

This approach results in a revenue recognition pattern that reflects the reduction in insurance protection being provided both (1) as the insured principal balance is repaid and (2) due to the passage of time.

Applying this principle results in the recognition of a portion of the overall contractual premium as revenue each period at a constant rate. The rate is based on the relationship between the insured principal amount outstanding in that reporting period and the sum of each of the insured principal amounts outstanding for all periods. Mechanically, this is accomplished by multiplying the insured principal amount outstanding for that reporting period by the ratio of (a) the total present value of the premium due or expected to be collected over the period of the contract to (b) the sum of all insured principal amounts outstanding during each reporting period over the period of the contract. Example IG 6-1 provides an illustration.

EXAMPLE IG 6-1

Premium recognition for financial guarantee insurance

Insurance Company issues a \$10 million bond with the following terms:

- a 10-year term
- no principal payments until maturity
- a single upfront premium of \$500,000

How should Insurance Company recognize and measure the premium revenue in each period?

Analysis

Insurance Company should recognize \$50,000 of premium revenue each year.

If Insurance Company uses an "expected contract period" for recognizing and measuring premiums receivable and the unearned premium revenue liability, rather than the actual contractual period, the constant rate is based on, and premium revenue is recognized over, the expected contract period. If prepayment assumptions change, the constant rate should be recalculated based on the new prepayment assumptions (and the current risk-free rate) and applied to the principal amounts outstanding for the remaining expected period of the contract.

When the financial obligation being insured has a single principal payment at maturity and no contractual interest payments (such as a zero-coupon bond), the insurance protection (and the principal amount outstanding for each period) is based on the accreted principal amount outstanding.

Therefore, in each year, \$50,000 of premium revenue would be recorded, calculated as \$10 million outstanding in each period \times \$500,000 premium/\$100 million (\$10 million/year for 10 years).

6.2.3 Financial guarantee refundings

In some instances, the issuer of the guaranteed obligation may retire the obligation before its maturity and replace it with a new financial obligation (often referred to as "refunding"). This often occurs, for example, when interest rates decrease and the issuer decides to refinance the debt at a lower interest

rate. If the financial guarantee contract has been extinguished (there are no future obligations from the original contract such as to cover a refinancing term), the insurer would immediately recognize any non-refundable unearned premium associated with the contract as premium revenue, and any unamortized acquisition costs as an expense. If the insurer insures the new obligation, an unearned premium revenue liability on the new financial obligation is recognized at an amount commensurate with the premium that would be charged to insure a similar financial obligation in a separate, standalone transaction. If this premium differs from the premium actually charged, the difference should be recognized currently in earnings.

6.2.4 *Financial guarantee claim liabilities*

The insurer is required to recognize a claim liability on a financial guarantee insurance contract when the insurer expects, based on the present value of expected net cash outflows to be paid under the insurance contract, that a claim loss will exceed unearned premium revenue for that contract. The analysis is done on a contract-by-contract basis each period. A claim liability must be recorded prior to an event of default (the insured event) to the extent that expected losses exceed the unearned premium liability (the stand ready obligation). An important distinction between financial guarantee contracts and property and casualty contracts is that the claim liability for a financial guarantee contract is not an entity's best estimate based on an incurred claim; instead, it is a probability weighted expected value liability which reflects the likelihood of all possible outcomes.

The amount to be recorded as the claim liability is the excess of the present value of expected net cash outflows over the remaining unearned premium revenue liability. These two components (the claim liability and the remaining unearned premium revenue liability) together represent the insurer's total obligation under the financial guarantee contract. The unearned premium revenue liability should continue to be amortized to premium revenue in periods after a claim liability is recognized. The claim liability is adjusted in subsequent periods for any additional changes in estimated net cash outflows, changes in the risk-free interest rate, accretion of interest on the claim liability balance, and adjustment resulting from the reduction in the unearned premium revenue liability caused by its amortization.

The "net cash outflows" to be used in determining whether an additional claim liability is required represent potential payments from the insurer to the holder of the insured financial obligation, net of potential recoveries, and excluding reinsurance. "Expected net cash outflows" represent the probability-weighted cash flows that reflect the likelihood of all possible outcomes (as compared to a "best estimate" approach, which represents the single most likely outcome). These cash flows must be discounted using a risk free rate. In subsequent periods, the rate used to discount cash flows relating to the claim liability should be updated to reflect changes in the risk-free rate. Expected net cash outflows should also be revised for changes in estimates of the likelihood of a default and the related amounts of net cash outflows. Once established, the claim liability should not be reduced below zero.

ASC 944 does not specify the number of possible outcomes (scenarios) that should be included in expected net cash outflows. The range of possible outcomes should consider remote outcomes in addition to outcomes that are probable and reasonably possible. Judgment is required in determining both the probability and number of scenarios, and will likely vary depending on the nature of the insured obligation.

6.2.5 Representation and warranty recoveries or “putbacks”

A financial guarantee insurer may insure selected tranches of collateralized securities. If a loan is placed in the trust, and subsequently is determined not to have met the underwriting standards contractually agreed to by the lender through representations and warranties provided at the inception of the securitization, the lender is typically required to make the structure whole, either through a cash payment, or by replacing the loan. This process is known as "putting back" the loan to the lender (putbacks) or representation and warranty recoveries. ASC 944-40-30-32 defines expected net cash outflows as "cash outflows, net of potential recoveries, expected to be paid to the holder of the insured financial obligation, excluding reinsurance." As such, representation and warranty recoveries would be considered potential recoveries under the contract.

If a financial guarantee insurer determines that it has a contractual right to collect representation and warranty recoveries, it should include these potential recoveries within its expected net cash outflows measured on a consistent basis (i.e., probability weighted). The measurement is often based on an evaluation of the financial guarantee insurer's specific loan portfolio, credit worthiness of its counterparties, transactions occurring in the marketplace, and status of any related litigation.

6.2.6 Bond buybacks

A financial guarantee insurer may purchase debt securities that they have previously guaranteed. These transactions are often referred to as bond buybacks. There are two alternative accounting treatments for bond buybacks used by financial guarantee insurers in practice, both of which we believe are acceptable. In the first alternative, the insurance policy is considered to be extinguished. Proponents of this view believe that the bond purchase is seen as effectively extinguishing the written guarantee, given that the financial guarantee insurer has no ultimate liability to any external party. Proponents of this view also believe that this best represents the economic substance of the transaction. In the second alternative, the guarantee is not considered to be extinguished. Proponents of this view believe that this best reflects the legal form of the transaction. The financial guarantee insurer's policy is not written to itself; rather, it was written at the time the insured bonds were issued to a trustee as beneficiary for all security holders and is contractually embedded within the terms of the debt security indenture.

6.3 Guaranty fund and other assessments

States establish guaranty funds to protect policyholders in the event insurance entities becomes insolvent or default on other insurance obligations. Insurers that sell insurance in a given state are assessed amounts to pay into the guaranty funds to provide for payment of claims owed by insolvent insurance entities in that state. The amount of the assessment required of an insurance company is based on a percentage of the net amount of insurance sold within a particular state, such as premium volume for certain covered lines of business. Insurance entities are also subject to other types of administrative assessments not associated with guaranty funds.

6.3.1 Accounting for guaranty funds and other assessments

ASC 405-30, *Insurance-related assessments*, applies to insurance companies subject to guaranty fund and other insurance-related assessments that are directly or indirectly related to underwriting activities, including non-insurance entities that self-insure. It does not apply to assumed

reinsurance transactions (including involuntary pools that are covered under ASC 944), income or premium taxes.

Under ASC 405-30-25-1, insurance-related assessment liabilities should be recognized when all of the following criteria are met:

- An assessment has been imposed or information available indicates an assessment will be imposed.
- The event obligating the insurance entity to pay has occurred on or before the date of the financial statements.
- The amount of the assessment can be reasonably estimated.

ASC 405-30-05-3 through ASC 405-30-05-6 categorize guaranty fund and other assessments into several main categories requiring different accounting models and ASC 405-30-25-6 discusses the recognition criteria. Figure IG 6-1 outlines the guaranty fund and other assessment categories and accounting models.

Figure IG 6-1

Guaranty fund and other assessment categories and accounting models

Method	Description	Recognition criteria
Retrospective - premium-based assessments	Guaranty funds covering benefit payments of insolvent life, annuity, and health insurance companies typically assess companies based on premiums written or received in one or more years prior to the year of insolvency.	A reporting entity that has the ability to reasonably estimate the assessment should recognize a liability for the entire amount of future assessments when a formal determination of insolvency is rendered. The formal declaration of insolvency from the domiciled state of the insolvent insurer may take several years. If there is evidence that the formal determination of insolvency is inevitable (e.g., communication by government official), we believe an insurance company might conclude that the assessment is probable, and could therefore be accrued prior to the formal declaration of insolvency.
Prospective premium-based assessments	Guaranty funds covering claims of insolvent property and casualty insurance companies typically assess based on premiums written in one or more years after the insolvency.	The obligating event is typically the writing of, or becoming obligated to write, the premiums on which the expected future assessments will be based. The assessments should be accrued as the premiums are written or

Method	Description	Recognition criteria
		<p>obligated to be written in the future.</p> <p>However, in states in which, through law or regulatory practice, a reporting entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is the formal determination of insolvency or similar event. In these situations, the insurance entity should accrue the liability consistent with retrospective premium-based assessments.</p>
<p>Prefunded premium-based assessments</p>	<p>Guaranty funds covering claims of insolvent property and casualty insurance companies are typically imposed prior to any particular insolvency, based on current written premiums.</p> <p>States that use this type of assessment intend to prefund the costs of future insolvencies.</p>	<p>An insurance company that has the ability to reasonably estimate the assessment should recognize a liability as the premiums are written.</p>
<p>Administrative-type assessments</p>	<p>These comprise assessments, which are typically a flat amount per entity, to fund operations of the guaranty association, regardless of the existence of an insolvency.</p>	<p>Generally, expensed in the period assessed.</p>
<p>Other insurance-related assessments</p>	<p>These assessments may fund operating expenses of state insurance regulatory bodies, such as the state insurance department or workers' compensation board, or to fund second-injury funds. Other assessments may be premium based (typically current year or preceding year assessment) or loss based (based on incurred or paid losses).</p>	<p>If the other assessment is premium based, it should be accounted for the same as prefunded premium-based assessments.</p> <p>If the other assessment is loss based, an insurance company that has the ability to reasonably estimate the assessment should recognize a liability as the related loss is incurred.</p>

6.3.2 *Estimating the guaranty fund and other assessments liability*

Insurance entities should have a reasonable, systematic methodology for estimating the assessment liability. An entity does not need to be able to compute the exact amounts of the assessment or be formally notified of such assessments by a guaranty fund to reasonably estimate the liability.

To determine the amounts and timing of the assessments, entities may make assumptions about future events, such as when the fund will incur costs and pay claims. The liability should be recorded based on the best estimate within the range. When no amount appears to be a better estimate, the liability should be recorded based on the minimum amount within the range. As a result of the uncertainties surrounding insurance-related assessments, the range of liability may have to be re-evaluated on a regular basis.

An assessment liability should be recorded for each state in which an insurer has a significant exposure. Insurers may use publicly available information to make estimates of future assessments taking into consideration the lines of business written by state, the maximum assessment for each year by state, and the permissibility of premium tax offsets. Under ASC 405-30-25-8 and ASC 405-30-30-11, when it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset should be recognized in an amount that is determined based on current laws and projections of future premium collections or policy surcharges from in-force policies. Premium tax offsets are reductions in premium taxes that are levied on an insurance company by the state. Therefore, a property/casualty insurer writing short-duration contracts may need to accrue for a guaranty fund assessment, but not be able to record all or a portion of the premium tax offset until a future year when it becomes realizable. This could occur, for example, when the assessment is either retrospective or prospective and the premium tax offset allowed is calculated based on business that will be written in the future. This is illustrated in ASC 405-30-55, Example 1.

Per ASC 405-30-25-11, policy surcharges required as a pass-through to the state or other regulatory bodies should be accounted for such that amounts collected or receivable are not recorded as revenues, and amounts due or paid are not expensed (i.e., similar to accounting for sales tax). In all instances, the asset recorded for premium tax offsets and policy surcharges would be subject to a valuation allowance (as described in ASC 405-30-35-1).

ASC 405-30 does not provide any guidance on how the expense should be classified, but ASC 405-30-15-2 states that the scope of the guidance includes only those assessments that are directly or indirectly related to underwriting activities.

6.3.3 *Discounting the guaranty fund and other assessments liability*

Under ASC 405-30-30-9, insurance entities are allowed, but not required, to discount the guaranty fund and other assessment liability when the amount and timing of the cash payments are fixed or reliably determinable. If the liability is not discounted, then the related asset is not required to be discounted either; however, there may be instances when the recovery period for the asset is substantially longer than the payout period for the liability. In that case, if the amount and timing is fixed or reliably determinable it may be appropriate to discount the asset regardless of whether the liability is discounted.

6.3.4 *Disclosures for guaranty fund and other assessments liability*

ASC 405-30-50-1 notes that the disclosure requirements in ASC 450-20-50 and ASC 275-10-50 relating to loss contingencies apply to insurance-related assessments. ASC 405-30-50-1 also requires that, if the amounts recorded have been discounted, the entity should disclose the undiscounted amounts, as well as the discount rate used. If the amounts have not been discounted, ASC 405-30 requires that the entity disclose the amount of the liability, any related asset, the

periods over which the assessments are expected to be paid, and the period over which the asset is expected to be realized.

***Chapter 7:
Loss recognition (premium
deficiency)—updated
November 2021***

7.1 *Loss recognition (premium deficiency) – chapter overview*

ASC 944-60 requires the recognition of a loss when an entity expects a loss on insurance policies based on current cash flow assumptions in excess of recorded amounts. The concept is consistent with the more general loss recognition guidance in ASC 450-20.

For short duration contracts, a loss is recognized when expected claim and claim adjustment costs, expected dividends, unamortized acquisition costs, and maintenance costs exceed recorded unearned premium. For certain long duration contracts, a loss is recognized when existing contract liabilities, together with the present value of future gross premiums, are not sufficient to cover both the present value of future benefits and settlements costs and to recover the unamortized present value of future profits. These long duration contracts do not consider unamortized acquisition costs in the premium deficiency calculation. Loss recognition is the common terminology used to describe a situation in which a premium deficiency exists.

The guidance in ASC 944-60 discusses the calculation and accounting for a premium deficiency for both short-duration and long-duration contracts.

ASC 944-60-25-2

A probable loss on insurance contracts exists if there is a premium deficiency relating to short-duration or long-duration contracts.

ASC 944-60-25-3

Insurance contracts shall be grouped consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists.

The grouping of contracts and lines of business for the premium deficiency determination is a judgmental area. In practice, each situation is based on the specific facts and circumstances of the company. Once a method of grouping contracts has been established, that method should be applied consistently. A change in the method of grouping contracts, absent a change in the manner in which the company acquires, services, or measures the profitability of its insurance contracts, constitutes a change in accounting principle or correction of an error subject to the accounting and reporting requirements of ASC 250, *Accounting Changes and Error Corrections*.

7.2 *Loss recognition (premium deficiency) – short-duration contracts*

If a premium deficiency exists for short-duration contracts, deferred acquisition costs (DAC) should be written off to the extent of the deficiency. If the premium deficiency exceeds the DAC, a liability is established for the amount of the excess remaining after the DAC amount is written off.

The premium deficiency test computation for short-duration contracts is described in ASC 944-60-25-4.

944-60-25-4

A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums.

Companies can consider anticipated investment income in determining whether a premium deficiency exists. A company's choice to consider anticipated investment income in premium deficiency calculations is considered an accounting policy election and must be disclosed in the footnotes to the financial statements. Because the method of including anticipated investment income in the calculation of short-duration premium deficiencies is not clearly defined in GAAP, approaches other than the investment income approach illustrated in Figure IG 7-1 may exist.

The test computation is illustrated in Figure IG 7-1 and assumes the company has elected to include anticipated investment income.

Figure IG 7-1**Premium deficiency computation for short-duration contracts**

Unearned premiums		\$1,000
Anticipated future investment income from funds made available by unearned premiums		50
Less:	Expected claim costs	(550)
	Expected claim adjustment expenses	(75)
	Unamortized acquisition costs	(200)
	Expected policy maintenance costs	(50)
	Expected policyholder dividends	(25)
		\$150
Premium sufficiency/(deficiency)		\$150

General overhead of an insurance company is a period cost and is similar to unabsorbed overhead of a manufacturing company. It does not enter into the test computation of a premium sufficiency/deficiency. However, expected losses, considering all costs of the business, may be an indication of a going concern or liquidity problem, which should be evaluated in the context of the related accounting guidance for these situations.

In practice, there are two basic methods of calculating the premium deficiency for short duration contracts:

- The discounting approach
- The expected investment income approach

These approaches are subject to many variables and assumptions, including projections of claims and claim adjustment expenses, payment patterns, and investment yields. Both methods incorporate the time value of money.

7.2.1 Loss recognition (premium deficiency) – discounting approach

The discounting approach uses the present value of expected future payments for claim costs, claim adjustment expenses, and maintenance costs. The costs in the premium deficiency test consist of (a) the present value of future payments for claims, claim adjustment expenses, and maintenance expenses expected to be incurred related to the unexpired portion of the contracts, plus (b) unamortized acquisition costs. A premium deficiency is recognized when these costs exceed the related unearned premiums. The unexpired portion of the in-force contracts or policies is viewed as separate and distinct, and no recognition is given to the time value of money associated with the expired portion of the policy. A variation of the approach considers the present value of future costs incurred and expected to be incurred on in-force policies less liabilities recorded at the measurement date (the unearned premium and any existing claim liability) plus the related unamortized acquisition costs. This variation gives accounting recognition to the time value of money associated with both the expired and unexpired portions of the policies.

7.2.1.1 Loss recognition (premium deficiency) – expected investment income

Under the expected investment income approach, the ultimate profitability of an insurance contract is evaluated using all cash flows from the in-force policies, such as premiums, commissions, premium taxes, claims and claim adjustment expenses, investment income and expenses, as well as anticipating the effects of installment premiums and retrospectively rated policies. Investment income is developed using all cash flows relating to the in-force policies. Typically, the entire premium is not available for investment. Some portion of in-force premiums is not collected in advance, and a portion is used to pay acquisition costs, primarily commissions and taxes. Thus, only the net cash is invested and earns income. Also, the receipt of cash may be delayed in some types of policies, such as retrospectively rated policies.

Under one variation of this approach, cash flows associated with only the unexpired portion of the in-force premium (that is, unearned premium less unamortized DAC) are used. We believe this is the most appropriate variation. Under another variation, cash flows from both the expired and unexpired portion are used in the calculation.

7.2.1.2 Loss recognition (premium deficiency) – interest rate

The interest rate used in either the discounting or expected investment income approach should be a rate equal to the expected yield to be earned on total invested assets (expected portfolio rate) over the period that the claim liabilities are expected to be paid. The yield is the ratio of expected interest income, dividends, and rents, net of investment expenses, to the total invested assets. The premium deficiency computation is a profitability test based on an insurance company's actual and expected investment performance. Use of a market rate is not appropriate, since it may not be representative of the actual earnings to be realized by the company.

7.3 *Loss recognition (premium deficiency) – long-duration contracts*

Long-duration contracts are principally life and annuity contracts, and the applicability of the premium deficiency test is dependent on the classification of the contract, as defined in ASC 944.

The premium deficiency test (detailed in ASC 944-60-15-5) is only required for universal life contracts and participating contracts. No testing is required for traditional and limited pay contracts. However, testing is required for the present value of future profit (PVFP) associated with all acquired blocks of long-duration contracts regardless of their contract classification.

7.3.1 *Loss recognition (premium deficiency) – traditional and limited-pay*

As cash flow assumptions are required to be updated regularly and the net premium ratio is capped at 100% (i.e., net premiums cannot exceed gross premiums), a premium deficiency test under ASC 944-60 is not required for nonparticipating traditional and limited-payment insurance contracts. Expected benefits and claim-related costs in excess of premiums are expensed immediately. As the liability assumptions are updated at least annually, if conditions improve whereby the contracts are no longer expected to have net premiums in excess of gross premiums, the improvement would be captured in the remeasurement process and reflected in earnings in the period of improvement. Unamortized deferred acquisition cost (DAC) is not part of the net premium ratio and is not subject to a separate premium deficiency or recoverability test, consistent with analogizing DAC to debt issuance costs. However, unamortized PVFP from past business combinations needs to be separately tested for recoverability even if associated with traditional and limited-payment contracts.

7.3.2 *Loss recognition (premium deficiency) – universal life and participating*

A premium deficiency test is required for contracts other than traditional and limited-payment contracts, such as universal life and participating insurance contracts. ASC 944 provides guidance for the initial and subsequent measurement. Refer to figure IG 5-4 for considerations regarding shadow adjustments.

7.3.2.1 *Initial measurement of loss recognition – updated March 2023*

The guidance for determining the existence of a premium deficiency for universal life and participating contracts is covered in ASC 944-60-25-7 through ASC 944-60-25-8, ASC 944-60-30-1, and ASC 944-60-30-2.

ASC 944-60-25-7

Original policy benefit assumptions for certain long-duration contracts ordinarily continue to be used during the periods in which the liability for future policy benefits is accrued under Subtopic 944-40. However, actual experience with respect to investment yields, mortality, morbidity, terminations, or expenses may indicate that existing contract liabilities, together with the present value of future gross premiums, will not be sufficient to do both of the following:

- a. Cover the present value of future benefits to be paid to or on behalf of policyholders and settlement costs relating to a block of long-duration contracts

- b. Recover unamortized present value of future profits.

ASC 944-60-25-8

The premium deficiency shall be recognized by a charge to income and either of the following:

- a. A reduction of unamortized present value of future profits
- b. An increase in the liability for future policy benefits

ASC 944-60-30-1

If the conditions in paragraph 944-60-25-7 exist, an entity shall determine the liability for future policy benefits using revised assumptions as the remainder of the present value of future payments for benefits and related settlement costs (determined using revised assumptions based on actual and anticipated experience) minus the present value of future gross premiums (also determined using revised assumptions based on actual and anticipated experience).

ASC 944-60-30-2

A premium deficiency shall then be determined as the liability measured in paragraph 944-60-30-1 minus the liability for future policy benefits at the valuation date, reduced by the unamortized present value of future profits.

For universal life-type contracts, we believe the premium deficiency analysis includes both the “liability for future policy benefits” described in ASC 944-40-30-16, unamortized deferred sales inducement assets, and any additional accrued liabilities for death, other insurance, and annuitization benefits. That is, the amount subject to premium deficiency testing should include the sum of the following components

- the accrued policyholder account balance (ASC 944-40-25-14),
- additional liabilities for death or other insurance benefits (as described in ASC 944-40-25-27A) and annuitization benefits (as described in ASC 944-40-25-26 and ASC 944-40-25-27),
- unamortized deferred sales inducement assets
- amounts assessed against policyholders for services to be performed in the future (e.g., unearned revenue),
- amounts previously assessed against policyholders that are refundable on contract termination, and,
- any amounts previously recorded for premium deficiencies.

The premium sufficiency/deficiency calculation is usually performed when current and anticipated experience varies significantly from the original assumptions. One indication that current and anticipated experience may be varying from original assumptions is when the insurance company significantly changes assumptions used for new business from those used in the prior period.

The significant assumptions are:

- investment yields
- mortality and morbidity rates
- terminations
- expenses

To determine if a premium deficiency exists, the present value of expected cash outflows or “future benefits and settlement costs” and the present value of expected cash inflows or “future gross premiums” relating to the contract are considered.

- Cash outflows include all the benefits (e.g., death benefits and surrenders) and related settlement costs that accrue to the benefit of the policyholder. Expected assessments, including charges for administration, mortality, and expense that are expected to be deducted from the account balance that is ultimately paid to the policyholder, are projected.
- Cash inflows include gross premiums expected to be paid by the policyholder. For universal life contracts, “gross premiums” refers to expected deposits to be paid by the policyholder.

Unamortized DAC is not a component in the analysis; however, the unamortized present value of future profits from past business combinations is included. Maintenance costs are specifically excluded as a cash outflow in the present value of future payments for benefits and related costs.

No loss is reported currently if it results in creating future income.

Question IG 7-1 addresses the appropriate discount rate to be used in determining the present value of expected cash outflows and inflows in the premium deficiency test for universal life type contracts.

Question IG 7-1

What discount rate should be used in the loss recognition test relating to universal life type contracts?

PwC response

ASC 944-60-25-7 requires that a reporting entity assess universal life-type contracts for premium deficiency, but it does not prescribe a particular discount rate to be used in the assessment. It does mention “investment yields, along with mortality, morbidity, terminations, or expenses” as relevant assumptions in performing a loss recognition test. As a result of the lack of a prescribed rate, a discount rate such as investment yield or the account balance crediting rate may be appropriate. We believe the discount rate used should be consistent with the underlying economics and other relevant assumptions. If investment yield is used as the discount rate, it must be disclosed in accordance with ASC 944-60-50-2. Refer to Figure IG 5-5 for considerations related to shadow adjustments.

Question IG 7-2 addresses how market risk benefits associated with universal life insurance contracts are considered in the premium deficiency analysis.

Question IG 7-2

Are market risk benefits a component of the universal life insurance premium deficiency analysis?

PwC response

No. The universal life liability for future policy benefits excludes market risk benefits because market risk benefits are measured at fair value and therefore do not meet the “liability for future policy benefits” glossary definition of “an accrued obligation to policyholders that relates to insured events, such as death or disability.” That is, premium deficiency guidance applies to balances measured under an accrual model, but not under a fair value model. Entities should ensure that the fees attributed to the market risk benefits in the fair value model are excluded from the cash inflows for the universal life liability for policy benefits premium deficiency test.

7.3.2.2 *Subsequent measurement of loss recognition*

If a premium deficiency liability is recognized, future changes in the liability are based on the revised assumptions. The liability for future policy benefits should be estimated periodically based on revised assumptions using actual and anticipated experience and compared with the current liability for future policy benefits (reduced by the unamortized present value of future profits) in accordance with ASC 944-60-35-5 to determine if any additional premium deficiency exist. We believe the assumptions should be unlocked even for favorable development that would lead to a reversal of previously recognized amounts.

7.3.3 *Profits followed by losses for universal life and participating contracts*

ASC 944-60-25-9 requires that an additional liability be recorded in situations when there are profits followed by losses for universal life and participating contracts.

ASC 944-60-25-9

In some instances, the liability on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits would be recognized in early years and losses in later years. In those situations, the liability shall be increased by an amount necessary to offset losses that would be recognized in later years.

There is no detailed guidance indicating how that liability should be measured or over what period it should be recognized. An example of a profits followed by losses situation for universal life is a contract priced such that cost of insurance (COI) assessments in later attained ages were not expected to fully cover expected mortality costs but expectations of other assessments and investment spread earnings in addition to the COI were expected to cover these costs such that the contracts were expected to be profitable in all future years. However, subsequent experience relating to mortality in later years or the level of future deposits and investment returns cause the company to now expect losses in later years even though currently all years combined do not demonstrate a premium deficiency.

In these situations, we believe there are at least two alternative approaches for accruing the additional liability:

- Accrue a liability over the profitable periods in a systematic and rational manner such that the additional liability is fully established by the date that the losses are expected to emerge, or
- Immediately recognize the full liability.

With respect to the systematic and rational manner in which to accrue the liability, different methods may be used. The key principle is, at the point in time when losses are expected to emerge, the liability should be fully established. The accrual is essentially meant to zero out the future loss periods without creating profits or losses in the later years.

We expect entities to apply a consistent accounting policy for profits followed by losses and describe the specific calculation method selected.

Question IG 7-3 addresses whether to include reinsurance benefits in the premium deficiency test.

Question IG 7-3

Can a company include reinsurance benefits and the cost of reinsurance in its premium deficiency test?

PwC response

Yes, if that is the company's accounting policy. There is no explicit guidance in ASC 944 on how to consider reinsurance costs and recoveries in the premium deficiency test in ASC 944-60-25-7 and likewise there is no guidance on what should be included in "profits" or "losses" for purposes of the "profits followed by losses" test in ASC 944-60-25-9. One option is to treat reinsurance as a component of the net profits or losses of the group, similar to other related revenues and expenses that are not part of the contract with the policyholder, such as investment yields and claim settlement expenses paid. The consideration of reinsurance in the premium deficiency calculation is akin to the inclusion of investment yields, as the purchased reinsurance has effectively replaced investments in supporting the payment of claims. Alternatively, reinsurance could be considered a separate financial instrument and not included in direct policy cash flows.

7.3.4 Recoverability test for present value of future profits

The fair value of insurance contracts acquired in a business combination is divided into two basic 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) the insurance contract intangible asset (or liability) representing the residual. In many cases this will represent the future GAAP profits to be realized from the acquired insurance contracts and is called "present value of future profits" (PVFP) or value of business acquired (VOBA).

To the extent that PVFP relating to all types of insurance (including traditional and limited payment) and reinsurance contracts acquired represents an asset under ASC 944-30-35-63 and ASC 944-805-35-3, it is subject to a recoverability test in accordance with ASC 944-60. For further consideration, see IG 12.3.4.

7.3.5 Loss recognition (premium deficiency) – investment contracts

For normal interest-bearing obligations, there is no premium deficiency test. If a company expects to incur a negative interest spread (i.e., expected investment earnings are less than contractual liability crediting rates), the loss from that spread is recognized as realized over the life of the obligation. It would not be appropriate to write down the DAC balance on these types of contracts to estimated net realizable value as neither ASC 944 nor ASC 310 subjects these balances to impairment testing. Similarly, if a PVFP asset exists for investment contracts, it would generally not be subject to a premium deficiency test or separate asset recoverability test given that PVFP is essentially a form of debt discount or premium associated with the investment contract liability.

Chapter 8
Short-duration reinsurance

8.1 *Short-duration reinsurance – chapter overview*

Reinsurance is the purchase of insurance coverage by an insurer to mitigate the risks of insurance it provides (or will provide) to its policyholders. In its simplest form, reinsurance provides risk mitigation for the frequency and/or severity of exposure an insurance entity has from its underlying insurance policies. This specialized accounting can vary depending on whether the underlying insurance contracts are classified as long-duration or short-duration. This chapter focuses on reinsurance of underlying insurance contracts that are classified as short-duration. See IG 2 for further information on the distinguishing between short-duration and long-duration insurance contracts and see IG 9 for further information on the reinsurance of long-duration insurance contracts. Specialized accounting guidance applies if the reinsurance contract transfers significant insurance risk. The accounting for the risk transferred will offset the income statement impact of insurance risk, similar to hedge accounting. To determine the appropriate accounting, evaluation of all contract terms is essential.

ASC 944-20-20 provides the following definition of reinsurance.

Excerpt from ASC 944-20-20

Reinsurance: A transaction in which a reinsurer (assuming entity), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding entity). For indemnity reinsurance, the legal rights of the insured are not affected by the reinsurance transaction and the insurance entity issuing the insurance contract remains liable to the insured for payment of policy benefits. Assumption or novation reinsurance contracts that are legal replacements of one insurer by another extinguish the ceding entity's liability to the policyholder.

This chapter discusses the accounting considerations with respect to the reinsurance of short duration contracts from both the ceding entity's and reinsurer's perspective (i.e., assuming entity).

8.2 *Purpose of short-duration reinsurance*

Insurance risk is the risk arising from (a) uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under the contract (i.e., underwriting risk) and (b) the timing of the receipt and payment of those cash flows (i.e., timing risk). An entity may purchase reinsurance for its insurance risk for a number of economic reasons, including:

- To reduce its exposure to the variability of particular risks or classes of risks
- To obtain financial capacity to accept risks and policies involving amounts larger than could otherwise be accepted
- To protect against accumulations of losses arising out of catastrophes (e.g., a single natural event)
- To protect against accumulations of losses in excess of an entity's risk appetite
- To facilitate the growth of new product lines or otherwise leverage a reinsurer's expertise

- To exit a line of business (e.g., through a loss portfolio transfer)
- To help fund product development and acquisition expenses
- To accomplish tax and/or regulatory (e.g., capital management) objectives

8.3 *Types of short-duration reinsurance*

Reinsurance contracts can be customized for specific exposures, events, and limits, based on the negotiation between the ceding and assuming entities. Broadly, the two types of reinsurance contracts are proportional and non-proportional. Figure IG 8-1 describes the characteristics of each type of reinsurance contract.

Figure IG 8-1
Characteristics of reinsurance contracts

Type of reinsurance	Definition
Proportional	<ul style="list-style-type: none"> □ Insurer and reinsurer share in the risks and rewards of the contract □ Participation is typically a percentage. Therefore premium paid to and losses recovered from the reinsurer vary based on the premium amount and claim experience □ Examples include quota share, surplus share, co-insurance and fronting reinsurance contracts
Non-proportional	<ul style="list-style-type: none"> □ Insurer typically pays a fixed premium, which allows recovery from the reinsurer if claims exceed a set threshold □ Examples include excess of loss contracts, which may be structured per risk, per occurrence, or total claims incurred in aggregate

Reinsurance contracts are also categorized as either treaty or facultative contracts. A treaty contract automatically covers (attaches) direct contracts with specific characteristics when the underlying direct policy is issued. Facultative contracts require the reinsurer to approve each new policy before it can be attached to a reinsurance contract. An insurance entity may enter into a reinsurance contract directly with a reinsurer (or pool of reinsurers) or may use alternative structures in order to involve non-reinsurers interested in assuming the risk. Figure IG 8-2 summarizes the characteristics of alternative reinsurers.

Figure IG 8-2
 Characteristics of alternative reinsurers

Reinsurance counterparties	Description
Syndicate	<ul style="list-style-type: none"> □ A group, association, or pool of insurance entities that share in the underwriting results of the underlying business □ Typically used when the underlying exposures are significant, and /or the policies include high limits □ Examples include assigned risk pools and Lloyd's of London
Special purpose vehicle	<ul style="list-style-type: none"> □ Structure created to allow investors to assume insurance risk for a premium, may be cheaper than traditional reinsurance □ Insurers cede premium and particular exposures to the structure, and the structure issues notes to investors □ Investor's exposure is capped at their investment □ Examples include captive insurance entities and risk retention groups

Reinsurance contracts can be highly customized agreements. Careful evaluation of the contract terms and understanding of the business purpose is necessary in deriving the appropriate accounting conclusion.

8.4 *Overview of reinsurance accounting of short-duration contracts*

ASC 944 requires that the substance (and not the form) of the contract drive the accounting treatment. When significant insurance risk is transferred, reinsurance accounting is required. In contrast, contracts that do not transfer significant insurance risk are accounted for as deposits (i.e., financing arrangements).

Recording a contract as reinsurance will generally enable the financial statements of the ceding entity to match the recognition of benefits for claims covered by the reinsurance with the recognition of the claims expense from the underlying contracts both in timing and amount. In addition, the benefit is presented as a reduction in claims expense. Premiums paid to the reinsurer are presented as a reduction in premium revenue. Although the income statement presentation is netted, reinsurance contracts rarely achieve offset accounting on the balance sheet and therefore result in a reinsurance recoverable asset.

Deposit accounting treats the contract more like a financial instrument, with an effective interest rate effect and no net presentation on the income statement (i.e., ceding entities cannot net the impact of reinsurance against direct written insurance). If the reinsurance involves risks on claims that have already been incurred by the underlying direct contracts, then retroactive reinsurance accounting is

appropriate. This is a hybrid between reinsurance and deposit accounting. An additional accounting model, multi-year retrospectively rated contract accounting, is appropriate for contracts that transfer significant insurance risk and have a deposit component.

Figure IG 8-3 is a summary of the prospective, retroactive, and deposit accounting models that would be applied by a ceding entity. The multi-year retrospectively rated contract accounting is discussed in IG 8.8.

Figure IG 8-3
Summary of the ceding entity accounting models

Prospective reinsurance accounting	Retroactive reinsurance accounting	Deposit accounting¹ (timing risk only, or no timing or underwriting risk)²
Premiums paid to the reinsurer are recorded as ceded premiums (a reduction to revenue attributable to direct insurance written) over the coverage period.	Premiums paid to the reinsurer are reported as reinsurance receivables to the extent they do not exceed the recorded liabilities relating to the underlying reinsured contracts. No amount is recorded as ceded premium.	Premiums paid to the reinsurer are recorded as a deposit asset with no effect on revenue.
Expected reimbursements for losses are recorded as a reduction in losses as the losses are incurred with a corresponding undiscounted reinsurance recoverable asset.	<p>If the recorded liabilities exceed the amounts paid, a reinsurance recoverable is increased to reflect the difference and the resulting gain deferred. The deferred gain is amortized over the estimated remaining settlement period using the interest method if cash flows are reasonably estimable, or based on the ratio of actual recoveries to total expected recoveries if they are not.</p> <p>If the amounts paid for retroactive reinsurance exceed the recorded liabilities relating to the underlying reinsured contracts, the ceding entity should increase the related liabilities or reduce the reinsurance recoverable (or both) at the time the reinsurance contract is entered into. Any excess is charged to expense immediately.</p> <p>Changes in the estimated amount of the liabilities relating to the underlying reinsured contracts are recognized in earnings in the period of the change, but the related increase in the reinsurance recoverable is not credited immediately to income to offset the loss. Instead, the gain is deferred and amortized over the settlement period.</p>	<p>Nonrefundable fees paid are recorded as expense over period benefited. The period benefited is typically the settlement period of the deposit.</p> <p>The asset is accreted using the interest method to the ultimate expected reimbursements.</p> <p>Reimbursements for losses are recorded as reduction in deposit asset when cash is received.</p>
<p>Impacts premiums/surplus ratio</p> <p>Impacts loss ratio (losses/premiums)</p>	Similar to deposit accounting.	Recorded as a financing with no impact on premiums, losses incurred, or related insurance ratios. Any benefit to the ceding entity is recognized using the effective yield interest method over the settlement period.

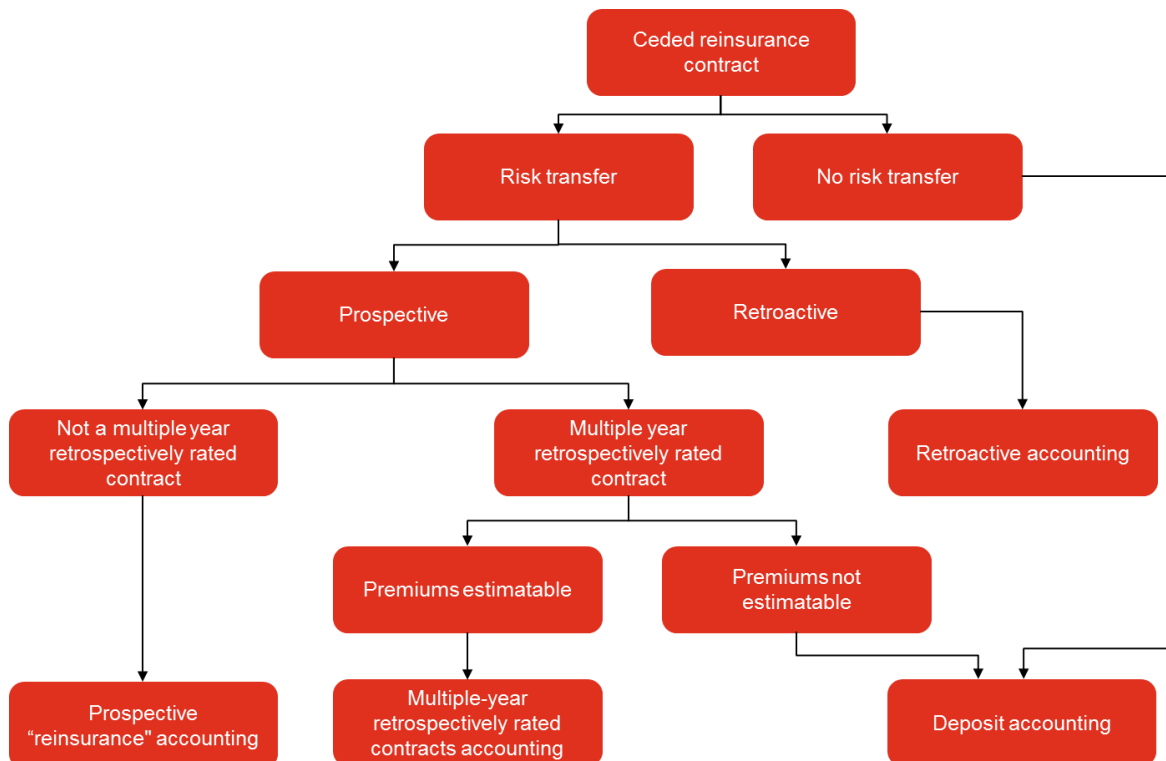
¹ Guidance on how to apply deposit accounting for insurance and reinsurance contracts, except long-duration life and health contracts, can be found in ASC 340-30, *Other Assets and Deferred Costs- Insurance Contracts that Do Not Transfer Insurance Risk*.

² Deposit accounting when there is significant underwriting risk but no timing risk is uncommon. However, if that is the case, the premiums paid to the reinsurer would be recorded as a loss or expense, and reimbursements for losses would be recorded at present value as a reduction in losses as losses are incurred.

The analysis required to determine the appropriate accounting method for reinsurance of short duration contracts is illustrated in Figure IG 8-4.

Figure IG 8-4

Reinsurance accounting short duration insurance contracts



The evaluation of the significance of the risk being transferred in a reinsurance contract is the first step in identifying the appropriate method to account for the reinsurance contract. The second step is to assess when claims that are covered by the reinsurance contract were incurred in comparison to the date on which the reinsurance contract was negotiated to determine whether the contract should be accounted for under prospective or retroactive reinsurance accounting. The third step is to assess if there are any retrospective or experience adjustment provisions that may indicate a deposit component that will need to be accounted for. The appropriate accounting considerations are further complicated by various contract terms, industry practice, and business purpose. The following sections discuss these steps in more detail.

Receivables for amounts recoverable under reinsurance contracts are considered financial assets for impairment purposes and should be assessed for credit impairment. Prior to the adoption of ASC 326, *Financial Instruments – Credit Losses*, a loss is recorded when a credit loss is incurred.

New guidance

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 introduces a new model for recognizing credit losses on financial instruments based on an estimate of current expected credit losses. The ASU also provides updated guidance regarding the impairment of available-for-sale debt

securities and requires additional disclosures. Receivables for amounts recoverable under reinsurance contracts are included in the scope of ASU 2016-13.

Upon adoption of ASU 2016-13, the recording of credit losses will change to an “expected loss” model from an incurred loss model, in which a loss for expected credit losses would be recorded upon initial recognition of the reinsurance recoverable not measured at fair value. See LI 13.1 for the applicable effective date of ASU 2016-13 and see LI 7.8 for further information on the application the current expected credit losses model for reinsurance receivables.

8.5 Evaluating risk transfer for short-duration contracts

To qualify for reinsurance accounting, ASC 944-20-15-59 indicates that a reinsurance contract must indemnify the ceding entity against loss or liability relating to insurance risk. In order to determine if a contract qualifies for reinsurance, reporting entities must obtain a complete understanding of the contract, and evaluate all of the features in the agreement, as well as how those features interrelate. All contract features should be evaluated to determine if they limit the amount of insurance risk the reinsurer assumes (e.g., through experience refunds, cancellation features, adjustable features), or delay the timely reimbursement of claims by the reinsurer. To the extent the risk-limiting features cause the contracts to not meet the significant risk transfer criteria, the entire reinsurance contract should be accounted for as a financing transaction (i.e., deposit accounting). Refer to IG 8.5.5 for further discussion of risk-limiting features.

Many reinsurance contracts contain terms that are intended to limit to some degree the variability in underwriting results to the reinsurer. In its broadest usage, the term “finite reinsurance” refers to contracts that are designed to transfer just enough risk to achieve a business objective for the ceding entity and no more. This will keep the cost of the reinsurance to an amount that relates solely to the business objective.

The premium-to-surplus ratio is a key statistic used by regulators and analysts to measure the financial leverage of an insurer. It is a convenient surrogate for estimating the amount of loss that an insurer's capital can support. This measure uses premiums before (gross) and after (net) considering ceded premiums. The cost of a traditional reinsurance product may be more than the ceding entity is willing to pay. This may result in revisions to the traditional reinsurance contract to reflect the cost objective of the buyer or the risk appetite of the seller. A finite reinsurance transaction may also be purchased when the ceding entity needs to reduce its net premiums but believes the underlying business is profitable and does not wish to forego the profit. A reinsurer is willing to forego this profit potential in return for a limit on its loss potential -- a finite risk transaction. If actual losses turn out to be higher than the limit accepted by the reinsurer, however, the total loss to the insurer (i.e., the combination of premiums paid to the reinsurer and the excess loss) could be more than it would have been under the "traditional product." Certain contract designs maximize the amount of premium ceded to the point of not representing the true risk ceded. This artificially improves the ceding entity's leverage ratio and makes it appear that the insurer does not have as much risk as it actually does. Such contracts may be structured as quota share contracts with caps, loss corridors, or sliding scale commissions.

In a free market environment, product development and innovation is expected. Such innovation may, however, lead to complex terms and conditions. The greater the number and/or degree of risk-limiting features that exist in a contract, the more difficult it is to assess whether the insurance risk transferred is significant enough for the contract to be accounted for as reinsurance rather than as a deposit.

8.5.1 *Defining the contract – short-duration reinsurance*

ASC 944-20-15-37 stresses substance over form in defining “the contract” that is subject to risk transfer analysis and accounting. All contracts, including contracts that may not be structured or described as reinsurance, must be assessed for potential reinsurance accounting. Although the legal form and substance of a reinsurance contract generally will be the same, this may not always be the case. Careful analysis and judgment is required to determine the boundaries of a contract for accounting purposes. In some instances, features of other related contracts may need to be considered part of the subject contract. It is therefore important to determine whether the ceding entity and the reinsurer have made any other legally binding agreements (e.g., collateral / funding agreement, separate reinsurance agreement passing the risk back to the insurer or insurer affiliate, servicing agreement, separate profit-sharing contracts), whether oral or written, in conjunction with the reinsurance contract being assessed. If so, they should be considered part of the subject contract, particularly if they were negotiated at the same time or in contemplation of entering into the reinsurance contract. Such agreements are often referred to as “side agreements.” In some instances, the side agreements serve to negate some or all of the risk transfer in the reinsurance contract.

Similarly, different kinds of exposures combined in a program of reinsurance should not be evaluated for risk transfer together, even if in the same contract. Doing so may allow a component of a contract that does not meet the conditions for reinsurance accounting to be accounted for as reinsurance by being designated as part of a larger reinsurance program. For example, for a multi-coverage program combining several distinct lines of business, each line should be evaluated separately as part of the risk transfer test.

8.5.2 *Risk transfer criteria for short-duration reinsurance contracts*

For short-duration contracts, ASC 944-20-15-41 identifies two criteria that must be met in order for a contract to be accounted for as reinsurance.

Excerpt from ASC 944-20-15-41

- a. Significant insurance risk. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts. Implicit in this condition is the requirement that both the amount and timing of the reinsurer’s payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts.
- b. Significant loss. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

The conditions are independent and the ability to meet one does not mean that the other has been met. A substantive demonstration that both conditions have been met is required for a short-duration contract to transfer risk.

Each contract needs to be analyzed based on the facts and circumstances of each transaction, the operating environment, and the contract’s potential impact on the reporting entity’s financial reporting. The assessment of significant insurance risk and significant loss is discussed further below.

8.5.3 Significant insurance risk – short-duration reinsurance

To determine whether the contract passes significant risk, both the qualitative and quantitative features of a contract should be considered, as well as the business purpose of the contract and the cash flows and associated probabilities and outcomes. The assessment should be performed at contract inception, and only reassessed upon modification of the contract. Reassessment of significant insurance risk transfer is required for all but the most trivial changes in financial and non-financial terms.

Significant insurance risk requires both the amount and timing of the reinsurer's payments to depend on and vary directly with the amount and timing of claims settled under the reinsured direct insurance contracts. The insurance risk born by the reinsurer need not be proportionate. A reinsurer may provide coverage on an excess of loss basis and still have significant underwriting risk. The evaluation is performed in relation to the insured portions of the underlying insurance contracts rather than all aspects for the contracts.

Significant insurance risk would not be transferred if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. In assessing whether there would be a significant variation in the amount of losses, reporting entities would need to consider risk-limiting features. For instance, a loss cap or a corridor may reduce or eliminate variability in the amount of losses ceded under a contract.

Contractual provisions that delay timely reimbursement to the ceding entity may also result in significant insurance risk not being transferred. Examples include payment schedules or accumulating and floating retentions from multiple years. ASC 944-20-15-48 states that "timely" should "be evaluated based solely on the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer." It does not matter if a contract provision stipulates that interest will be assessed on the amount owed to the cedant as a result of a contract provision that delays timing of reimbursement to the cedant by the reinsurer.

Timing delays may be built into features that may not appear on initial review to impact cash flow at all, such as coverage changes and other techniques. Careful evaluation of the business purpose of each contract provision and a review of cash flow scenarios are necessary to determine whether a contract meets the timely reimbursement criteria. Risk-limiting features are discussed in IG 8.5.5.

8.5.4 Reasonable possibility of a significant loss – short-duration reinsurance

ASC 944-20-15-41 does not define "significant loss" for purposes of the risk transfer criteria. It also does not define "reasonable possibility." Determining the reasonable possibility of a significant loss will require an assessment of the qualitative and quantitative facts and the use of judgment.

To determine the amount of loss for a given reasonably possible scenario, ASC 944-20-15-51 requires the comparison of (1) the present value of all cash flows between the ceding and assuming entities to (2) the present value of amounts to be paid to the reinsurer, before commissions. Insurers must consider all cash flows (included within the reinsurance contract or potentially by combining side agreements) between the ceding entity and assuming entity in the present value calculation, as there may be payments that effectively represent premiums or refunds of premiums that are not characterized as such in the contract or side agreements. Additionally, ASC 944-20-15-49 indicates that the same interest rate should be used to compute the present value of the cash flows for each reasonably possible outcome tested. The rate should reflect both (1) the expected timing of payments

to the reinsurer and (2) the duration over which those cash flows are expected to be invested by the reinsurer. In performing this quantitative assessment, insurers must consider reasonably possible outcomes. Typically, reporting entities would consider their historical premium and loss experience in developing reasonably possible outcomes. If an insurer does not have enough of its own historical data, then industry experience may be used.

Question IG 8-1 addresses which cash flows should be included in the significant loss calculation.

Question IG 8-1

Are cash flows associated with the reinsurer's administration of the agreement included in the significant loss calculation?

PwC response

No. Cash flows related to expenses of the reinsurer, such as taxes or operating expenses, are excluded from the calculation. Only the cash flows between the two parties to the contract are included.

In practice, informal quantitative guidelines have been used to define the reasonable possibility of significant loss criterion. While more than a 10% probability of at least a 10% loss is widely used, there is no "bright line" in the accounting literature. For a plain vanilla reinsurance contract without complex provisions and risk-limiting features, there may be numerous reasonably possible scenarios that could result in a 10% loss while remote scenarios could cause an even greater loss. If the assumptions supporting the estimate are reasonable, a 10% chance of a 10% loss may be sufficient to conclude that a significant loss is reasonably possible.

The further away from a plain vanilla contract (and the more loss limiting features included in the contract), the greater the percentage of loss needs to be in order to qualify for reinsurance accounting. In more complex contracts, a loss that is capped at 10% may not be considered significant.

In addition, qualitative factors need to be considered in evaluating whether a loss is significant, including:

- The relationship between the possibility of loss and the potential magnitude of the loss
- Maximum possible loss
- Rate used to discount the cash flows in the quantitative assessment
- Range of assumptions used
- Possibility that the assumptions could all be realized at the same time
- Other indirect factors, such as the impact of reinsurance versus deposit accounting on the entity's risk-based capital and other key ratios (e.g., premiums/surplus ratio, debt covenants)

Question IG 8-2 discusses the impact of contract limits on the quantitative significant loss test. Question IG 8-3 addresses accounting practice for contracts with a low probability of loss but a high level of loss severity.

Question IG 8-2

Would a contract that has a 15% probability of a 10% loss, but no probability of a loss above 15% due to contract limits meet the quantitative significant loss test?

PwC response

Most likely not. Although the assessments are facts and circumstances dependent, there would be limited circumstances in which this would be considered a reasonable possibility of a significant loss. In this scenario, the business purpose is more likely financial, such as a loan.

Question IG 8-3

How should contracts with a low probability of loss and a high level of severity, such as a catastrophe cover, be evaluated?

PwC response

The informal quantitative guideline for the probability of loss criterion can be problematic for certain types of reinsurance that have a low frequency of occurrence but potentially high severity of loss, such as catastrophe covers. Accounting practice has evolved such that catastrophe covers are deemed by most practitioners to be reinsurance, even if the probability of loss is very low but the potential magnitude of the loss in comparison to the amounts to be paid to the reinsurer is significant. This also assumes that the potential inclusion of risk-limiting features does not significantly limit the loss exposure. Typically, the premium for such coverage is very small, with little to no financing economics. As a result, reinsurance accounting has little impact on the financial statements unless the event occurs.

8.5.5 Risk-limiting contract features – short-duration reinsurance

As the structures of risk-limiting reinsurance transactions become more complex, and their terms become more indefinite, the economics become increasingly difficult to quantify. Terms that make it difficult or impossible to evaluate the economics of a transaction suggest that reinsurance accounting may not be appropriate.

Figure IG 8-5 summarizes common risk-limiting features that may be present in reinsurance contracts, and their respective features. The existence of one or more of these features does not immediately cause the contract to fail risk transfer; however, the effect of each feature should be evaluated in the risk transfer analysis.

Figure IG 8-5
Common risk-limiting features

Risk-limiting feature	Attributes
Sliding scale, profit or contingent commissions	<ul style="list-style-type: none"> <li data-bbox="570 386 1521 449">□ Adjustment of cash flows between the ceding and assuming entities based on loss experience <li data-bbox="570 470 1521 569">□ Sliding scale commission varies inversely with movements in the loss ratio. For example, ceding commission may increase as losses decrease (and vice versa), subject to maximum and minimum limits <li data-bbox="570 590 1521 688">□ Profit commission increases based on profitability of business ceded to reinsurer. For example, profit commission may increase as losses decrease, subject to maximum limits <li data-bbox="570 709 1521 772">□ Contingent commission is dependent on a specified event occurring. For example, no-claims bonus experience adjustment
Adjustments to coverage	<ul style="list-style-type: none"> <li data-bbox="570 814 1521 982">□ The deductible adjusts based on changes in loss coverage for occurrences. For example, for each \$2M occurrence, the reinsurer will cover any loss in excess of \$8M with an annual deductible of \$10M. For each \$3M occurrence, the reinsurer will cover any loss in excess of \$7M with an annual deductible of \$15M.
Experience accounts	<ul style="list-style-type: none"> <li data-bbox="570 1024 1521 1192">□ Allow the ceding entity to participate in residual profit in the contract by establishing an experience account that tracks the amount of “on risk” premium (stated reinsurance premium less any stated margin that is explicitly excluded from the account), less fees and losses, plus interest. These are sometimes entitled a “profit sharing account.” <p data-bbox="618 1213 1521 1476">For example, the reinsurer would maintain an experience account balance in the amount of the premium, less the reinsurer’s contractual margin, less losses, less fees, plus interest credited at 2% of the average quarterly account balance. To the extent this account balance is positive as of December 31, 20X1, the reinsurer would pay this amount to the cedant. To the extent that the interest credited is above the risk-free rate and there are fees paid to the reinsurer for this account, these would contribute to the consideration paid to the reinsurer and therefore mitigate the total loss to the reinsurer.</p>
Retrospective premium adjustments	<ul style="list-style-type: none"> <li data-bbox="570 1518 1521 1612">□ Premiums are adjusted subsequent to the effective date of the contract, and typically subsequent to the coverage period, based on the loss experience of the contract. <p data-bbox="618 1633 1521 1801">For example, an initial premium of \$500K is received, but based on estimated claim experience, the premium will increase \$200K for losses in excess of \$1M, and be reduced by the same amount if losses are below \$300K unless the minimum premium associated with the contract is reached.</p>

Risk-limiting feature	Attributes
Reinstatement clauses	<p data-bbox="570 300 1438 363">□ The ceding entity pays additional amounts if a certain level of losses is incurred (in exchange for restoration of the reinsurance limit)</p> <p data-bbox="618 390 1516 485">For example, if losses ceded under the reinsurance contract exceed \$5M, \$2M of additional premium will be paid to the reinsurer. These are typical in catastrophe contracts and occur upon exhaustion of a coverage limit.</p>
Loss caps	<p data-bbox="570 520 1516 615">□ Limit the assuming entity's aggregate exposure by imposing a dollar limit, or a limit expressed as a loss ratio, on the amount of claims to be paid under the reinsurance contract</p> <p data-bbox="618 642 1516 705">For example, the reinsurer will not be responsible for claims beyond a 150% loss ratio in the underlying primary business.</p>
Loss corridors	<p data-bbox="570 741 1446 804">□ Limit the assuming entity's exposure by including a corridor (generally expressed as a loss ratio band) to which the cedant cannot cede losses</p> <p data-bbox="618 831 1516 926">For example, the reinsurer will be responsible for losses up to 80% of premiums, but will not be responsible for losses in between 80% and 95% of premiums, but then is responsible for losses in excess of 95% of premiums.</p>
Dual triggers	<p data-bbox="570 961 1474 1024">□ Losses are payable by the reinsurer to the extent both the insurable event and a separate/distinct triggering event occurs</p> <p data-bbox="618 1052 1516 1146">For example, the reinsurer will pay losses to the extent those losses are covered by the contract and industry losses relating to the insured event exceed \$5 billion. See DH 4.6.2 for information on derivative considerations.</p>
Side letters	<p data-bbox="570 1182 1507 1283">□ Separate written or oral agreements from the reinsurance contract that may mask the true nature of the agreement, or include additional incentives for the insurer or reinsurer to facilitate additional business</p>
Use of captives or affiliates	<p data-bbox="570 1318 1490 1381">□ Reinsurer passes the risk back to the cedant by entering into an agreement with the cedant's affiliate and/or captive</p>
Funds withheld	<p data-bbox="570 1417 1438 1512">□ Premium due to the reinsurer is withheld by the cedant, and typically accrues interest that inures to the reinsurer to the extent losses do not exceed the funds withheld balance</p> <p data-bbox="618 1539 1516 1675">For example, the cedant will not pay the reinsurer the premium amount, and will instead accrue interest at the stated 3% interest rate on the average funds withheld balance. As losses that would be payable by the reinsurer emerge, they will be deducted from the accumulated funds withheld balance.</p>

Risk-limiting feature	Attributes
Indefinite terms / auto-renewals	<ul style="list-style-type: none"> <li data-bbox="570 302 1507 359">□ Based on the experience of an underwriting year, the contract renews, and/or creates an accumulating retention for the underwriting years to date <p data-bbox="621 386 1507 478">For example, the contract will renew if the current underwriting year, or the cumulative underwriting years based on renewals, exceed a loss ratio of 100%.</p>
Commutation clause	<ul style="list-style-type: none"> <li data-bbox="570 520 1507 577">□ Provides the reinsurer with a partial or complete discharge of obligation of current and future losses covered under the contract <p data-bbox="621 604 1507 697">For example, at the fifth anniversary of the effective date, the reinsurer may commute the policy and have no further obligation to pay the cedant, based on the known reserves as of the commutation date.</p>

In addition to the common risk-limiting features listed in Figure IG 8-5, unique risk transfer considerations may need to be considered based on the structure of the reinsurer. If the structure includes special purpose vehicles with limited activities and ability to finance losses, then the ability to pay potential losses should be considered.

Evaluating whether insurance risk is transferred is complex, and the effect of any risk-limiting features on this evaluation will likely require the collaboration of actuaries with the accountants performing the assessment.

To the extent the contract passes the risk transfer assessment, the terms of the contract and timing of entering into the agreement should then be analyzed to determine if the contract should be accounted for under prospective or retroactive reinsurance accounting. Refer to IG 8.6 for a description of this accounting assessment. If the contract fails the risk transfer assessment, the contract should be reported using deposit accounting. Refer to IG 8.7 for a discussion of the accounting implications.

Question IG 8-4 addresses the application of the “timely reimbursement” criteria.

Question IG 8-4

A reinsurance contract contains a loss corridor, whereby aggregate losses within the range of 50% to 70% can be ceded to the reinsurer, only if the losses are at or in excess of a 70% loss ratio (i.e., a cumulative catch up of cessions will occur when a 70% loss ratio exists, and all losses within the corridor will be ceded, but if the losses fall below 70%, no losses can be ceded).

If the trigger point is expected to be met, the reinsurer reimburses the ceding entity as the underlying losses are paid. However, if the initial loss estimate is below the trigger point, the reinsurer has no obligation, and therefore no losses are paid or accrued by the reinsurer (regardless of when the underlying losses are paid) until such time as that estimate changes to trigger coverage under the reinsurance contract. If payments are made by the reinsurer based on an initial loss estimate that exceeds the trigger point, and the claim subsequently settles for less than the limit, all amounts previously paid will be returned to the reinsurer.

Would this reinsurance contract provision meet the “timely reimbursement” criteria in evaluating risk transfer?

PwC response

It depends on the expectation of the loss ratio and the tail associated with the underlying coverage.

To the extent the reinsurance agreement reinsures auto coverage and the expected loss ratio under the agreement is 85%, the timely reimbursement criteria would likely be met. This is due to the fact that the business has a relatively short tail (i.e., claims are expected to be reported within a year), and there is an expectation that the cumulative catch up provision will occur based on the expected loss ratio exceeding the 70% cap. Therefore, when paid losses begin to emerge within the corridor, the time between when those losses would have been reimbursed from the reinsurer, and when they actually will be reimbursed, based on the 70% cap being met, will likely be within a year. As such, any potential timing delay would likely be considered insignificant.

In contrast, if the coverage related to a longer tail line, such as general liability, and the loss experience by underwriting year is erratic (i.e., losses have not emerged consistently based on the experience of the insurer), then the contract would not meet the “timely reimbursement” criteria. The inclusion of this clause with a longer tail line would cause the contract to fail significant risk transfer if all calculations are done on a paid basis.

Example IG 8-1 illustrates a risk transfer analysis for an excess of loss reinsurance contract. Example IG 8-2 and Example IG 8-3 show the analysis for an excess of loss reinsurance contract with a retrospectively-rated premium adjustment.

EXAMPLE IG 8-1**Risk transfer analysis of an excess of loss reinsurance contract**

P&C Insurance Company enters into an excess of loss reinsurance contract that covers its general liability book of business and is expected to pay claims over the next seven years for losses occurring in the current year.

Cover: \$1,000,000 of loss per occurrence in excess of \$1,000,000

Annual Premium: \$2,000,000

Commission: 15% of the premiums ceded

Loss Ratio: It is reasonably possible that the ultimate ratio on the contract could range from 75% of premiums ceded to 120% of premiums ceded.

Payment Pattern: The payment pattern is expected to vary; the majority of claims are expected to be paid at least 2 years from the occurrence date. The entity has estimated three payment patterns under each reasonably possible loss ratio: fast, medium, and slow.

Assumptions in loss scenario used to demonstrate risk transfer:

Estimated ultimate loss ratio: 120%

Estimated payment pattern (“medium” speed of payment):

Year 1	10%
Year 2	20%
Year 3	30%
Year 4	20%
Year 5	10%
Year 6	6%
Year 7	4%
	100%

Loss payments are made at the end of the year.

Premiums are received on the first day of the contract period.

Interest rate used: US Treasury yield curve

Cash flows:

Year	1/1/X1	12/31/X1	12/31/X2	12/31/X3	12/31/X4	12/31/X5	12/31/X6	12/31/X7	Total
Premium	\$2,000,000								\$2,000,000
Commission	(300,000)								(300,000)
Loss payments		(240,000)	(480,000)	(720,000)	(480,000)	(240,000)	(144,000)	(96,000)	(2,400,000)
Cash flows	\$1,700,000	(240,000)	(480,000)	(720,000)	(480,000)	(240,000)	(144,000)	(96,000)	(\$700,000)

Present value of cash flows:

	1/1/X1	12/31/X1	12/31/X2	12/31/X3	12/31/X4	12/31/X5	12/31/X6	12/31/X7	Total
US Treasury yield curve	0	3.525%	4.374%	4.872%	5.383%	5.893%	6.140%	6.386%	
Present value	\$1,700,000	(231,828)	(440,612)	(624,243)	(389,188)	(180,250)	(100,714)	(62,241)	(\$329,076)

Does this contract transfer significant risk?

Analysis

Assuming the contract has a valid business purpose, the evaluation of underwriting risk, timing risk, and reasonable possibility of a significant loss is as follows:

Does the contract have uncertainty in the ultimate amount of cash flows paid to P&C (has underwriting risk been transferred)? Yes. The contract has reasonable potential variability in loss payments. As discussed above, losses and adjustable premiums could vary from a best case of \$1,500,000 (annual premium multiplied by the 75% loss ratio) to a worst case of \$2,400,000 (annual premium multiplied by the 120% loss ratio). There are no other features that would serve to reduce variability.

Does the contract have uncertainty in the timing of cash flows paid and received by P&C (has timing risk been transferred)? Yes. The contract has an expected payout pattern of seven years with other reasonably possible scenarios. No provisions in the contract limit the timely reimbursement of losses.

Does the reinsurer have a reasonable possibility of a significant loss on the contract? Yes. An analysis of the expected cash flows reveals that a significant loss to the reinsurer would occur under a reasonably possible scenario.

Test:

Total present value of cash flows	(\$329,076)	
	<hr/>	
Total present value of amounts to be paid to reinsurer (gross)	\$2,000,000	= (16.5%) potential loss to reinsurer

An analysis of the expected cash flows of the contract is required to determine their expected present values under a number of different loss and payout assumptions. The loss scenario used in the test uses a loss ratio of 120%, which is at the high end of the range of reasonably possible loss ratios.

Since the entity has demonstrated that the reinsurer is exposed to the possibility of a significant loss under a reasonably possible scenario, no further tests are required. For illustrative purposes, however, the table below summarizes the results of other reasonably possible outcomes using other loss ratios in the range of loss ratios and faster and slower payment patterns.

	Loss ratio		
	75%	90%	120%
Payout	75%	90%	120%
Fast	19.3%	6.1%	(20.2%)
Medium	21.6%	8.9%	(15.5%)
Slow	24.3%	12.2%	(12.1%)

Since the contract transfers underwriting and timing risks and the reinsurer has a reasonable possibility of incurring a significant loss, the contract would be accounted for as reinsurance.

EXAMPLE IG 8-2**Risk transfer analysis of an excess of loss reinsurance contract with a retrospectively rated premium adjustment**

P&C Insurance Company enters into an excess of loss reinsurance contract that covers its general liability book of business and is expected to pay claims over the next seven years for losses occurring in the current year.

Cover: \$1,000,000 of loss per occurrence in excess of \$1,000,000

Annual Premium: \$2,000,000, subject to a retrospectively rated premium adjustment. The retrospectively rated premium is based on the combined ratio of the contract (losses plus commissions as compared to premiums). The adjustable feature has a minimum combined ratio of 100% and a maximum combined ratio of 130%. The RRP is payable beginning as of the end of year 5.

Commission: 15% of the premiums ceded

Loss Ratio: It is reasonably possible that the ultimate ratio on the contract could range from 75% of premiums ceded to 120% of premiums ceded.

Payment Pattern: The payment pattern is expected to vary; the majority of claims are expected to be paid at least 2 years from the occurrence date. The entity has estimated three payment patterns under each reasonably possible loss ratio: fast, medium, and slow.

Assumptions in loss scenario used to demonstrate risk transfer:

Estimated ultimate loss ratio 120%

Estimated payment pattern (“medium” speed of payment):

Year 1	10%
Year 2	20%
Year 3	30%
Year 4	20%
Year 5	10%
Year 6	6%
Year 7	4%
	100%

Loss payments are made at the end of the year.

Premiums are received on the first day of the contract period.

Interest rate used: US Treasury yield curve

Cash flows:

Year	1/1/X1	12/31/X1	12/31/X2	12/31/X3	12/31/X4	12/31/X5	12/31/X6	12/31/X7	Total
Premium	\$2,000,000								\$2,000,000
Commission	(300,000)								(300,000)
Loss payments		(240,000)	(480,000)	(720,000)	(480,000)	(240,000)	(144,000)	(96,000)	(2,400,000)
ADJ. Prem.:	Min					0	0	0	0
	Max					0	4,000	96,000	100,000*
Cash flows	\$1,700,000	(240,000)	(480,000)	(720,000)	(480,000)	(240,000)	(140,000)	0	(\$600,000)

*2,000,000 × (1.20 + .15 – 1.30)

Present value of cash flows:

Year	1/1/X1	12/31/X1	12/31/X2	12/31/X3	12/31/X4	12/31/X5	12/31/X6	12/31/X7	Total
US Treasury yield curve	0	3.525%	4.374%	4.872%	5.383%	5.893%	6.140%	6.386%	
Present value	\$1,700,000	(231,828)	(440,612)	(624,243)	(389,188)	(180,250)	(97,916)	0	(\$264,037)

Does this contract transfer significant risk?

Analysis

Assuming the contract has a valid business purpose, the evaluation of underwriting risk, timing risk and reasonable possibility of a significant loss is as follows:

Does the contract have uncertainty in the ultimate amount of cash flows paid to P&C (has underwriting risk been transferred)? Yes. The contract has reasonable potential variability in loss payments. Losses and adjustable premiums could vary from a best case of \$1,700,000 (annual premium multiplied by the 75% loss ratio plus retrospectively rated premium) to a worst case of \$2,300,000 (annual premium multiplied by the 120% loss ratio less a retrospectively rated premium adjustment). While the adjustable feature somewhat mitigates the amount of underwriting loss, a significant amount of variability is still present.

Does the contract have uncertainty in the timing of cash flows paid and received by P&C (has timing risk been transferred)? Yes. The contract has an expected payout pattern of seven years. No provisions in the contract limit the timely reimbursement of losses.

Does the reinsurer have a reasonable possibility of a significant loss on the contract? Yes. An analysis of the expected cash flows reveals that a significant loss to the reinsurer would occur under a reasonably possible scenario. Using the same loss and payout assumptions as Example IG 8-1 and adding the cash flows from the RRP. Since the combined ratio of the contract is greater than

130%, the maximum under the adjustable feature term, an additional premium of \$4,000 will be due the reinsurer at 12/31/X6 and an additional \$96,000 at 12/31/X7.

Test:

Total present value of cash flows	(\$264,037)	
	<hr/>	
Total present value of amounts to be paid to reinsurer (gross)	\$2,065,039	= (12.8%) potential loss to reinsurer

Since the entity has demonstrated that the reinsurer is exposed to the possibility of a significant loss under a reasonably possible scenario, no further tests are required. For illustrative purposes, however, the table below summarizes the results of other reasonably possible outcomes using other loss ratios in the range of expected loss ratios and faster and slower payment patterns.

	Loss ratio		
Payout	75%	90%	120%
Fast	11.4%	6.1%	(16.3%)
Medium	15.1%	8.9%	(12.8%)
Slow	16.0%	12.2%	(8.6%)

Although the variability of loss is somewhat reduced by the retrospectively rated premium, the reinsurer still has the potential for a significant loss under reasonably possible outcomes.

Since the contract transfers underwriting and timing risks and the reinsurer has a reasonable possibility of incurring a significant loss, the contract should be accounted for as reinsurance.

EXAMPLE IG 8-3

Risk transfer analysis of an excess of loss reinsurance contract with a retrospectively rated premium adjustment

P&C Insurance Company enters into an excess of loss reinsurance contract that covers its general liability book of business and is expected to pay claims over the next seven years for losses occurring in the current year.

Cover: \$1,000,000 of loss per occurrence in excess of \$1,000,000

Annual Premium: \$2,000,000, subject to a retrospectively rated premium adjustment. The contract has a retrospectively rated premium adjustment based on the combined ratio of the contract (losses plus commissions as compared to premiums). The adjustable feature has no minimum combined ratio and a maximum combined ratio of 110%. The RRP is payable beginning as of the end of year 5.

Commission: 15% of the premiums ceded

Loss Ratio: It is reasonably possible that the ultimate ratio on the contract could range from 75% of premiums ceded to 120% of premiums ceded.

Payment Pattern: The payment pattern is expected to vary; the majority of claims are expected to be paid at least 2 years from the occurrence date. The entity has estimated three payment patterns under each reasonably possible loss ratio: fast, medium, and slow.

Assumptions in loss scenario used to demonstrate risk transfer:

Estimated ultimate loss ratio 120%

Estimated payment pattern (“medium” speed of payment):

Year 1	10%
Year 2	20%
Year 3	30%
Year 4	20%
Year 5	10%
Year 6	6%
Year 7	4%
	100%

Loss payments are made at the end of the year.

Premiums are received on the first day of the contract period.

Interest rate used: US Treasury yield curve

Cash flows:

Year	1/1/X1	12/31/X1	12/31/X2	12/31/X3	12/31/X4	12/31/X5	12/31/X6	12/31/X7	Total
Premium	\$2,000,000								\$2,000,000
Commission	(300,000)								(300,000)
Loss payments		(240,000)	(480,000)	(720,000)	(480,000)	(240,000)	(144,000)	(96,000)	(2,400,000)
ADJ. Prem.:	Min					0	0	0	0
	Max					260,000	144,000	96,000	500,000*
Cash flows	\$1,700,000	(240,000)	(480,000)	(720,000)	(480,000)	20,000	0	0	(\$200,000)

*2,000,000 × (1.20 + .15 - 1.10)

Present value of cash flows:

Year	1/1/X1	12/31/X1	12/31/X2	12/31/X3	12/31/X4	12/31/X5	12/31/X6	12/31/X7	Total
US Treasury yield curve	0	3.525%	4.374%	4.872%	5.383%	5.893%	6.140%	6.386%	
Present value	\$1,700,000	(231,828)	(440,612)	(624,243)	(389,188)	15,021	0	0	\$29,150

Does this contract transfer significant risk?

Analysis

Assuming the contract has a valid business purpose, the evaluation of underwriting risk, timing risk and reasonable possibility of a significant loss is as follows:

Does the contract have uncertainty in the ultimate amount of cash flows paid to P&C (has underwriting risk been transferred)? Yes. The contract has reasonable potential variability in loss payments. As discussed above, losses and adjustable premiums could vary from a best case of \$1,500,000 (annual premium multiplied by the 75% loss ratio) to a worst case of \$1,900,000 (annual premium multiplied by the 120% loss ratio less a retrospectively rated premium adjustment). While the adjustable feature mitigates the amount of underwriting loss, a significant amount of variability is still present.

Does the contract have uncertainty in the timing of cash flows paid and received by P&C (has timing risk been transferred)? Yes. The contract has an expected payout pattern of seven years. No provisions in the contract limit the timely reimbursement of losses.

Does the reinsurer have a reasonable possibility of a significant loss on the contract? No. An analysis of the expected cash flows reveals there are no reasonably possible scenarios under which the reinsurer would incur a significant loss.

Test:

Total present value of cash flows	\$29,150	
Total present value of amounts to be paid to reinsurer (gross)	\$2,358,226	= 1.2% potential gain to reinsurer

The sum of the present value of all the expected cash flows using all of the assumptions presented above is a gain to the reinsurer of \$29,150.

Since the chosen loss scenario produced a gain, the entity would rerun the test using the other reasonably possible scenarios. The table below summarizes the results of other reasonably possible outcomes using other loss ratios in the range of loss ratios and faster and slower payment patterns.

Loss ratio			
Payout	75%	95%	120%
Fast	19.3%	1.7%	(2.0%)
Medium	21.6%	4.7%	1.2%
Slow	24.3%	8.1%	5.4%

The reinsurer has only insignificant exposure to loss under reasonably possible outcomes.

Since all of the risk-transfer tests have not been passed, the contract is accounted for as a deposit.

8.5.6 “Stepping in the shoes” exception – short-duration reinsurance

ASC 944-20-15-53 allows a limited exception to the requirement that a reinsurer have a reasonably possible chance of incurring a significant loss. Essentially, it permits a reinsurer to account for the assumed business under reinsurance accounting, without further quantitative risk transfer analysis, based on the premise that the economic nature of the reinsurance contract virtually matches the economic position of the insurer’s risk on the reinsured portions of the underlying insurance policies.

Excerpt from ASC 944-20-15-53

...the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. That condition is met only if insignificant insurance risk is retained by the ceding entity on the reinsured portions of the underlying insurance contracts. The assessment of that condition shall be made by comparing both of the following:

- a. the net cash flows of the reinsurer under the reinsurance contract
- b. the net cash flows of the ceding entity on the reinsured portions of the underlying insurance contracts.

No more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the cedant, and the reinsurer’s economic position must be virtually equivalent to having written the relevant portions of the reinsured contracts directly. If the economic position of the reinsurer relative to the insurer cannot be determined, the contract would not qualify for the scope exception.

Examples of contracts that may meet the “stepping in the shoes” exception include straightforward quota share contracts with an inception at the beginning of the underwriting year and most facultative reinsurance. Fronting arrangements would also likely meet the spirit of the exception. However, the existence of loss ratio caps, retrospective rating provisions, adjustable ceding commissions, excess provisions, or other risk-limiting features could violate the virtually equivalent economic position criteria.

Question IG 8-5 addresses the impact of differences between a ceding commission and the direct acquisition costs on the “stepping in the shoes” exception to risk transfer.

Question IG 8-5

Ceding Company entered into a quota share reinsurance contract with Assuming Company.

To what extent do differences between a ceding commission and the direct acquisition costs incurred by Ceding Company related to the portions of underlying contracts reinsured impact the “stepping in the shoes” exception to risk transfer? For instance, assume the ceding commission is 25% and the portion of direct acquisition costs incurred by the insurer is 35%.

PwC response

The variance in the ceding commission could prohibit application of the “stepping in the shoes” exception. Although the commission on a “pure” quota share contract is the only area allowing for negotiation between the two parties, a commission less than the portion of direct acquisition costs incurred by the insurer could mean the reinsurer has not assumed “substantially all” of the insurance risk related to the underlying insurance contracts.

Ceding Company may incur an underwriting loss on the direct policies but Assuming Company could still recognize a profit on the reinsurance contract based on the excess ceding commission. Alternatively, if Assuming Company assumed all of the insurance risk, as well as some additional risk, an excess ceding commission may not be an issue.

Failing this exception does not automatically fail the risk transfer assessment, but a full analysis of the reinsurance contract and consideration of all contract provisions would be required.

8.5.7 “Reasonably self-evident” risk transfer – short-duration reinsurance

The phrase “reasonably self-evident” risk transfer has been developed in the sector to address certain reinsurance contracts that do not require cash flow projections and present value calculations to determine that risk has been transferred under the contract. This term arose from US statutory guidance around risk transfer documentation requirements, with such guidance clarifying that documentation of risk transfer is only required to be maintained when risk transfer is not self-evident. Reporting entities generally use this concept when applying US GAAP as well.

The concept of “reasonably self-evident” is meant to address certain reinsurance contracts where the fundamental structure and substance of the contract would obviously result in compliance with the criteria defined in IG 8.5.2 above. Agreements that have reasonably self-evident risk transfer typically have a potential loss to the reinsurer much larger than the premium for the coverage provided, terms and conditions of coverage are standard for the class of business being reinsured, and the contract does not include provisions that enable the reinsurer to recover all or a significant portion of the covered losses.

8.6 *Retroactive vs. prospective short-duration reinsurance*

Once it is determined that the contract passes significant insurance risk, the next step is to evaluate whether the contract is prospective or retroactive.

The determination of whether the contract reinsures future versus past insurable events is the key deciding factor in determining the appropriate accounting treatment. ASC 944-20-20 provides the following definitions of prospective and retroactive reinsurance.

Definitions from ASC 944-20-20

Prospective Reinsurance: Reinsurance in which an assuming entity agrees to reimburse a ceding entity for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

Retroactive Reinsurance: Reinsurance in which an assuming entity agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

It is common industry practice to sign final contracts after the effective date of the coverage. The determination of whether past insurable events are covered should be based on the date on which there is a documented binding agreement on the significant terms of the contract, which may be different than the date the final contract is signed or the effective date specified in the contract.

Question IG 8-6 addresses the accounting for a reinsurance contract for changes occurring between the effective date and the date the contract was signed.

Question IG 8-6

A quota share reinsurance contract with a January 1, 20X6 effective date was first drafted in December 20X5 and signed on May 15, 20X6. All significant terms of the contract remained unchanged from the first draft to the final signed agreement, other than the addition of a new profit commission clause added just prior to the signing of the contract.

What is the appropriate accounting for the reinsurance contract?

PwC response

If the reinsurer is not obligated to consummate the transaction then it is not binding. The negotiation of a profit commission is a significant term of a reinsurance contract that changes the economics of the agreement between the ceding and assuming entities. For instance, the performance of the underlying policies subject to the reinsurance contract to date may have been considered in the negotiation of the profit commission. As a result, the contract should be treated as retroactive, at a minimum, for all activity occurring between the effective date and the date the contract was signed.

8.6.1 *Contracts with both prospective and retroactive provisions*

Reinsurance contracts may contain both prospective and retroactive provisions. ASC 944-605-25-21 requires that, if it is practicable, the insurer should separate the contract into its prospective and retroactive components and apply the requisite accounting to each component.

There is no prescribed method to allocate reinsurance premiums to the prospective and retrospective portions of the contract. If it is impracticable for the ceding insurer to determine what portion of the contract is prospective and retroactive, then the contract is required to be accounted for as a retroactive contract. In a quota share reinsurance contract (as in Question IG 8-6), the premium associated with the direct policies subject to the contract prior to the signing date could be a practical way to separate the retroactive reinsurance. The allocation becomes more difficult in reinsurance contracts with stated premium amounts as of the effective date, typical in aggregate non-proportional contracts, such as excess of loss and facultative contracts.

Question IG 8-7 addresses the accounting treatment for a reinsurance contract that covers insurance contracts with effective dates after the reinsurance contract date.

Question IG 8-7

A one-year aggregate excess of loss reinsurance contract with a January 1, 20X6 effective date was drafted, negotiated, and signed on May 15, 20X6. The underlying insurance policies subject to the excess of loss contract relate to property exposures in various global geographic locations. The premium amount in the contract is a single fixed amount.

What is the appropriate accounting for the reinsurance contract?

PwC response

As the significant terms of the contract were negotiated subsequent to the effective date of the policy, at a minimum, a portion of the contract should be accounted for as retroactive. As this is an aggregate excess of loss reinsurance contract, losses have been accumulating between the effective date and the date the contract was signed. Since the premium is a single fixed amount, it is impractical to determine the portion applicable to the prospective period. As such, the entire contract should be accounted for as retroactive.

8.6.2 *Prospective reinsurance accounting for ceding entities*

If the contract passes significant insurance risk and is prospective, prospective reinsurance accounting should be applied. Prospective reinsurance accounting directly offsets the underwriting results of the direct contracts covered by the reinsurance contract.

The ceding entity will generally record the full premium as a prepaid reinsurance premium (often reported as ceded unearned premium reserve (ceded UPR)) and expense the amount over the contract period or the term of the reinsured policies, assuming the full premium associated with the contract is non-cancellable. Example IG 8-4 and Example IG 8-5 illustrate the accounting by the ceding entity, depending on the type of reinsurance contract.

Example IG 8-4 illustrates the accounting for ceded premium associated with an excess of loss reinsurance contract and Example IG 8-5 shows the accounting for ceded premium associated with a quota share reinsurance contract.

EXAMPLE IG 8-4

Accounting for ceded premium associated with an excess of loss reinsurance contract

Ceding Company entered into a one-year excess of loss contract with Assuming Company covering catastrophic wind loss exposure emanating from its in force US property division. The contract passes the risk transfer criteria, and was finalized and signed the same day as its effective date of January 1, 20X6. The premium is \$1.2 million payable at inception. During the exposure period, no losses occurred in excess of the attachment point of the reinsurance contract. The contract is non-cancellable.

How should Ceding Company record the contract at inception, as well as in its March 31, 20X6 quarterly financial statements?

Analysis

At inception, Ceding Company would record the following journal entry.

Dr. Ceded UPR (prepaid reinsurance asset)	\$1,200,000	
Cr. Cash		\$1,200,000

The premium associated with non-proportional reinsurance contracts should be recognized over the contract period. The pattern of recognition of ceded UPR should match Ceding Company's policy for recognition of covered direct earned premium, in this case, assumed to be straight line.

As of March 31, 20X6, Ceding Company would record the following journal entry to reflect one quarter of amortization.

Dr. Change in ceded UPR (contra revenue)	\$300,000	
Cr. Ceded UPR		\$300,000

EXAMPLE IG 8-5

Accounting for ceded premium associated with a quota share reinsurance contract

Ceding Company entered into a one year 40% quota share contract with Assuming Company reinsuring all personal auto policies underwritten. The contract passes the risk transfer criteria, and was finalized and signed the same day as its effective date of May 1, 20X6. The direct auto policies' premium underwritten during May and June were \$800k and \$600k, respectively. As these policies have effective dates distributed evenly throughout the year, the Ceding Company assumed a mid-month convention in reporting ceded UPR. Ceding Company remits cash to Assuming Company each month.

How should Ceding Company record the ceded premium of the reinsurance contract?

Analysis

As of May 31, Ceding Company would record the following journal entries.

Dr. Ceded UPR ($\$800,000 \times 40\%$)	\$320,000
Cr. Cash	\$320,000
Dr. Ceded earned premium (contra revenue) ($\$320,000 \div 12$) \div 2 (mid-month convention)	\$13,000
Cr. Ceded UPR	\$13,000

In June, Ceded Company would record Ceded UPR of \$240 ($\$600 \times 40\%$) and \$37 of Ceded earned premium, calculated as \$27k for May ($\$320 \div 12$) and \$10k for June ($(\$240 \div 12) \div 2$).

Although not reflected in this example, losses associated with the underlying policies would be ceded to Assuming Company at the 40% participation percentage. For example, if \$10k of claims expense was recorded relating to the underlying auto policies subject to the reinsurance contract, Ceding Company would record a reinsurance recoverable of \$4k, partially offsetting the \$10k claims expense in the income statement.

8.6.2.1 *Minimum premiums/installments – short-duration reinsurance*

Often, reinsurance contracts contain provisions whereby the annual premium amount is estimated at contract inception, but will ultimately vary based on exposure or loss experience. See IG 8.8 for contracts with ceded premium adjusted based on loss experience.

Contracts with exposure-based premium adjustments will typically adjust the premium amount based on the amount of premium related to the underlying policies (subject base premium) that subsequently attach to the reinsurance contract. At inception, the estimated premium amount will be based on the ceding entity's estimated direct policy premium. However, these contracts typically have a minimum premium, so that even if no policies are underwritten that attach to the reinsurance contract, the ceded premium would not adjust below the stated minimum premium amount.

For these types of contracts, the ceding entity should record the full estimated premium at contract inception. As the underwriting year progresses, the ceding entity should monitor the subject base premium associated with the reinsurance contract, and adjust the ceded premium upward or downward (but not below the minimum premium), pursuant to the contract.

In addition, these contracts may contain quarterly installment payments, either corresponding to the estimated premium or minimum premium amounts. It would not be appropriate to simply record the quarterly payments as ceded premium earned each quarter, with no corresponding unearned, if the contract was not cancellable. Ceded premium recognition should not be based on premium payment schedules, but on estimated premium amounts.

If rather than entering into a reinsurance contract with an annual term, an insurance entity entered into a multi-year short duration reinsurance contract whereby there is a stated premium, payable in

equal annual installments, no minimum premium and cancellable by either party, there would be a basis for only recording the ceded premium each year.

Question IG 8-8 addresses the recognition of ceded premium for a contract with a payment schedule determined based on the minimum premium amount.

Question IG 8-8

Ceding Company entered into a one-year aggregate excess of loss contract on January 1, 20X6. Ceding Company reinsures its US homeowners' insurance portfolio written in January 20X6 with a contract that was negotiated and effective on January 1, 20X6. The contract passes the risk transfer criteria.

The contract has an estimated premium of \$1.2 million and a minimum premium of \$1 million. The contract states that Ceding Company will pay Assuming Company quarterly premium based on the minimum premium, and the final true-up of premium will be settled in the first quarter of 20X7 based on final expected exposure.

How should Ceding Company recognize ceded premium during 20X6?

PwC response

Ceding Company should record the full estimated premium of \$1.2 million on Day 1 as ceded unearned premium and recognize expense (contra revenue) ratably throughout the year. Even though a payment schedule has been determined based on the minimum premium amount, the year's expense should be based on the estimated premium in the contract of \$1.2 million.

Example IG 8-6 illustrates the accounting for a reinsurance contract with a premium adjustment clause.

EXAMPLE IG 8-6

Accounting for a contract containing a premium adjustment clause

Ceding Company entered into a one-year, non-cancellable aggregate excess of loss contract on January 1, 20X6 with Assuming Company covering catastrophic wind loss exposure emanating from its in force US homeowners property division during calendar year 20X6. The contract passes risk transfer.

The contract has a premium adjustment clause as follows:

- Minimum premium: \$1 million
- If the premium associated with the policies attaching to the reinsurance agreement exceed \$10 million, the premium will increase by \$50,000 for each additional \$1 million of subject base premium in excess of \$10 million.

Based on the average premium of the direct policies over the previous three years of \$12.5 million, both the Ceding and Assuming Company agreed to an estimated premium of \$1.1 million at contract inception. Ceding Company recorded the \$1.1 million as Ceded premium at contract inception to be expensed ratably over the contract period. The contract has a funds withheld clause.

During the first six months of the year, Ceding Company's subject base premium associated with this contract was \$8 million, and the Company expects the subject base premium to continue at this pace for the duration of the year.

What entries should Ceding Company record as of June 30, 20X6?

Analysis

As of June 30, Ceding Company would record the following journal entries.

Dr. Ceded UPR (asset)	\$100,000	
Dr. Ceded premium earned (contra revenue)	\$100,000	
Cr. Funds withheld payable		\$200,000

This would reflect the fact that Ceding Company is projecting \$16 million of subject base premium for the full year, which based on the contract clause, would entitle the reinsurer to a total ceded premium of \$1.3 million. As \$1.1 million of ceded UPR was recorded as of January 1, 20X6, Ceding Company would true-up the ceded UPR to reflect the newly estimated Ceded premium amount. However, since 50% of the exposure period has elapsed, \$100k of Ceded UPR was expensed immediately and the remaining \$100k would be recognized ratably throughout the remainder of 20X6.

If instead, during the first six months of the year, Ceding Company's subject base premium associated with this contract was \$4 million, and the Company expected the subject base premium to continue at that pace for the duration of the year, Ceding Company would have recorded the following entry as of June 30, 20X6.

Dr. Funds withheld payable	\$100,000	
Cr. Ceded premium earned (contra revenue)		\$50,000
Cr. Ceded UPR (asset)		\$50,000

Because Ceding Company was projecting \$8 million of subject base premium for the full year, the reinsurer would have been entitled to a total ceded premium of \$1 million, as the subject base premium would be below the minimum. As \$1.1 million was recorded as of January 1, 20X6, Ceding Company would need to true-up the ceded premium earned and remaining ceded premium UPR to reflect the new estimate.

8.6.2.2 *Written premium – short-duration reinsurance*

Many entities present written premium as an income statement amount used to measure sales effort in the period. As this is not GAAP earned revenue, another financial statement line item, change in unearned premium, is presented to reconcile to GAAP earned revenue. These entities also present ceded written premium and change in ceded written premium accounts that reduce a direct written premium and change in direct written premium accounts in the income statement for ceded reinsurance activity. The net impact of these amounts is \$0, as the Ceded written premium expense

offsets the impact of the Change in ceded UPR in the income statement, resulting in an earned premium revenue amount net of earned ceded premium.

As these amounts are non-GAAP, there is no guidance regarding their presentation. Diversity exists on the amount of future earned premium included in written premium. Many reinsurance contracts have payment clauses that allow for quarterly remittance, often allowing the ceding entity the ability to cancel. Some ceding entities have therefore established a practice of recording the quarterly installments as Ceded written premium with no Ceded UPR. Reporting entities should determine which method corresponds best with the economics and business purpose of the reinsurance contract, as well as to the exposure of the underlying direct policies, and apply the method consistently.

8.6.3 *Retroactive reinsurance accounting by ceding entities*

Retroactive reinsurance accounting applies when a reinsurance contract transfers significant risk and the contract premium, in part or in its entirety, relates to reinsured losses of past insurable events. Retroactive reinsurance accounting is applied to the premium relating to the past insurable events. When only part of the contract premium relates to past insurable events, the ceding entity should split the premium into retroactive and prospective components, unless impracticable. Common examples of retroactive reinsurance contracts are loss portfolio transfers and agreements that cover potential adverse development on currently carried loss reserves, known as adverse development covers or “ADCs.”

Retroactive reinsurance is accounted for as a financing of existing obligations and as a result, most cash flows associated with the contract are recognized as deposits on the balance sheet. The income statement benefits are recognized ratably over the life of the contract in contrast to matching any accounting for covered direct policies. The ceded premium and ceded benefits applicable to prospective reinsurance accounting are not presented. The accounting result is similar to accounting for a financial instrument; the economic benefit of transferring the risk of future changes in the covered insurance obligation is not recognized immediately. Subsequent changes in the covered obligation are not immediately offset in the period of the change. Any initial gains and any benefits due from a reinsurer as a result of any subsequent adverse development are deferred, and any premium payments to the reinsurer in excess of direct insurance liabilities are immediately recognized as a loss.

8.6.3.1 *Payment to reinsurer exceeds retroactive reinsured liabilities*

If the amounts paid to the reinsurer exceed the recorded liabilities for covered claims, ASC 944-605-25-23 requires the ceding entity to either increase the related covered claims liabilities or reduce the reinsurance recoverable (or both) at the inception of the reinsurance contract, with the offset to earnings. Determining whether the reinsurance recoverable is reduced or the ceding entity’s related claim liabilities are increased depends on the facts and circumstances. Generally, increasing the ceding entity’s liabilities would be appropriate, as the reinsurance premium is an indicator of estimated future payments on the claims. Increasing the liability reflects the expense as a claims expense in the income statement. Alternatively, the excess could solely reflect the compensation for the uncertainty of future claims development, which is not being measured in a best estimate claim liability. In this case, the receivable could be reduced, but the charge is still to earnings.

8.6.3.2 *Retroactive reinsured liabilities exceed payments to reinsurer*

When claims liabilities are measured on an undiscounted basis, the reinsurance premium negotiated between the parties will often reflect the present value of the expected future claim payments and will be less than the undiscounted recorded reinsured liabilities. To the extent that the reinsured liabilities are in excess of the amounts paid to the reinsurer, the ceding entity would record the excess as a deferred gain. The deferred gain would be amortized using either the interest method or the recovery method over the estimated remaining settlement period. The interest method is used when the amounts and timing of the reinsurance recoveries can be reasonably estimated. In this method, the deferred gain is amortized using the effective interest rate inherent in the amount paid to the reinsurer.

When the amount and timing of the reinsurance recoveries are uncertain, the recovery method should be used. Under the recovery method, the deferred gain is reduced based on the ratio of actual recoveries to total expected recoveries. Example IG 8-7 and Example IG 8-8 illustrate the recovery and interest methods.

Determining whether the amount and timing of reinsurance recoveries can be reasonably estimated in order to determine the amortization method requires judgment. If the future claim amounts or timing are highly unpredictable and the liability reserve estimate is based on a diverse set of scenarios with no good “baseline” emerging as having some significant likelihood of occurring, it may be difficult to demonstrate the “reasonable estimated” criteria. Alternatively, the discounting of underlying claim liabilities would be evidence that the amount and timing are reasonably estimable. Although, the reasonably estimable criteria may be met even if the claim liabilities are not discounted (see ASC 944-20-S99-1).

8.6.3.3 *Retroactive reinsurance - subsequent recognition*

Changes in the estimated amount of the direct reinsured liabilities are recognized immediately in the period of the change. Figure IG 8-6 summarizes the manner in which subsequent movements in the reinsured liabilities are recognized pursuant to ASC 944-605-35-12 and ASC 944-605-35-13.

Figure IG 8-6
Subsequent measurement of retroactive balances

Day 1 accounting	Subsequent liability movement	Subsequent accounting
Deferred gain (i.e., reinsured liabilities exceed amounts paid)	Adverse development	<input type="checkbox"/> Increase the reinsurance recoverable in the amount of the adverse development
		<input type="checkbox"/> Increase the deferred gain for the same amount
	Favorable development	<input type="checkbox"/> Decrease the reinsurance recoverable in the amount of the favorable development
		<input type="checkbox"/> Decrease the deferred gain for the same amount
		<input type="checkbox"/> If the decrease in the reinsurance recoverable is in excess of the deferred gain, reduce the deferred

Day 1 accounting	Subsequent liability movement	Subsequent accounting
		gain to zero and immediately expense any remaining amount of the decrease
Loss (i.e., amounts paid exceed reinsured liabilities)	Adverse development	<input type="checkbox"/> Increase the reinsurance recoverable in the amount of the adverse development <input type="checkbox"/> Reverse the loss initially recorded to the extent of the increase in the reinsurance recoverable <input type="checkbox"/> Once all previously recorded losses have been reversed, defer any resulting gains
	Favorable development	<input type="checkbox"/> Decrease the reinsurance recoverable in the amount of the favorable development <input type="checkbox"/> Record this additional loss immediately

When a deferred gain is recorded, subsequent changes to the underlying liabilities associated with the retroactive reinsurance contract (i.e., either adverse or favorable development), the amount of the deferred gain should be adjusted and a cumulative amortization adjustment recognized in the income statement. In the reporting period in which the adverse or favorable development is recognized, the deferred gain would be adjusted to reflect what the gain would have been at inception of the reinsurance contract had the reserve development been known at that time. Under both the interest and recovery methods, a recalculation of the experience to date is performed and a cumulative amortization adjustment in the income statement is recognized based on the new deferred gain balance.

The guidance does not specify a required presentation in the statement of net income of any losses or amortization of the deferred gain relating to retroactive reinsurance. In practice, we have seen cedants record day 1 losses as ceded premium or as an adjustment to losses incurred, depending on whether the corresponding entry for the loss is a decrease to the reinsurance recoverable or an increase in the direct liability. Deferred gain amortization is typically recorded in underwriting income, often as a reduction to incurred losses.

The retroactive reinsurance model may need to be applied in situations when the underlying claim liabilities and the reinsurance recoverable are discounted. In such cases, the retrospective catch up adjustment would need to be made when there is a change in the timing or amount of expected future cash flows, but also when there is a change in the discount rate used to discount the recoverable, which should mirror the underlying direct liabilities.

EXAMPLE IG 8-7

The recovery method of amortization of a deferred gain

As of December 31, 20X6, Ceding Company has an unpaid losses incurred (i.e., case and IBNR) liability of \$250k. On January 1, 20X7, Ceding Company enters into a retroactive reinsurance agreement with Assuming Company. For a premium of \$200k, Assuming Company agrees to

indemnify Ceding Company for the unpaid incurred losses on this block of business. Ceding Company has determined that the contract passes risk transfer and therefore, qualifies for reinsurance accounting. Ceding Company is unable to reasonably estimate the timing of the recoveries on this block of business, and will therefore use the recovery method to amortize the expected gain on the transaction.

During 20X7 and 20X8, Ceding Company paid \$40k and \$30k, respectively, to the insureds relating to the liabilities ceded to Assuming Company. Ceding Company recognized \$100k of adverse development at the end of 20X7.

What journal entries should Ceding Company record for this reinsurance contract at inception, as well as during 20X7 and 20X8?

Analysis

At the inception of the contract, Ceding Company would record the following entry (\$ '000s):

Dr. Reinsurance recoverable	\$250,000	
Cr. Cash		\$200,000
Cr. Deferred gain		\$50,000

Ceding Company would record the following entry for the \$40k of reinsurance recoveries received during 20X7.

Dr. Cash	\$40,000	
Cr. Reinsurance recoverable		\$40,000
Dr. Deferred gain	\$8,000	
Cr. Underwriting gain/other income		\$8,000

The amortization of the deferred gain was calculated using the recovery method. \$40k losses recovered divided by total expected recovery of \$250k (16%) multiplied by the deferred gain of \$50k.

The adverse development at the end of 20X7 would cause the amount of deferred gain and the amortization rate to be recalculated. In December 31, 20X7, Ceding Company would record the following entry to reflect the \$100k of adverse development.

Dr. Underwriting loss	\$100,000	
Cr. Loss reserves		\$100,000
Dr. Reinsurance recoverable	\$100,000	
Cr. Deferred gain		\$100,000

In addition, Ceding Company would record the following entry to record a cumulative adjustment on the deferred gain.

Dr. Deferred gain	\$9,000	
Cr. Underwriting gain /other income		\$9,000

The adjustment to the deferred gain was calculated using the recovery method. \$40k cumulative losses recovered divided by the new total expected recovery of \$350k (11.4%) multiplied by the new deferred gain of \$150k is a new total amortization of \$17. As Ceding Company previously recognized \$8k, the additional deferred gain amortization is \$9k.

Ceding Company would record the following entry for the \$30k of reinsurance recoveries received during 20X8.

Dr. Cash	\$30,000	
Cr. Reinsurance receivables		\$30,000
Dr. Deferred gain	\$13,000	
Cr. Underwriting gain/other income		\$13,000

The new total amortization of the deferred gain is the \$70k cumulative losses recovered divided by the total expected recovery of \$350k (20%) multiplied by the total deferred gain of \$150k, which is a cumulative gain of \$30k. As Ceding Company previously recognized \$17k, the additional deferred gain amortization is \$13k.

EXAMPLE IG 8-8

The interest method of amortization of a deferred gain

As of December 31, 20X6, Ceding Company has an unpaid losses incurred (i.e., case and IBNR) liability of \$250k. On January 1, 20X7, Ceding Company enters into a retroactive stop loss reinsurance agreement with Assuming Company. For a premium of \$200k, Assuming Company agrees to indemnify Ceding Company for the unpaid losses incurred on this block of business. Ceding Company has determined that the contract passes risk transfer and, therefore, qualifies for reinsurance accounting.

On the date of entering into the contract, Ceding Company expects to receive \$50k of claim payments in each of the subsequent five years. The premium paid to Assuming Company assumes a discount factor of 7.93%. As the amounts and timing of recoveries can be reasonably estimated, the interest method will be used to amortize the deferred gain.

At the inception of the contract, Ceding Company records the same entry as that under the recovery method in Example IG 8-7.

What journal entries should Ceding Company record each year, assuming there are no changes to the timing of the claim payments?

Analysis

For the next five years, Ceding Company will amortize the deferred gain using the interest method. Amortization, assuming a 7.93% discount rate, would be as follows:

Date	Unpaid losses liability	Present value of remaining claim payments*	Unamortized deferred gain	Annual amortization
1/1/X7	\$250,000	\$200,000	\$50,000	\$0
12/31/X7	\$200,000	\$165,865	\$34,135	\$15,865
12/31/X8	\$150,000	\$129,018	\$20,982	\$13,153
12/31/X9	\$100,000	\$89,249	\$10,751	\$10,231
12/31/X0	\$50,000	\$46,326	\$3,674	\$7,077
12/31/X1	\$0	\$0	\$0	\$3,674

* Calculated by taking the present value of an annuity at the end of N years.

The journal entry to record the subsequent recovery as of December 31, 20X7 and to amortize the gain would be as follows.

Dr. Cash	\$50,000	
Cr. Reinsurance receivables		\$50,000
Dr. Deferred gain	\$15,865	
Cr. Underwriting gain/other income		\$15,865

An identical entry would be made each year for the remainder of the settlement period using the above amortization schedule. Changes in the estimated amount of the liabilities relating to the underlying reinsured contracts would be recognized in earnings in the period of change. When changes in the estimated amount recoverable or the timing of receipts related to that amount occur, a cumulative amortization adjustment should be recognized in earnings in the period of the change so that the deferred gain reflects the balance that would have existed had the revised estimate been available at inception, including a new implied interest rate.

Question IG 8-9 addresses the accounting for reinsurance cash premiums received from affiliated entities in the separate financial statements of an assuming entity.

Question IG 8-9

Assuming Company enters into a loss portfolio transfer with its parent and affiliates, assuming workers' compensation liability for several prior loss periods. The premiums paid by the parent and affiliates to Assuming Company for the policy exceed the best estimate of the ultimate liability assumed. The contract passes risk transfer and will be accounted for as retroactive.

Should the difference between the cash received and the liability assumed be accounted for in the separate financial statement of Assuming Company as a capital contribution?

PwC response

The accounting should reflect the terms of the contract, rather than automatically being recorded as a capital contribution. This transaction is not a "transfer" of an asset or a liability in accordance with ASC 860, *Transfers and Servicing*, but rather an insurance contract between related parties. Because ASC 850, *Related Party Disclosures*, does not require imputation of arms length terms in related party transactions, in most circumstances, the insurer should not impute a capital contribution for the difference between the liability assumed and the cash received in its separate company financial statements. Robust disclosure of the related party transaction should be included in the notes to the financial statements, as required by ASC 850.

8.7 *Deposit accounting contracts – short-duration reinsurance*

When a contract does not transfer significant insurance risk due to risk-limiting features or other reasons, the entire reinsurance contract must be accounted for using deposit accounting. ASC 340-30-05-2 requires the transfer of significant insurance risk to include both timing risk and underwriting risk. As a result, there are four possible categories used to classify deposit contracts.

- A contract that transfers only significant timing risk (see IG 8.7.1)
- A contract that transfers only significant underwriting risk (see IG 8.7.2)
- A contract that transfers neither significant timing nor significant underwriting risk (see IG 8.7.1)
- A contract with indeterminate risk (see IG 8.7.3)

For a contract to be considered to have transferred significant timing risk, the timing of the loss reimbursement under the contract must be based on the timing of the loss event. For a contract to be considered to have transferred significant underwriting risk, the probability of a significant variation in the amount of payments under the contract must be more than remote. Both the ceding and assuming entity in a reinsurance contract are required to apply the deposit accounting guidance. Under deposit accounting, the contract is recorded as a financing, with no impact on premiums, losses incurred, or related insurance income statement ratios.

At inception, a reporting entity would record a deposit asset or liability based upon the consideration paid or received, less any explicitly identified premiums or fees to be retained by the reinsurer, irrespective of the experience of the contract. These are typically called nonrefundable fees. The deposit assets and liabilities should be reported on a gross basis, unless the right of setoff exists per

ASC 210-20, *Balance Sheet Offsetting*. The subsequent measurement of the deposits varies based on the category of deposit contract.

8.7.1 *Deposit accounting when underwriting risk is not transferred*

When a contract transfers only significant timing risk or transfers neither significant timing nor significant underwriting risk, the recorded deposit asset or liability is accreted in subsequent reporting periods using the interest method. The effective yield is calculated using the estimated amount and timing of cash flows. If a difference arises between actual and estimated future cash flows, a new effective yield should be calculated to reflect the revised actual and estimated future cash flows. The prior deposit balance would be adjusted to the amount that would have existed had the new effective yield been applied from inception of the contract. A corresponding charge or credit to interest income or expense would be recognized.

Given the nature of these contracts, changes in the expected amount of cash flows are unlikely. If the variations are significant, the entity should reassess whether the contract has significant underwriting risk. A contract that is subsequently determined to transfer significant underwriting risk should be accounted for as a contract that only transfers significant underwriting risk (see IG 8.7.2). The contract cannot be reclassified as risk transfer reinsurance if it was originally determined that deposit accounting was appropriate.

8.7.2 *Deposit accounting – transfers of significant underwriting risk*

Delayed reimbursement features, floating limits, and other timing delays will cause a contract to fail risk transfer but can still transfer significant underwriting risk. The deposit asset or liability for contracts that transfer only significant underwriting risk should be subsequently measured based upon the unexpired portion of the coverage provided until a loss is incurred. Once a loss is incurred that will be reimbursed under the contract, the deposit asset or liability should be measured at the present value of the expected future cash flows arising from the contract plus the remaining portion of the deposit asset or liability related to the unexpired coverage provided. See ASC 340-30-55-8 for an example of this accounting.

The ceding entity should measure the present value of expected future cash flows component of the deposit asset using the current rate on US government obligations (the risk free rate) with similar cash flow characteristics. The assuming entity is also required to use the current rate on US government obligations with similar cash flow characteristics in estimating the deposit liability. In either case, an individual rate must be established at the date each loss is incurred and used for the remaining life of the contract, and is not updated to current rates. As the use of individual rates might be burdensome, the use of average rates is permitted if numerous losses occur.

8.7.3 *Deposit accounting – indeterminate risk*

Contracts with indeterminate risk are accounted for under the open-year method. The open-year method is required when ultimate underwriting results cannot be reasonably estimated. Under the open-year method, nothing is recognized in the income statement until sufficient information becomes available to reasonably estimate and allocate premiums. Cash received or paid is accumulated and reported in the balance sheet as an aggregated underwriting deposit balance. ASC 340-30-25-5 states that, while an underwriting balance must be accumulated, the open-year method cannot be used to defer losses that otherwise would be recognized under ASC 450-20, *Loss contingencies*.

When sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk is required to be reclassified into one of the other three categories of deposit contracts. The change in deposit assets and liabilities that result when sufficient information becomes available is treated as a change in accounting estimate.

8.7.4 *Deposit accounting – nonrefundable fees*

Nonrefundable fees are not included as part of the initial deposit and are recognized based on the terms of the contract. Reporting entities should consider whether it would be more appropriate to amortize the nonrefundable fee over the coverage period or the settlement period. If the contract has timing risk, it may be more appropriate to amortize the fee over the settlement period. However, if the contract has underwriting risk, it may be appropriate to amortize the fee over the coverage period. The amortization should not be included as part of premium revenue or premium revenue ceded.

8.8 *Multiple-year retrospectively rated reinsurance contracts*

A multiple-year retrospectively rated reinsurance contract (RRC) has features in which events in one period of the contract create rights and obligations in another. A funded catastrophe cover is a common example of these types of contracts. Economically, the contract features decrease the overall risk covered under a contract and fund some of claim payments in a period under the contract with obligations to pay more cash in the future, or result in the loss of an experience refund asset that would have been owed in the future. RRC accounting recognizes the new obligations (or loss of assets) in the period of the loss experience rather than smoothly over the life of the contract.

RRCs provide for at least one of the following based on contract experience:

- Changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding enterprise
- Changes in the contract's future coverage

A critical distinguishing feature of these contracts is that part or all of the retrospective rating provision is obligatory, such that the retrospective rating provision creates rights and obligations for cash in the future as a result of past events. Experience refund accounts and obligatory reinstatement premiums would be examples of such features.

Although the guidance refers to multiple-year contracts, the concepts may also be applicable in quarterly reporting of yearly contracts.

8.8.1 *Scope for retrospectively rated reinsurance contracts accounting*

RRCs are accounted for using deposit accounting unless the three criteria in ASC 944-20-15-55 are met.

Excerpt from ASC 944-20-15-55

To be accounted for as reinsurance, a contract that reinsures risks arising from short-duration insurance contracts must meet all of the following conditions:

- a. The contract shall qualify as a short-duration contract under paragraph 944-20-15-7.
- b. The contract shall not contain features that prevent the risk transfer criteria in this Subsection from being reasonably applied and those risk transfer criteria shall be met.
- c. The ultimate premium expected to be paid or received under the contract shall be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraphs 944-605-25-2 and 944-605-35-8.

If any of these conditions are not met, a deposit method of accounting shall be applied by the ceding and assuming entities.

The reinsurer's accounting should be symmetrical to that of the ceding insurer although estimates of incurred losses could be different.

8.8.1.1 *Classification of retrospectively rated reinsurance contracts*

Short-duration considers the length of the underlying covered insurance contracts and the length of the reinsurance contract itself. In practice, contracts with a term longer than three to five years are not considered short duration. RRCs with a term of three years or less typically qualify as short-duration. Longer term contracts require judgment and analysis to classify as long or short duration. In addition, the longer the term of a contract with a retrospective adjustment provision, the less likely it transfers significant insurance risk. Contracts that were negotiated separately for each underwriting year could have a feature within each contract (such as an experience refund or profit commission) linking these contracts together. This could lead to a contract that has a stated term of one year but, because of the contractual feature, may actually be a multi-year contract.

8.8.1.2 *Indeterminate cash flows for retrospectively rated contracts*

An RRC must not contain features that prevent an entity from applying the risk transfer criteria. The ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided. In assessing risk transfer in RRCs, an analysis of expected contractual cash flows is essential. An inability to measure contractual cash flows under a contract is an indication that the ultimate premium may not be reasonably estimable, and may prevent application of the risk transfer criteria, which would result in the RRC being accounted for as a deposit. Additionally, ASC 944-20-15-56 notes that, when assessing whether the contract transfers significant insurance risk, the coverages in an agreement with a reinsurer that consist of both risk transfer and non-risk transfer coverages that have been combined into a single legal document must be assessed separately for accounting purposes.

In practice, there are at least two types of contracts that may preclude analysis of expected contractual cash flows: indefinite term RRCs and variable premium RRCs. Under indefinite term RRCs, the cash flows and ultimate premium expected cannot be determined without making significant assumptions regarding the timing of contract termination. Similarly, certain RRCs with variable-based premiums may also preclude a reasonable assessment of cash flows and/or ultimate premiums (e.g., a reinsurance contract with premiums stated as a percentage of the underlying business written), due to an inability to establish a stated premium base.

8.8.2 Accounting for retrospectively rated reinsurance contracts

For RRCs that meet the three criteria in ASC 944-20-15-55, the ceding entity recognizes a liability and the assuming entity recognizes an asset to the extent that the cedant has an obligation to pay cash, or other consideration, to the reinsurer that would not have been required absent losses experienced to date under the contract. Conversely, the cedant recognizes an asset and the assuming entity recognizes a liability to the extent that any cash or other consideration is payable from the reinsurer to the cedant based on contract experience to date. “Other consideration” includes changes in coverage and are accounted for in the same manner as changes in contractual cash flows.

8.8.2.1 Initial recognition – retrospectively rated reinsurance contracts

At the beginning of a contract, experience refunds owed at the end of a contract are assets recorded by the ceding entity until a loss event has occurred, rather than contingent assets, which are not recorded until the end of the contract. Assets and liabilities for the retrospective adjustment features are measured using experience to date, which essentially eliminates the smoothing of non-transferred risks over the life of the contract.

Experience refund receivable assets are not considered contingent assets as they represent a probable future economic benefit under the control of the ceding entity, in which case they meet the definition of an asset. Events, such as a future loss, impair their value when they occur. Even if it is likely that a loss will occur, the decrease in value cannot be recognized in the current period, as the event has not yet occurred. Additionally, the ceding entity will receive the cash represented by the initial experience refund asset either through loss recoveries from the reinsurer or as part of its experience refund. Upon a loss in a future period, the character of the asset simply changes from experience refund to reinsurance recoverable.

8.8.2.2 Subsequent accounting – retrospectively rated reinsurance

The amount of the asset or liability recorded in the current period under an RRC is computed using the with-and-without method. Under the with-and-without method, the amount of the asset or liability is the difference between the ceding entity’s total contract costs before and after the experience under the contract as of the reporting date. Contract costs include premium adjustments, settlement adjustments, and impairments of coverage.

An entity is required to determine the amount of premium expense related to impairments of coverage in relation to the original contract terms. ASC 944-20-35-4 prohibits future experience under the contract (i.e., future losses and future premiums that would be required to be paid regardless of past experience) from being considered in measuring premium expense or earned revenue.

In an RRC in which coverage is depleted as losses are incurred, premium expense related to coverage impairment is also measured in relation to the original contract terms. For example, consider a three-year RRC that provides for an annual premium of \$1,000,000 and an aggregate coverage limit of \$6,000,000 over the three years. If no losses occur, premiums will be expensed pro rata as the coverage expires (e.g., on a straight-line basis over the three-year period). If losses are incurred and coverage is diminished, premiums are expensed proportionate to the coverage used. For example, if a loss of \$3,000,000 occurs in year one, one half of total contractual premiums would be expensed in year one.

In an RRC contract in which (a) the cedant could terminate the contract before the end of its term and (b) termination would change the amounts paid, the measurement of the cedant's liability would be based on whether the cedant has decided to terminate the contract. Under ASC 944-20-35-18, if a decision to terminate the contract has been made, the measurement is required to be based on the assumption that the contract will be terminated and experience to date. If a decision to terminate has not been made, the measurement will be based on the lesser of (1) the total incremental cost that would be paid based on the with-and-without calculation, assuming experience to date and assuming termination, and (2) the total incremental cost that would be based on the with-and-without calculation, assuming experience to date and assuming no termination. In either scenario, the effects of future losses and future premiums are excluded.

Example IG 8-9 illustrates the recognition of ceded premium associated with a quota share reinsurance contract with an experience account.

EXAMPLE IG 8-9

Initial and subsequent recognition of ceded premium associated with a quota share reinsurance contract with an experience account

Ceding Company entered into a three-year term property catastrophe excess of loss reinsurance contract with Assuming Company beginning January 1, 20X6. It is in effect until December 31, 20X8. The contract passes risk transfer. Each 12-month period from January 1 to December 31 represents a "contract year."

The following table summarizes some of the key contract terms.

Contract term	Description
Exposure	<ul style="list-style-type: none"> □ Assuming Company is liable for losses in excess of \$100,000 subject to a limit of \$145,000 each year, with an aggregate limit of \$205,000.
Premium	<ul style="list-style-type: none"> □ Ceding Company will pay Assuming Company a total premium of \$60,000 payable \$20,000 each year at the beginning of the contract year.
Experience account	<ul style="list-style-type: none"> □ Assuming Company is obligated to maintain an experience account, representing 75% of the premiums paid, less any claims incurred. □ If the experience account has a positive balance upon completion of the contract period, or upon termination, the amount is refunded to Ceding Company after passage of sufficient time to allow for loss development and claim settlement.

Contract term	Description
Cancellation provision	<ul style="list-style-type: none"> □ The contract can be cancelled by either party. □ If the loss account is negative, and the contract is cancelled by Ceding Company, Ceding Company must pay the lesser of the negative loss account balance or the remaining premium. □ If the loss account is negative, and the contract is cancelled by Assuming Company, Ceding Company has no obligation. □ If the loss account is positive upon cancellation or expiration, Ceding Company receives the balance.

Analysis

Ceding Company's premium expense for 20X6 is \$5,000 (75% of the \$20,000 year one premium payment). The entry for 20X6 would be:

Dr. Experience refund receivable	\$15,000	
Dr. Ceded premium expense (contra revenue)	\$5,000	
Cr. Cash		\$20,000

If a limit loss of \$145,000 occurred in the first year, an additional \$45,000 of premium expense would be accrued by Ceding Company, representing the additional incremental premium to be paid as a result of the loss. This is calculated using the with-and-without method. The \$15,000 total three-year premium (\$60,000 less 75% refund) if there is no loss is compared to \$60,000 total three-year premium with the experienced loss. The difference is \$45,000. Another way to think about it is the experience refund balance changes from an asset of \$15,000 to a liability of \$30,000 for the two \$15,000 premium payments in 20X7 and 20X8, which will no longer be refunded. The additional entry in 20X6 to reflect the limit loss would be:

Dr. Reinsurance claims recoverable	\$145,000	
Dr. Ceded premium expense	\$45,000	
Cr. Ceded claims expense		\$145,000
Cr. Experience refund receivable		\$15,000
Cr. Experience refund payable		\$30,000

The proportion of the aggregate limit of the contract used in year one also causes additional expense in 20X6. \$145,000 of losses is 71% of the aggregate limit of the contract of \$205,000. As \$15,000 is the total three-year premium if there is no loss, Ceding Company would recognize a loss of future coverage

of \$10,610 (71% of the \$15,000 of premium). Only \$5,000 has been recognized, requiring an additional entry for \$5,610 of ceded premium expense.

Dr. Ceded premium expense	\$5,610	
Cr. Ceded premium payable		\$5,610

8.8.2.3 *Reinstatement premiums – retrospectively rated reinsurance*

While the RRC guidance explicitly applies to multi-year contracts with obligatory retrospective payment provisions, we believe that the concepts can also apply to multi-period reporting (e.g., quarterly) for single year contracts with obligatory retrospective payment provisions. Such retrospectively rated contracts often include mandatory reinstatement provisions that obligate the ceding insurer to pay additional premium amounts (or to pay a termination amount, if termination is elected) if a certain loss level occurs, in order to continue coverage under the contract. This provision is common in single year and multi-year catastrophe covers.

Upon a loss event when the reinstatement premium is obligatory, the ceding insurer recognizes a liability and the reinsurer recognizes an asset to the extent that the ceding insurer has an obligation to pay cash or other consideration to the reinsurer that would not have been required absent the loss experience to date. Additionally, the cedant recognizes the entire additional reinstatement premium as an immediate expense, as it is an obligatory payment that would not have been required absent losses under the contract. The original ceded premium that is in part unearned would continue to be recognized over the remaining coverage period.

For assuming entities, there is an alternative view that the guidance for short-duration contracts (refer to ASC 944-605-25-2) on premium revenue recognition is applicable. That guidance requires that, for retrospectively rated or other experience-rated insurance contracts for which the premium is determined after the period of the contract based on claim experience and for which the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium is revised to reflect current experience. This method results in a delayed rather than immediate recognition of premium income.

If the ceding entity can terminate the contract and not be required to pay any further amounts, the reinstatement premium is not obligatory. There would be no immediate expense for a reinstatement premium. However, if existing coverage limits have been exhausted and a prepaid reinsurance asset remains, the asset is impaired. If the ceding entity elects to pay the reinstatement premium, a new prepaid reinsurance premium would be recognized for the reinstatement premium, which would then be expensed over the new remaining coverage period. Similar accounting would apply for the assuming entity.

8.9 *Interest credits on funds withheld for short-duration reinsurance*

Reinsurance contracts may include a clause that allows the ceding entity to keep the premium payable under the reinsurance contract while reporting it as ceded to the reinsurer, known as “funds withheld.”

This practice developed to minimize cash transferred between the ceding entity and reinsurer when the ceding entity expects to pay losses quickly or to mitigate credit risk between the parties. In some finite risk transactions, this practice has expanded to coverages when the loss payments are not expected to occur for several years. Some contracts require the ceding entity to credit the funds withheld account with interest at an above-market rate. In effect, the ceding entity pays the reinsurer an extra amount, but spreads the recognition of that extra amount over many years. That additional cost is recognized by the ceding entity as additional premiums to the reinsurer over the coverage period and included in the risk transfer analysis.

A variation of this approach involves deferred ceding commissions that allow the reinsurer to defer payment of the ceding commission and, thus, earn extra investment income on that amount while the payment is deferred. The extra cost should be considered in the risk transfer analysis. These features also have the effect of reducing financial leverage without the ceding entity losing control of the funds.

8.10 *Assuming reinsurance not relating to a business combination*

Cash and/or any investment assets received or paid is accounted for at fair value upon transfer. For short-duration reinsurance, the assuming entity records an unpaid claim liability using its own assumptions and estimates. Any remaining difference could represent, at least in part, a financing element resulting from recording claim reserves at gross rather than discounted amounts. This intangible asset financing element would be amortized over the loss settlement period. An intangible asset representing reimbursement of the ceding entity's acquisition costs may also exist if there are unearned premiums, and would typically be established as deferred acquisition costs and amortized over the remaining contract period.

If a net credit results, consistent with our view that entering into a reinsurance transaction does not result in an immediate gain, we believe that a deferred gain should be established and amortized over the settlement period of the claims. We believe that to the extent there is adverse development on the assumed business, the amount should be recorded as an immediate incurred loss, although we are aware that in certain circumstances, some may view the change as a change in effective yield and adjust the deferred gain financing element. For reinsurance transactions that are determined for accounting purposes to be business combinations, specific insurance industry considerations can be found in IG 12.3.

8.11 *Loss commutations – short-duration reinsurance*

Loss commutations are agreements to terminate all or part of a reinsurance agreement in return for cash (or other form of payment), generally at a discounted amount. Loss commutations result in the insurer reassuming the risk of liabilities for losses previously ceded to the reinsurer. Under a loss commutation, the reinsurer is generally released of the obligation for payment of known and unknown losses and uncertainties associated with severity of the losses. The insurance entity is no longer covered for (1) investment risk, and (2) loss (reserve) risk. The primary business reasons insurers initiate loss commutations are:

- The reinsurer is having or has previously had trouble performing under the contract
- The reinsurer is known to be in serious financial difficulty

- It is suspected that the reinsurer may not be able to perform in the future
- The assuming entity believes it was misled
- The parties believe it is more efficient to end the relationship, as much of the variability in frequency, severity of the coverage period has passed, and therefore statutory surplus strain has passed
- Features in the reinsurance agreement encourage termination when the policies are profitable with the elimination of profit sharing after a period of time

The accounting treatment for the insurance entity originally ceding the business is to eliminate the existing reinsurance recoverable and recognize a gain or loss immediately for the difference between the cash (or other consideration) received and the reinsurance recoverable. Gain or loss recognition is immediate because a commutation is a legal extinguishment of all rights and obligations under a reinsurance contract. While there is no definitive guidance as to the income statement presentation of the gain or loss, we believe that presentation as a single amount in loss expense is appropriate. Alternatively, presenting cash received from the commutation as a reduction in ceded premium and the elimination of the reinsurance recoverable as additional loss expense effectively reverses all activity previously recorded from the financial line items effected by the contract in past periods. Whichever method is selected should be consistently applied.

The cash received represents the fair value of the future claims payments. As claim liabilities typically are not discounted, there will be a loss on commutation. In situations when the entity recognizes a gain, the entity should determine why such a gain occurred and its impact on the underlying direct contract estimates and assumptions (including premium deficiency considerations).

The accounting by the reinsurer “mirrors” that of the ceding insurer, except that the reinsurer may have a different accounting policy as to gross versus net income statement presentation.

Occasionally, a ceding entity will substitute one reinsurer for another, releasing the original reinsurer. As the primary obligor to a contract is a key provision, such substitution constitutes a commutation of the original contract and creation of a new contract. There will be a gain or loss on the terminated contract and a new risk transfer evaluation on the new retroactive reinsurance agreement.

Frequent commutations between a ceding and assuming insurer may bring into question whether there was ever an intent to transfer risk, especially for aggregate excess of loss contracts that are commuted as incurred losses approach the attachment point.

Question IG 8-10 addresses the accounting impact of a reporting entity reassuming its own risk from a third-party reinsurer.

Question IG 8-10

Alpha Insurance Company cedes financial guarantee business with an approximate 15-year life on a quota share basis to Beta Reinsurance Company. Beta subsequently retrocedes 100% of the risk assumed from Alpha to Omega Reinsurance Company. Premiums under both contracts are paid at inception. The retrocession to Omega was not a condition of the original reinsurance agreement between Alpha and Beta and Alpha was not involved in arranging the retrocession.

Seven years later, Omega wants to exit the financial guarantee business and Alpha is willing to reacquire the risk it originally ceded. To accomplish this, Omega could negotiate a commutation of the retrocession contract with Beta and Beta could simultaneously negotiate a commutation of its reinsurance agreement with Alpha. Alternatively, Omega could negotiate a new retrocession agreement directly with Alpha. Assume there are no existing claim liabilities relating to the reinsured business.

What is the accounting impact of Alpha reassuming its own risk, albeit from a different third party reinsurer rather than from a commutation of its original contract with Beta?

PwC response

Whether Alpha reassumes its own risk by commuting its contract with Beta or by entering into a retrocession contract with Omega, the economic substance of the two approaches is the same and therefore the accounting result is similar. Even though the contract with Beta has not legally been modified, in substance, it has been commuted. That is, through the two agreements, Alpha has reassumed its own risk. ASC 944-20-15-40 states that the determination as to what constitutes a contract "...involves a complete understanding of that contract and other contracts or agreements between the ceding enterprise and related reinsurers." The accounting should follow the substance of the combined contracts.

Therefore, the transaction should be accounted for similar to a commutation. Any excess of the remaining prepaid ceded premium asset with Beta over the premium received from Omega represents a loss that should be recognized immediately. This elimination of the prepaid ceded premium asset reflects that any remaining prepaid asset in excess of the unearned assumed premium is not recoverable, as there is no net benefit (i.e., reduction in risk) from these two transactions. If there were any existing claim liability relating to the reinsured business that Alpha legally assumed from Omega, such amount represents a deposit obligation and would be a component of the net loss calculation as well. Alternatively, if there is an excess of premium received from Beta over any remaining prepaid ceded premium asset with Omega, such amount would result in a potential gain. Such gain would be recognizable when no obligations or contingencies remain under the contracts with both Beta and Omega, consistent with the accounting for a commutation between two parties.

The legal contracts between Alpha and Beta and between Beta and Omega still exist; consequently, any amounts payable to Omega and receivable from Beta would be presented separately on Alpha's balance sheet as they are with any separate counterparties.

8.12 Purchaser accounting for seller's guarantee

As noted in IG 12.6, in accordance with ASC 944-805-25-5, indemnification agreements relating to the adequacy of acquired claim liabilities, which may be in the form of reinsurance contracts, are accounted for on the acquisition date consistent with other indemnification assets in accordance with ASC 805-20-25-27 and ASC 805-20-25-28, as opposed to using retroactive reinsurance accounting.

8.13 Discontinued operations treatment for short-duration reinsurance

An insurer may have a disposal strategy that involves the "run-off" of operations (i.e., to cease accepting new business but to continue to provide service under existing contracts until they expire or are terminated). Under ASC 360-10-45-15, a component of an entity that is to be abandoned through

the run-off of operations is not be reported as discontinued operations until all operations, including run-off operations, cease. The insurer will be conducting the activities of meeting claim obligations and investing in assets until all obligations have been extinguished. Therefore, the insurance entity will not report run-off operations as discontinued operations until the run-off is completed.

A component that is expected to be disposed of by sale or a novation may meet the criteria for classification as assets held for sale under ASC 360-10-45-9. The results of operations for a component that qualifies as held for sale may be reported as discontinued operations in the income statement in accordance with ASC 205-20-45-1. ASC 360-10-45-9(b) requires that the asset (disposal group) be available for “immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups).” Insurers may agree to sell an operation through a novation agreement that becomes effective at some point in the future because policyholder approval is needed to legally transfer policies from the seller to the buyer. Until the novation is effective, the two parties often enter into a 100% indemnity reinsurance agreement, which transfers the underlying economics of the policies being sold, but does not result in the extinguishment of the seller’s policy obligations. Although legal requirements for affecting a novation may differ among states, we expect that satisfaction of the criteria in ASC 360-10-45-9(b) prior to the effective date of the novation will be rare given the requirement for policyholder approval.

Reinsurance transactions that do not qualify for sale treatment under reinsurance accounting (e.g., 100% indemnity reinsurance agreements with no expectation of sale/novation) do not result in classification of a component as held for sale and, therefore, are not reported as discontinued operations.

***Chapter 9:
Long-duration reinsurance—
updated May 2022***

9.1 Long-duration reinsurance – chapter overview

Reinsurance is the purchase of insurance coverage from another insurer to mitigate certain risks. In its simplest form, reinsurance provides risk mitigation for the frequency and/or severity of exposure an insurance entity has from its underlying insurance policies. Reinsurance accounting guidance applies if the reinsurance contract transfers significant insurance risk and deposit accounting applies if it does not. Reinsurance accounting can vary depending on whether the underlying insurance contracts are classified as long duration or short duration. This chapter focuses on reinsurance of underlying insurance contracts that are classified as long duration. Long-duration insurance contracts are principally life, annuity, and non-cancelable or guaranteed renewable accident and health (such as long-term-care and disability). The accounting for the insurance risk transferred will offset the income statement impact of insurance risk, similar to hedge accounting. To determine the appropriate accounting, evaluation of all contract terms is essential.

ASC 944-20-20 provides a definition of reinsurance.

Definition from ASC 944-20-20

Reinsurance: A transaction in which a reinsurer (assuming entity), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding entity). For indemnity reinsurance, the legal rights of the insured are not affected by the reinsurance transaction and the insurance entity issuing the insurance contract remains liable to the insured for payment of policy benefits. Assumption or novation reinsurance contracts that are legal replacements of one insurer by another extinguish the ceding entity's liability to the policyholder.

This chapter mainly discusses the accounting considerations with respect to indemnity reinsurance of long-duration contracts from both the ceding and assuming entity's perspectives. See IG 9.10.1 for accounting of assumption or novation reinsurance contracts, which are legal replacements of one insurer by another that extinguish the ceding entity's liability to the policyholder.

9.2 Purpose of long-duration reinsurance

Insurance risk is the risk arising from (a) uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under the contract (i.e., underwriting risk) and (b) the timing of the receipt and payment of those cash flows (i.e., timing risk). An entity may purchase reinsurance for its insurance risk for a number of economic reasons, including to:

- reduce its exposure to the variability of particular risks or classes of risks;
- obtain financial capacity to accept risks and policies involving amounts larger than could otherwise be accepted;
- protect against accumulations of losses arising out of catastrophes (e.g., a single natural event);
- protect against accumulations of losses in excess of an entity's risk appetite;
- facilitate the growth of new product lines or otherwise leverage a reinsurer's expertise;

- exit a line of business (e.g., through reinsurance of 100% of the risks and rewards of the line of business);
- help fund product development and acquisition expenses; or
- accomplish tax and/or regulatory (e.g., capital management) objectives.

9.3 *Types of long-duration reinsurance*

Reinsurance contracts can be customized for specific exposures, events, and limits based on the negotiation between the ceding and assuming entities. Broadly, the two types of reinsurance contracts are proportional and non-proportional. Figure IG 9-1 describes the characteristics of each type of reinsurance contract.

Figure IG 9-1
Characteristics of reinsurance contracts

Type of reinsurance	Characteristics
Proportional	<ul style="list-style-type: none"> □ The reinsurer's share of risk is fixed for each underlying contract, as a percentage or an amount. Therefore, premium paid to and losses recovered from the reinsurer are shared based on that proportional relationship. □ Examples include quota share, co-insurance, modified co-insurance, yearly renewable term, and fronting reinsurance contracts
Non-proportional	<ul style="list-style-type: none"> □ Insurer typically pays a fixed premium and receives claim reimbursement from the reinsurer if claims exceed a set threshold. The reinsurer's share can only be determined sometime after claims are incurred. □ Examples include aggregate excess of loss and excess of time contracts, which may be structured per risk, per occurrence, or total claims incurred in aggregate

Reinsurance contracts are also categorized as either automatic or facultative contracts. An automatic contract automatically covers (attaches) direct contracts with specific characteristics when the underlying direct policy is issued. Facultative contracts require the reinsurer to approve each new policy before it can be attached to a reinsurance contract. An insurance entity may enter into a reinsurance contract directly with a reinsurer (or pool of reinsurers) or may use alternative structures in order to involve non-reinsurers interested in assuming the risk, such as mortality bonds.

Reinsurance contracts can be highly customized agreements, including side agreements covering related items such as investment restrictions and/or service and administration. Evaluation of the contract terms and an understanding of the business purpose are necessary to determine the appropriate accounting.

Figure IG 9-2 describes the characteristics of common forms of long-duration reinsurance contracts.

Figure IG 9-2
Common long-duration reinsurance contracts

Form of reinsurance	Characteristics
Yearly renewable term (YRT)	<ul style="list-style-type: none"> □ Also called annual renewable term or mortality risk premium reinsurance □ Only base mortality or morbidity risk is covered. Premium rates for future years may be guaranteed for a short period (typically for one-year) and/or subject to maximums. The premium rates are commonly expressed as a rate per thousand of coverage, vary by the age of the underlying direct policyholder and are multiplied by the net amount at risk of the policy to determine premium due.
Coinsurance	<ul style="list-style-type: none"> □ Reinsurer participates in the risk of loss due to mortality or morbidity, lapses, and the investment risk, if any, in the underlying policy. The participation may be a specified percentage (quota share) of premiums and claims and may have a maximum limit, or may cover amounts in excess of a specified retention limit.
Modified coinsurance (modco) or funds withheld	<ul style="list-style-type: none"> □ Coinsurance in which the ceding entity does not transfer cash or investments to cover future benefit liabilities. The ceding entity keeps control of investments supporting the liabilities and has a payable to the reinsurer that is adjusted each period for investment and insurance experience.
Stop loss/excess of loss	<ul style="list-style-type: none"> □ Reinsurer participates in adverse claim experience of a block of covered policies (i.e., claims above a predetermined dollar amount within a specified time period or from a single event).

9.4 Overview of reinsurance accounting for long-duration contracts

ASC 944 requires that the substance, and not the form of the contract drive the accounting treatment. When significant insurance risk is transferred, reinsurance accounting is required. In contrast, contracts that do not transfer significant insurance risk that exists in direct contracts are accounted for as deposits (i.e., financing arrangements). Deposit accounting treats the contract more like a financing; cash outflows and inflows increase or decrease the balance and interest is recognized using an effective interest rate approach. Unlike reinsurance accounting, the amounts being paid or received in conjunction with the contract are not presented on the income statement. When direct contracts do not contain significant insurance risk, and are subsequently ceded, these contracts are accounted for as investment contracts.

Recognizing a contract as reinsurance will generally enable the financial statements of the ceding entity to match the recognition of benefits received for claims covered by the reinsurance with the recognition of the expense for claims under the underlying contracts both in timing and covered amount. The reinsurance contract is a contract between the reinsurer and the insurer, separate from the contract between the insurer and the policyholder. However, for income statement purposes, the

benefits received are permitted to be presented as a reduction in claims expense, and premiums paid to the reinsurer are permitted to be presented as a reduction in premium revenue, with disclosure of the reinsurance amounts either parenthetically or in the notes to financial statements. On the balance sheet, the reinsurance contract is presented gross of the direct contract liabilities as a reinsurance recoverable asset.

Figure IG 9-3 compares the ceding entity accounting for when contracts transfer insurance risk (reinsurance accounting) and when sufficient insurance risk is not transferred (deposit accounting).

Figure IG 9-3

Comparison of the ceding entity accounting using reinsurance and deposit accounting models

Reinsurance accounting	Deposit accounting
Premiums paid to the reinsurer are recorded as ceded premiums (a reduction to revenue attributable to direct insurance written) over the coverage period of the reinsurance.	Net amounts paid to the reinsurer are recorded as a deposit asset with no effect on revenue.
Expected reimbursements for losses are recorded as a reduction in losses as the losses are incurred with a corresponding reinsurance recoverable asset.	<p>Nonrefundable fees paid are recorded as expense over the period benefited, which is typically the settlement period of the deposit.</p> <p>The asset is accreted using the interest method to the ultimate expected reimbursements.</p> <p>Reimbursements for losses are recorded as a reduction in the deposit asset when cash is received. Any benefit to the ceding entity is recognized using the effective yield interest method over the settlement period.</p>
Impacts premiums/surplus ratio/loss ratio (losses/premiums)	No impact on premiums, losses incurred, or related insurance ratios.

Receivables for amounts recoverable under reinsurance contracts are considered financial assets for impairment purposes and should be assessed for credit impairment. Prior to the adoption of ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, a loss is recorded when a credit loss is incurred. See LI 13.1 for the applicable effective date of ASU 2016-13 and LI 7.8 for further information on the application of the current expected credit losses model to reinsurance receivables.

Assuming reinsurer accounting for deferred acquisition costs, policyholder liabilities and other related balances is the same as that of direct insurers. Reinsurance contracts sometimes specify an effective date for coverage that is prior to the date on which the agreement has been finalized. Reinsurance contracts assumed (or ceded) should be reflected in the financial statements of the reinsurer (or cedant) on the date a legally enforceable contract is finalized. Any amounts exchanged that are characterized in form as assumed (or ceded) premium or assumed (or ceded) losses for periods prior to contract finalization should be viewed as an adjustment to the consideration received or paid that

would form part of the price/cost of reinsurance and would not be presented in the income statement as premiums and claims.

9.5 Evaluating risk transfer for long-duration reinsurance contracts

ASC 944-20-15-59 indicates that the reinsurance contract must indemnify the ceding entity against loss or liability relating to insurance risk, and there must be a reasonable possibility that the reinsurer may realize a significant loss from assuming insurance risk (e.g., mortality and morbidity risk). Contracts that fail either of these criteria are accounted for as deposits. This assessment should be performed at contract inception, and a reassessment is required upon any change or adjustment to the contractual terms as outlined in ASC 944-20-15-62 through ASC 944-20-15-65.

9.5.1 Defining the contract – long-duration reinsurance

ASC 944-20-15-37 stresses substance over form in defining “the contract” that is subject to risk transfer analysis and accounting. All contracts, including contracts that may not be structured or described as reinsurance, must be assessed for potential reinsurance accounting. Although the legal form and substance of a reinsurance contract generally will be the same, this may not always be the case. Analysis and judgment is required to determine the contract for accounting purposes. In some instances, features of other related contracts may need to be considered part of the accounting contract. It is therefore important to determine whether the ceding entity and the reinsurer have made any other legally binding agreements (e.g., collateral/funding agreement, separate reinsurance agreement passing the risk back to the insurer or insurer affiliate, servicing agreement, separate profit-sharing contracts), whether oral or written, in conjunction with the reinsurance contract being assessed. If so, they should be considered part of the accounting contract, particularly if they were negotiated at the same time or in contemplation of entering into the reinsurance contract. Such agreements are often referred to as “side agreements.” In some instances, the side agreements serve to negate some or all of the risk transfer in the reinsurance contract.

Different kinds of exposures combined in a program of reinsurance should not be evaluated for risk transfer together, even if in the same contract. Doing so may allow a component of a contract that does not meet the conditions for reinsurance accounting to be accounted for as reinsurance by being designated as part of a larger reinsurance program. For example, for a multi-coverage program combining several distinct lines of business, each line should be evaluated separately as part of the risk transfer test.

9.5.2 Insurance risk – long-duration reinsurance

The requirement that the ceding entity must be indemnified from insurance risk precludes reinsurance accounting for reinsurance of investment contracts. ASC 944-20-20 defines investment contracts as “long-duration contracts that do not subject the insurance entity to risks arising from policyholder mortality or morbidity.” Common examples of investment contracts are guaranteed investment contracts (GICs) and annuities payable not based on life contingencies (e.g., single-premium deferred annuity contracts, fixed period payout annuities). Additionally, certain annuity contracts where no insurance risk remains after separating market risk benefits and embedded derivatives would be considered an investment contract.

9.5.3 ***Reasonable possibility of significant loss – long-duration reinsurance***

ASC 944-20-15-59 requires that indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance of long-duration contracts have the “reasonable possibility” that the reinsurer may realize “significant loss.” However, the guidance does not define “reasonable possibility” or “significant loss” for purposes of the risk transfer criteria. Determining the amount of risk transfer of long-duration contracts is a matter of judgment after evaluating all facts, both qualitative and quantitative.

ASC 944 does not specify an explicit quantitative test to determine the reinsurer’s exposure to significant loss for long-duration contracts. In practice, various types of quantitative tests with entity-specific thresholds (of reasonable possibility and significance) are used to evaluate whether insurance risk transferred under long-duration contracts meet this “reasonable possibility of significant loss” requirement. In practice, entities also use qualitative judgments about whether the range of assumptions used in preparing loss scenarios is reasonably possible.

ASC 944-20-15-61 notes that the evaluation of mortality risk or morbidity risk in contracts that reinsure universal life-type policies and other long-duration contracts must be consistent with the criteria for distinguishing investment contracts from universal life-type contracts in ASC 944-20-15-16 through ASC 944-20-15-19 used for direct contracts. ASC 944-20-15-19 requires a test of mortality risk be a present value calculation. ASC 944-20-15-19 is silent as to which discount rate (expected earned rate or GAAP discount rate used for liability for future policy benefits or otherwise) should be used.

The “stepping in the shoes” exception afforded to short-duration contracts (when 100% of the risk is transferred even if there is not a significant risk of loss to the reinsurer under the reinsurance contract) is not afforded to long-duration contracts. However, there are some circumstances when entities may analogize to the “stepping in the shoes” exception rather than perform a quantitative assessment to demonstrate that risk has been transferred for a long-duration contract. For example, some entities have qualitatively concluded that they should account for life reinsurance contracts as reinsurance as long as they transfer all risks of the underlying contracts (e.g., 100% coinsurance). However, the presence of an experience rating feature, “forced” recapture terms, or other provisions that vary from the direct insurance contract would generally indicate further risk transfer analysis is required.

9.6 ***Accounting for ceded long-duration reinsurance contracts***

A ceded reinsurance contract must first be evaluated for risk transfer to determine whether the arrangement should be accounted for as reinsurance or under a deposit accounting model, as described in IG 9.5.

When a long-duration reinsurance contract passes risk transfer, the reinsurance recoverable arising from benefits of the contract is measured using methods and assumptions consistent with those used to measure the covered direct insurance benefit liability. Additionally, in accordance with ASC 944-30-35-64, proceeds from reinsurance transactions that represent recovery of acquisition costs reduce the applicable unamortized acquisition costs in such a manner so that net acquisition costs are capitalized. In some instances, this amount will be represented by the amount characterized as the “ceding commission” in the contract. However, in other instances, the ceding commission specified in the agreement may be more or less than the amount representing recovery of acquisition costs, requiring an understanding of the substance of the transaction in order to determine the amount by which

capitalized acquisition costs should be reduced. Any remainder would be part of the "cost of reinsurance," as described in IG 9.6.2.

9.6.1 *Reinsurance recoverable for ceded long-duration reinsurance contracts*

There is no specific guidance on how to determine the reinsurance recoverable asset for ceded contracts. ASC 944-40-25-34 provides only general guidance.

ASC 944-40-25-34

Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported and future policy benefits) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities.

Various approaches to calculating the reinsurance recoverable are used in practice that attempt to mirror the measurement of the underlying covered direct contracts. Generally, the common goal of such approaches is to present the net income statement effect of the direct policies on an after ceded basis by using cash flow assumptions and methodology for calculating the reinsurance recoverable consistent with those used for the direct policies (akin to an accounting hedge), combined with a cost of reinsurance that must be amortized. These approaches become more complex when the reinsurance contracts are not on a proportional basis (e.g., excess of loss). Additionally, the determination of reinsurance recoverables for ceded reinsurance contracts subject to ASU 2018-12 is impacted by the new requirement to review (and update as necessary) all insurance assumptions on at least an annual basis (see IG 5.2.4) and to remeasure the liability for future policy benefits using the current upper-medium grade rates (see IG 5.2.3 for further guidance).

9.6.1.1 *Application to traditional and limited payment long-duration contracts*

Reinsurance recoverables relating to reinsurance of traditional and limited payment contracts are required to be recognized and measured in a manner consistent with the liabilities relating to the underlying reinsured contracts, including using consistent cash flow assumptions. As a result, a net premium ratio and retrospective updating of cash flows should be used in the recognition and measurement of reinsurance recoverables for traditional and limited-payment long duration contracts, consistent with the direct liabilities. On direct contracts, a net premium ratio is used to derive a constant profit margin over the entire life of a group of contracts (i.e., the cohort). Employing this constant margin concept to the reinsurance recoverable results in accounting that is consistent with the purpose of the transaction - to act as an economic hedge of the reinsured business.

Two acceptable methods for determining the reinsurance recoverable are the "net cost" method, which is calculated in relation to the entire direct cohort's gross premiums, and the "standalone" method which is calculated only in relation to the contracts within the cohort that are subject to the reinsurance treaty (using either direct premiums on reinsured contracts or ceded premiums as the accrual basis). In proportional reinsurance of a contemporaneous reinsurance treaty, both methods will yield the same result; however, in certain circumstances (e.g., if the timing/amount of ceded premium is not consistent with the direct premium), the standalone method will not achieve a constant margin.

The cash flow assumptions for the reinsurance, such as estimates of mortality, morbidity, terminations, and expenses, need to be consistent with those for the direct policies, in accordance with

ASC 944-40-25-34 and ASC 944-605-35-15. In addition, entities are required to use a locked-in contract issue date upper-medium grade yield in calculating the net premium ratio, ceded benefit expense and interest accretion for income statement purposes, as well as a current upper-medium grade yield for balance sheet remeasurement of the reinsurance recoverable, consistent with the principles applicable to direct insurance contracts.

In many instances, an insurer may enter into a ceded reinsurance contract on a prospective basis, meaning that the reinsurance contract covers direct insurance contracts issued contemporaneously with and/or for some period subsequent to the inception date of the reinsurance contract. The locked-in contract issue date yield curve used to measure each new portion of the reinsurance contract recognized and for subsequent income statement measurement should be consistent with the locked-in issue date yield curve used to measure each of the direct reinsured contracts. In subsequent periods, the current yield curve (i.e., current upper-medium grade curve) is used for balance sheet remeasurement purposes for both the direct liability for future policy benefits and the reinsurance recoverable.

Reinsurance contracts may also be executed subsequent to the direct contract issue dates, and market interest rates may have changed between the date that the underlying insurance contracts were issued and the date the reinsurance contract is recognized in the financial statements. The yield curve at the date the reinsurance contract is recognized should be used as the locked-in issue date yield curve for initial measurement of the reinsurance recoverable and any cost of reinsurance and for subsequent income statement measurement purposes. This is required to comply with the principle in ASC 944-40-35-6A(b)2 that the discount rate for income statement purposes is the discount rate at the contract issue date; in this case, that is the reinsurance contract issue date. Using the current yield curve also satisfies the ASC 944-40-25-34 requirement that the reinsurance recoverable be recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts, and using consistent assumptions. That is, the direct liabilities that are being referenced in ASC 944-40-25-34 are the direct liabilities as remeasured using the current yield curve at the date the reinsurance contract is recognized in the financial statements. There is no immediate comprehensive income or loss relating to the initial recognition of the reinsurance recoverable.

Example IG 9-1 illustrates the accounting for 100% coinsurance of a block of traditional inforce insurance contracts.

EXAMPLE IG 9-1

Reinsurance of inforce contracts

For simplicity, this example ignores acquisition costs and reinsurer credit risk, assumes use of an equivalent level discount rate and assumes that the reinsurance transaction is executed for initial consideration equal to the GAAP liability for future policy benefits.

A group of direct life insurance contracts was written on 1/1/X1 when the upper-medium grade fixed income discount rate was 5%. Three years later, on 12/31/X3, the direct writer remeasures the liability for future policy benefits using a 3% rate, which represents the current upper-medium grade fixed income discount rate.

On 12/31/X3, the liability for future policy benefits measured using the locked in rate of 5% used to calculate benefit expense and accrete interest expense is \$100 million, while the remeasured liability

using the current 3% rate is \$110 million. A debit balance (unrealized loss) of \$10 million exists in accumulated other comprehensive income (AOCI) relating to the direct liability remeasurement.

On the same day, 12/31/X3, the direct writer cedes 100% of the contracts in the group through a coinsurance contract for initial consideration of \$110 million, for which the locked-in rate for the reinsurance policy would be 3%, the rate at the recognition date of the reinsurance contract.

What amounts should the direct writer recognize for the reinsurance recoverable and cost of reinsurance in connection with ceding the group of contracts?

Analysis

The direct writer would recognize a ceded reinsurance recoverable of \$110 million for the consideration paid of \$110 million. The reinsurance recoverable and any cost of reinsurance (in this case \$0) would be measured using the discount rate at the date the reinsurance contract is recognized; there is no “day one” accumulated other comprehensive income associated with the reinsurance contract because the 5% locked-in discount rate used to measure benefit expense and interest accretion on the direct liability is not relevant to the reinsurance contract entered into three years later.

In subsequent periods, the direct policies will continue to use 5% while the reinsurance recoverable will use 3% for future income statement interest accretion and benefit expense/ceded benefit expense recognition, resulting in a 2% negative spread differential recognized in income. The direct insurance liability and reinsurance recoverable will be remeasured each period end using the current period-end discount rate, with the difference between the locked-in issue date discount rates (5% for the direct contracts and 3% for the reinsurance contract) and current discount rate measurement of the balances recognized in AOCI. Over time, the starting difference in AOCI between the direct policies and the reinsurance contract of \$10 will unwind through OCI as the group of direct contracts approaches maturity in a pattern consistent with the spread differential in the income statement such that on a total comprehensive income basis, the net of the direct and reinsurance transactions will be zero.

Calculating the ceded net premium ratio under the “net cost” method

The numerator in the ceded net premium ratio (cNPR) calculation would be the present value of expected ceded premiums minus ceded benefits (“net cost”), and the denominator would be the present value of expected gross direct premiums of the entire direct cohort.

Additionally, a ceding entity should calculate the ceded net premium ratio and reinsurance recoverable by utilizing the cohorts of the reinsured direct policies when calculating the net premium ratio and related reinsurance recoverable. For example, if the direct writer cedes two cohorts within one reinsurance contract, each of the two cohorts would require a separate calculation to determine their respective ceded net premium ratios. Alternatively, if one direct cohort is subject to multiple reinsurance contracts, the ceding company will calculate one ceded net premium ratio that considers all reinsurance contracts associated with the cohort.

Example IG 9-2 illustrates how a ceding entity can establish the ceded net premium ratio and calculate the reinsurance recoverable under the “net cost” method when a direct cohort is subject to multiple reinsurance contracts.

EXAMPLE IG 9-2**Calculation of initial ceded net premium ratio and reinsurance recoverable under the “net cost” method**

Insurance Company A has a cohort of traditional life insurance contracts with estimated total cash flows summarized below. (Note that the cash flows used in this example are based on the direct cohort net premium ratio calculation in Example IG 5-1).

Direct activity	Benefits	Gross premiums	Net premiums	Net premium ratio
Total - Cohort 1	\$4,504	\$6,338	\$4,504	71.07%

The cohort is subject to two reinsurance treaties which were entered into at inception of the direct cohort (note that discounting of cash flows to derive the ceded net premium ratio uses the initial reinsurance contract issuance discount rate, which for simplicity of illustration is assumed to be 0%). One treaty is a 50% coinsurance agreement and the other reinsures any benefits in excess of \$220 per year (before application of the 50% coinsurance), for an annual premium of \$10. Using the direct cash flows in Example IG 5-1, the total benefits in excess of \$220 are \$154. The total cash flows for both reinsurance treaties are below.

Reinsurance - Cohort 1	Benefits (A)	Premiums (B)	Net cost (B-A)
Treaty 1: 50% coinsurance	\$2,252	\$3,169	\$917
Treaty 2: Excess of \$220 claims	\$154	\$200	\$46
Total reinsurance - Cohort 1	\$2,406	\$3,369	\$963

How is the initial ceded net premium ratio calculated, and how is the reinsurance recoverable calculated under the “net cost” method?

Analysis

Under the net cost approach, the total pre-tax income statement impact of the reinsurance in each period is equal to the gross premiums for that period multiplied by the ceded net premium ratio (with any cumulative catch up, as necessary). The change in the reinsurance recoverable is therefore the difference between (1) actual ceded premiums less benefits for each period and (2) the actual gross premium of the total cohort multiplied by the ceded NPR. This results in a constant profit margin over the life of the cohort on a net of reinsurance basis.

The ceded net premium ratio is calculated by first determining the projected net cost of reinsurance over the life of the cohort by taking the difference between projected total ceded premiums and benefits (\$3,369 - \$2,406 = \$963), and then dividing the net cost by expected gross premiums of the cohort (\$963 / \$6,338 = 15.2%).

In this example, profits before reinsurance from the direct cohort are expected to be 28.9% of gross premiums (1 – the NPR of 71.1%). The 15.2% represents the portion of the total profit of the direct cohort ceded to the assuming company.

The table below illustrates the calculation of the reinsurance recoverable over the life of the cohort. (Note amounts are rounded to the nearest dollar.)

Year	Net cost (A)	Gross premium x cNPR (15.2%) (B)	Change in recoverable (A-B)	Recoverable balance
1	160	76	84	84
2	143	72	71	155
3	127	68	59	213
4	110	65	45	259
5	92	62	31	290
6	76	58	18	307
7	62	55	7	314
8	50	53	-3	312
9	40	50	-10	301
10	31	47	-16	285
11	24	45	-21	264
12	17	42	-25	238
13	13	40	-28	211
14	9	38	-29	181
15	6	36	-30	151
16	4	34	-30	121
17	3	33	-29	92
18	2	31	-29	63
19	-2	29	-31	32
20	-5	28	-32	0
Total	963	963	0	

As discussed in more detail in IG 9.7.1.1, there may be differences in the cohorts used by the ceding entity and those used by the assuming entity in a reinsurance arrangement. The entity that is not the administrator of the business should ensure that the data the administrator provides is in enough detail to allow for the required disclosures and cohort level for measurement. Refer to IG 10.3 for further information.

Additionally, when the reinsurance contract is a short-duration contract covering long-duration direct policies, such as certain stop-loss reinsurance, the reinsurance benefit will be recognized over the life of the short-duration reinsurance contract, but the direct claim experience will be recognized over the longer term of the direct contracts, resulting in a mismatch in revenue and expense recognition.

Reinsurance NPR cap

For direct traditional and limited payment long-duration insurance contracts (see IG 5.2.5), an immediate charge is recognized in income for the amount by which the present value of future benefits and expenses exceeds the present value of future gross premiums (i.e., if the NPR exceeds 100%). No specific guidance addresses how this principle relating to direct contract liabilities should be applied to reinsurance recoverables. Following the guidance in ASC 944-40-25-34 that reinsurance recoverables should be recognized in a manner consistent with the direct liabilities being reinsured, to the extent that the insurer has recognized an immediate loss on the reinsured portion of the direct contracts in the current period, the insurer should recognize an immediate gain on the reinsurance ceded contract. However, in accordance with the reinsurance guidance in ASC 944-40-25-33 that prohibits gain recognition upon entering into a reinsurance contract, an insurer should not recognize a gain at inception of a reinsurance transaction to offset a previously recognized loss on direct business.

Judgment will be required in applying this guidance to situations when the insurer has purchased reinsurance on only a portion of a cohort and the cohort is generating a loss, or in situations when the insurer has purchased reinsurance on multiple cohorts, some of which have reached the 100% cap and others have not.

Reinsurance recoverable “floor”

The liability for future benefits on directly written contracts cannot be less than zero (i.e., an asset) at the cohort level. The net premium calculation can result in a liability balance of less than zero that must be floored at zero for products when the rate of premium increase exceeds the rate of increase in the assumed mortality rate over the term of the contract, such as yearly renewable term insurance. In these situations, an entity would recognize a charge to income to prevent the recognition of an asset.

There is no specific guidance as to how the “liability floor” guidance for direct contracts impacts the measurement of the reinsurance recoverable. We believe an acceptable interpretation is that in situations when the ceding entity is prohibited from recognizing an asset on the direct contracts in accordance with the liability floor provisions, it may also not recognize a liability relating to the purchased reinsurance contract.

However, there may be certain circumstances when the recognition of a reinsurance liability may be appropriate. For example, a noncancellable yearly renewable increasing premium term or excess of loss reinsurance contract may be purchased to reinsure level premium direct insurance contracts. In that circumstance, following the net premium approach and constant margin principle discussed for the ceded reinsurance transaction, a ceded reinsurance liability may result. Conceptually, a net liability can result in various situations in which cash flows relating to ceded premium are lower (or benefits are higher) in earlier periods but the impact of reinsurance is recognized for accounting purposes on a constant margin basis.

9.6.1.2 *Application to non-traditional contracts*

In some cases, a cedant may reinsure death or other insurance benefits (such as no lapse guarantee benefits) that require an additional direct liability in accordance with ASC 944-40-25-27A. In such instances, as required by ASC 944-40-30-20, a ceded benefit ratio using the same assumptions and scenarios used to establish the direct contract liability should be used to establish a reinsurance recoverable. The reinsurance recoverable is calculated using premiums ceded under the terms of the contract multiplied by the ceded benefit ratio (excess benefit payments ceded under the terms of the

reinsurance contract as the numerator and direct contracts' assessments as the denominator) less ceded excess benefits paid to date under the contract, which is similar to the reinsurance recoverable described for traditional contracts in IG 9.6.1.1.

9.6.2 Initial measurement - cost of reinsurance

ASC 944-605-30-4 states that "the difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized." A common interpretation of this requirement is that all amounts paid to the reinsurer, less the expected recoveries and reimbursements to be paid to the ceding entity, plus or minus any "ceding commission" not representing recovery of acquisition costs, comprise the "net cost" to be amortized.

The consideration paid may be in the form of investments. The transfer of the investments must meet the conditions to be treated as a sale under ASC 860 to be derecognized (and for any gain or loss on the sale of those assets to be recognized immediately in income). If so, the fair value of those assets, along with any other consideration received or paid, including any ceding commission received from the reinsurer that does not represent recovery of acquisition costs, would be components of the net consideration paid to the reinsurer. Typically, funds withheld and modco treaties do not meet the ASC 860 sale criteria.

The cost of reinsurance to be amortized arises primarily due to differences between the cash flow and discount rate assumptions used by the ceding enterprise in its liability for future benefits and those negotiated in pricing the risk transferred, as well as any risk premium and profit margin. One area of difference that is likely for all products is the discount rate, because the reinsurer's return on investment used in pricing the assumed business will be different from the discount rate used in measuring the liability for future policyholder benefits under GAAP.

Due to the differences between the "book value" liabilities and the fair value consideration exchanged, the cost of reinsurance may in some cases result in a net debit, and in other cases a net credit. Reinsurance contracts do not result in immediate gain recognition unless the reinsurance contract is a legal replacement of one insurer by another and the cedant's liability to the policyholder is extinguished, as noted in ASC 944-40-25-33. Therefore, to the extent that the "net cost" is a credit, that amount is recorded as a deferred gain and amortized as described in IG 9.6.3.

In a "net debit" situation, ASC 944 requires amortization of the net cost of reinsurance rather than the immediate recognition of a loss. In most situations, this would be appropriate, with the rationale being that the cedant has paid the reinsurer to take on the uncertainty inherent in the direct insurance liabilities (i.e., the risk that the liabilities may develop adversely in the future). As a result, the "net cost" can be viewed as a prepaid asset providing future benefit to the cedant in the event of adverse development. However, when a premium deficiency test is required (e.g., for universal life-type contracts), and when an entity's accounting policy is to include reinsurance-related balances and cash flows in that analysis, the inclusion may result in a write-off of any net debit. See Question IG 7-2 in IG 7.3.3.

With the elimination of the impairment test for DAC and changes to premium deficiency guidance for traditional and limited pay contracts under ASU 2018-12, entities will no longer be able to write off any net debit resulting from a reinsurance transaction or impair DAC for those contracts. The amortization expense related to any remaining DAC (after reduction for consideration received from the reinsurer representing recovery of DAC) and cost of reinsurance for traditional and limited pay

contracts will continue throughout the remaining life of the direct contracts, even if those contracts are 100% ceded.

For limited payment contracts, a cost of reinsurance can be established which represents the portion of the consideration relating to the deferred profit liability.

Question IG 9-1

Should an insurance entity establish a cost of ceded reinsurance on reinsurance treaties that reinsure limited payment contracts?

PwC response

Reinsurance of limited payment contracts introduces additional complexity due to the nature of the contracts. The objective of using a net premium approach, which is also required for reinsurance accounting, is to reflect a constant margin over the life of the contracts. On limited payment contracts, as profit is earned over time through DPL amortization on the direct contracts, from a reinsurance perspective, this profit emergence should be similarly captured.

There is no explicit guidance for recognizing a ceded DPL, however, upon initial recognition of a reinsurance contract ceding limited payment contracts, insurance entities should determine if a cost of reinsurance exists that relates to the direct DPL. By establishing a cost of reinsurance to represent the deferred profit to be recognized over time, and amortizing this balance using the same driver as the direct DPL, a ceding entity can appropriately reflect the impact of the reinsurance.

9.6.3 Amortization of the cost of reinsurance

ASC 944-605-35-14 notes that the period of amortization of the cost of reinsurance (which, as noted in IG 9.6.2, may be a net debit or a net credit) depends on whether the reinsurance contract is long-duration or short-duration. If the reinsurance contract is short-duration, the cost is amortized over the reinsurance contract period. If the reinsurance is long-duration, the cost is amortized over the life of the underlying reinsured contracts.

ASC 944 is silent as to the pattern of amortization. In practice, some view the amortization as similar in concept to the amortization of DAC and, accordingly, amortize the cost of reinsurance using a straight-line pattern consistent with DAC amortization under ASU 2018-12. Alternatively, a pattern of recognition based on premiums, gross profits, gross margins, or some other method that reflects the economics of the transaction and the principles of ceded reinsurance accounting may also be appropriate. It would also be consistent with the requirement that assumptions used in accounting for reinsurance costs be consistent with those used for the direct contracts.

9.7 Assuming reinsurance of long-duration contracts

Assuming reinsurers use the same recognition and measurement accounting guidance as direct insurers for their assumed reinsurance contracts. GAAP is generally silent on the accounting for an assumed reinsurance contract because assuming insurance risk from another insurer or from non-insurers is economically the same. Refer to IG 5 for additional guidance that should be followed for assumed reinsurance contracts.

9.7.1 Traditional long-duration and limited payment assumed reinsurance

Assumed long-duration and limited payment reinsurance contracts are subject to the guidance applicable to direct writers of such contracts. This includes all of the relevant guidance for the liability for future policy benefits including the ongoing updating of assumptions (unlocking), use of an upper-medium fixed income yield to discount the net premium ratio, and being subject to the annual cohort restrictions. These concepts are further discussed in IG 5.2 and IG 5.3.

Reinsurance of existing blocks of traditional life insurance contracts and limited-pay contracts will typically lead to differences between the ceding insurer's accounting and the assuming reinsurer's accounting. The ceding insurer will have separate reserve cohorts at the issue year and product level. Each reserve cohort will have a different locked-in interest rate assumption and different periods for measuring the retroactive adjustment for changes in cash flow assumptions. The assuming entity will have a single-issue year as of the date of the inception of the reinsurance contract and thus the retrospective adjustment period due to updating of assumptions and the discount rate will be different. As a result, the assuming entity needs to ensure they are receiving the appropriate data to determine the liability for future policy benefits.

Often, there will be upfront consideration received for assuming the risks of an existing block of life insurance contracts. The guidance for direct insurers is applicable to assuming entities writing reinsurance cover without a level premium. We believe that this upfront consideration with ongoing payments can be analogized to a limited-payment contract model, where the collection of premium does not represent the completion of an earnings process. Any gross premium received in excess of the net premium would be deferred.

If the net consideration is less than the policy benefit reserves, the difference could be accounted for as deferred acquisition costs. This is sometimes done in practice despite the fact that unlike DAC on direct contracts, this allocated "payment" is part of the net consideration exchanged between the two parties to the contract rather than a separate acquisition cost paid to third parties to acquire the contract. See IG 3.8.2 for further information on the assuming reinsurer accounting for DAC.

Differences may also exist between the ceding insurer's accounting for its direct liabilities and the assuming reinsurer's accounting, even if the reinsurance is executed concurrent with the direct contracts. For example, the ceding and assuming entities may incorporate different cash flows into each of their measurements if they have differing views on actuarial and economic assumptions.

9.7.1.1 Unit of account considerations for assumed reinsurance contracts

Sometimes, reinsurers enter into reinsurance contracts that provide coverage for direct insurance contracts that are issued for a specified period of time subsequent to the inception date of the reinsurance contract. In addition, reinsurers may provide coverage for different types of cedant products in a single legal insurance contract. These situations require consideration of the unit of account for recognition and measurement purposes.

Some entities may recognize assumed reinsurance as the direct reinsured contracts are issued ("look through approach").

Under this approach, the assuming entity is effectively looking through the legal contract to the reinsured contracts issued by the ceding entity as the contracts for accounting purposes. In accordance with ASC 944-40-30-7, an entity must then determine the cohorts for its assumed contracts. In

accordance with ASC 944-40-30-7, and consistent with how the ceding entity calculates its liability, the assuming entity “shall not group contracts together from different issue years but shall group contracts into quarterly or annual groups.” In applying this guidance to assumed reinsurance under the look through approach, each underlying reinsured contract is the unit of account for recognition purposes. Therefore, an assuming entity’s annual grouping limitation should be based on underlying reinsured contract policy issue dates, not the reinsurance contract issue date. When the direct reinsured contracts are the units of account for recognition purposes, the discount rate used to calculate the net premium ratio for a cohort would take into consideration the discount rate (or curve) in effect at the dates that each underlying reinsured contract was issued.

As of the publication date of this guide, there continues to be debate as to whether there may be circumstances when the reinsurance contract is determined to be the unit of account for recognition purposes rather than each of the underlying reinsured contracts. In such cases, the discount rate for interest accretion purposes would be the rate (or curve) at the date the reinsurance contract is entered into, and provisions that allow either party to terminate the reinsurance contract for newly-written business, such as a reinsurer’s right to cancel the contract for new business without cause with 90 days notice, would be considered in determining the accounting term of the contract. Due to the complex nature of reinsurance, if the treaty is determined to be the unit of measurement, we strongly recommend consulting with auditors and regulators on the acceptability of such an accounting approach. Additionally, it is important to note that when a termination provision shortens the accounting term of the reinsurance contract to annual periods or less, the differences in accounting results between the noncancellable term of the reinsurance contract approach and the look through approach may not be that significant.

We believe that consistent with ASC 944-40-30-7, if the accounting unit for measurement is determined to be the reinsurance contract, the measurement of the net premium ratio would include all future cash inflows (premiums) and outflows (benefits and expenses) expected for the life of the noncancellable term of the reinsurance contract, including cash flows relating to policies not yet written by the ceding entity, but subject to the treaty. Gross disclosures of benefits and net premiums would be required to be included in the rollforward, taking into account the amounts relating to all of those future cash flows.

A single reinsurance contract may reinsure multiple coverage types, including whole life, disability, long-term care, and universal life insurance. In practice, different types of business are often separated into smaller units of account for recognition purposes within the larger reinsurance contract. As a result, if there are separate units of account for different products, they would be included in separate cohorts with a separate net premium ratio and liability for future policy benefits calculated for each cohort.

9.8 Reinsurance of market risk benefits

Market risk benefits (MRBs) can be present in contracts written by both insurers and reinsurers. A reinsurer may assume all or a portion of market risk benefits. ASC 944-40-25-40 clarifies that both the assuming reinsurer and the ceding entities are subject to the MRB guidance. For purposes of the assessment of whether the reinsurance contract is or contains an MRB in accordance with ASC 944-40-25-25D, reference to the account balance refers to the underlying reinsured contract. Consistent with the guidance in ASC 944-40-30-19C(c), if there are multiple MRBs in the contract, they should be

bundled into one compound MRB regardless of the differences in the individually identified MRB's characteristics.

If the reinsurance contract does not meet the definition, in whole or in part, of an MRB, it would still be assessed to determine if it is or contains a derivative under ASC 815. If it does not meet the definition of either an MRB or an embedded derivative, the guidance on death benefit or other insurance benefit features or annuitization benefits under ASC 944-40 should be considered.

Consistent with direct contracts, features in ceded reinsurance contracts that meet the definition of MRBs are required to be accounted for at fair value. At inception of the reinsurance contract, management must determine the terms of the purchased MRBs and, as described in ASC 944-40-30-19D, whether a non-option (attributed fee method) or an option approach is appropriate. If the non-option method is used, the day 1 value of the MRB would generally be expected to be zero unless the fees in the contract are insufficient to fund the benefits as described in IG 5.6.1. If the option method is used, the contractual terms under the reinsurance agreement must be considered in determining the fair value of the purchased MRB at inception, which would typically result in a day 1 non-zero value of the MRB.

When a reinsurance contract is in its entirety an MRB, for example because it only reinsures the direct contract's MRB features, the fees used to determine the fair value of the purchased MRB are those defined in the reinsurance contract. This is in contrast to when an attributed fee method is used for hybrid contracts. Assuming the reinsurance contract represents an arm's length transaction between a willing buyer and seller, neither party should be expected to have a gain or loss upon entering the contract because the reinsurance fee is a good indicator of the fair value of the MRB. In addition, the ceding entity should consider the reinsurance contract fair value in calibrating its MRB fair value models used for existing MRBs as it represents an observable data point of fair value.

On the ceded side, the fair value of the reinsurance MRB asset will be measured considering the counterparty credit risk of the reinsurer, while the direct contract MRB liabilities fair value will only include the instrument-specific credit risk of the insurer. As a result, the fair value of the direct and ceded contracts will be different even if the contracts are entered into simultaneously and contractual fees and benefits are the same. In addition, only fair value changes in MRBs (issued or purchased) attributable to a change in the instrument-specific credit risk of the reporting entity will be recognized in OCI. This will result in a potential accounting mismatch between the recording of the change in the fair value of MRBs on direct (and assumed) products and the MRB resulting from a ceded reinsurance transaction.

If a reinsurance agreement covers both the accumulation and payout phase, we believe that any MRBs related to the reinsurance contract should be derecognized at annuitization (for a GMIB) or extinguishment of the account balance (for a GMWB), and a reinsurance recoverable should be established for the payout annuities reinsured, which is consistent with the guidance for direct MRBs in ASC 944-40-35-8B (described in IG 5.6.6).

The "in substance" single pay premium for the reinsurance of the payout annuity will include the portion of the purchased MRB balance related to counterparty credit, as the derecognition guidance only allows amounts in AOCI related to instrument-specific credit risk to be reversed prior to the determination of the "in substance" single pay premium, and will result in either:

- A gain, which should be used to offset direct losses to the extent they are incurred on the direct MRB derecognition, or

- A loss, which would be deferred as a cost of reinsurance in line with ASC 944-605-30-4. We believe this cost of reinsurance is analogous to a ceded DPL, and should be amortized on a consistent basis with the direct DPL as described in Question IG 9-1.

Question IG 9-2

Is the reinsurance recoverable for a ceded reinsurance contract that meets the definition of an MRB outside the scope of ASC 326, *Financial Instruments – Credit Losses*?

PwC response

Yes. A reinsurance contract that meets the definition of an MRB is required to be recognized at fair value with changes in fair value recognized in the income statement. Financial assets measured at fair value are outside the scope of the CECL model.

9.9 *Reinsurance contracts with embedded derivatives*

ASC 815-15-25-47 requires an entity to separate a debt instrument into a debt host and an embedded derivative when the debt incorporates credit-risk exposures that are unrelated to, or only partially related to, the creditworthiness of the instrument's issuer. Examples of contracts that may have embedded derivatives include the following:

- Modco and funds withheld arrangements that provide returns to the reinsurer referenced to a specified portion of the ceding entity's assets (as cited in ASC 815-15-55-107 and ASC 815-15-55-108).
- Funds-withheld reinsurance or deposit contracts that have receivables/payables with interest crediting based on the total return bond index or other pool of investments
- Contracts with experience accounts or refund accounts with interest crediting tied to a referenced portfolio of assets
- Group pension experience rated or participating direct contracts

The guidance does not specify the precise nature of the derivative in the modco or similar arrangement. Rather, ASC 815-15-55-102 states that the nature of the embedded derivative should be determined based on the facts and circumstances of the individual contract. Therefore, each embedded derivative will vary based on specific facts and circumstances, although they are likely to be either total return swaps or credit default swaps.

9.9.1 *Identification of embedded credit derivative – long-duration reinsurance*

In the broadest sense, a credit derivative is a financial instrument designed to transfer credit risk from the party exposed to that risk (protection buyer) to a party willing to take on that risk (protection seller). A credit derivative primarily derives its value from the credit quality of a bond, loan, or other financial obligation or group of financial obligations of an underlying entity or entities (the reference entity). The most common credit derivatives are credit default swaps, total return swaps, and credit-linked notes.

□ *Credit default swap*

A credit default swap is a contract under which the protection seller, in return for a premium, agrees to compensate the protection buyer for the financial loss it may incur following the occurrence of a credit event in relation to a specified obligation in return for a premium. The contract thereby allows one party to transfer the credit risk of a particular reference asset, which it may or may not own, to another party. The protection seller assumes the credit risk associated with the reference asset without directly owning it. A credit default swap contract can be tailored to provide protection for a number of potential credit events.

□ *Total return swap*

A total return swap is a contract under which one party (the total return payer) transfers the economic risks and rewards associated with an underlying asset to another counterparty (the total return receiver). The transfer of risks and rewards is effected by an exchange of cash flows that mirrors changes in the value of the underlying asset and any income derived from the underlying asset. The total return payer will make periodic payments to the total return receiver comprising the coupons/interest from the underlying asset and, either periodically or at maturity of the swap, an amount equivalent to the appreciation in the market value of the underlying asset. If the value of the reference asset depreciates, a payment would typically be made by the total return receiver to the total return payer. In contrast to a credit default swap, a total return swap transfers the credit risk and the market risk associated with the underlying asset. The economic effect for a total return receiver is equivalent to that derived from owning the asset. The total return receiver, however, does not incur the direct costs of funding the purchase of the underlying asset. As a result, the total return receiver makes a payment to the total return payer to compensate the latter for the funding costs. This payment, sometimes referred to as the premium or fee, is the other leg of the swap and usually comprises a one- or three-month benchmark based (e.g., Treasury or some other floating rate index) payment plus or minus a spread. The spread above or below the referenced interest rate index will be determined by the relative credit quality of the two counterparties as well as any collateral called for from a counterparty.

□ *Credit-linked note*

A credit-linked note is a contract under which one party issues a note to another party in return for cash or other consideration equal to the principal value of the note. The coupon on the note is linked both to the credit quality of the issuer and an obligation of a third party (the reference entity). In economic terms, it comprises a fixed income instrument and an embedded credit derivative.

Insurance-specific products that could potentially fall within the scope of ASC 815 and be subject to embedded derivative accounting include products for which a receivable, payable, deposit, account balance, commutation provision, or experience refund is credited or changes based on the realized or unrealized gains and losses of a specific pool of bonds, stocks, or mortgage loans. These products could include the following.

□ *Modified coinsurance and coinsurance with funds withheld arrangements* (also referred to as modco or funds withheld arrangements)

These contracts are reinsurance arrangements in which payments are made to the reinsurer over time, and interest is credited on that payable based on the return of the ceding entity's general account assets or a specified block of those assets (e.g., a specific portfolio of the ceding entity's investments). At inception, the ceding entity does not meet the sale criteria in ASC 860 related to the cash and investments supporting the future benefit liabilities. In these arrangements, the

ceding entity records a payable to the reinsurer, along with the reinsurance recoverable for the liabilities reinsured.

ASC 815-15-55-108 states that whether the modco or funds withheld arrangement is classified as a GAAP reinsurance contract or a GAAP deposit contract (e.g., because it “reinsures” annuity contracts that are classified as GAAP investment contracts or because it fails risk transfer due to certain risk limiting features), the embedded derivative analysis and conclusion as to whether the derivative is clearly and closely related will be the same.

- *Certain reinsurance contracts with experience refund provisions*

Certain contracts contain experience accounts or profit-sharing provisions that are based on a total return bond index, an equity index, or the total return on an investment portfolio. These provisions represent embedded derivatives requiring separate accounting.

Question IG 9-3

How should the embedded derivative in a modco agreement be characterized under ASC 815?

PwC response

There may be diversity in how the debt host is defined. ASC 815-15-25-25 states that “in the absence of stated or implied terms, it is appropriate to consider the features of the hybrid instrument, the issuer and the market in which the instrument is issued, as well as other factors, to determine the characteristics of the debt host contract.” Once the debt host is defined, the terms of the embedded derivative can be determined. In applying that guidance, typically the embedded derivative is determined to be either a credit derivative or a total return swap based on the particular facts and circumstances of the transaction. As a result of the judgment required, the conclusion around the terms of the embedded derivative may differ for the two counterparties of the same contract. The ceding entity may believe it has given away the total return on the investments it owns, while the assuming entity may believe it has just changed the credit risk in the contract.

Question IG 9-4

What circumstances should be considered in determining whether the embedded derivative is a credit in a reinsurance agreement is a credit derivative or a total return swap?

PwC response

As discussed in Question IG 9-3, ceding and assuming entities should consider the guidance in ASC 815-15-25-25 in their assessment of whether the embedded derivative is a credit derivative or a total return swap.

At a minimum, credit risk exposure that is not clearly and closely related to that of the host contract exists. This is because the credit risk exposure is that of the underlying referenced bond portfolio rather than the credit risk exposure of the ceding entity.

This consideration should also include analysis of the cash flows under the contract. For example, if the fee paid to the reinsurer is primarily for surplus relief, and it is unlikely that there will be any variation in the payment unless there is a credit event on the underlying referenced portfolio, then an

insurance entity may conclude that the derivative is a credit derivative. Alternatively, if the cash flows include incremental variability unrelated to credit, an insurance entity may conclude the derivative is a total return swap. In either case, the underlying terms of the agreement should be carefully considered in making this determination.

Question IG 9-5

Is there an embedded derivative in modco contracts that reinsure only the separate account portion of the variable annuity or variable life separate account products?

PwC response

Yes, there are two potential embedded derivatives. However, the two derivatives would typically offset one another. For the assuming entity, the first embedded derivative would be in the liability that the assuming entity has taken on (the reinsurance of the variable annuity or variable life liability) because the liability promises to pay a total return on a referenced portfolio (that of the ceding entity separate account). For the ceding entity the first embedded derivative would be in the reinsurance recoverable (the reinsurance of the variable annuity or variable life liability). The second embedded derivative would be the reinsurer modco receivable/ceding entity reinsurance payable, which would typically be equal to the assumed liability/reinsurance recoverable and would also have the same total return on the referenced portfolio. ASC 815-15-25-7 requires that derivatives in a single contract be accounted for together as one compound derivative. Differences between the two derivative components could, in certain instances, result in a net balance for the compound derivative (e.g., if there were a risk that the assuming entity would be required to pay on the variable annuity or variable life liability in the event of a ceding entity insolvency).

Question IG 9-6

If a modco contract or similar arrangement provides a total return on the modco receivable/payable, but receivables/payables relating to the contract are accounted for on a net basis rather than a gross basis because the contract satisfies the right of offset requirements of ASC 210-20-45, does ASC 815 still apply?

PwC response

Yes. Even if receivable/payables relating to the contract are recorded on the balance sheets on a net basis by either the reinsurer or ceding entity, if one of the terms of the contract provides for a total bond portfolio return based on some referenced amount (in this case the modco receivable/payable), an embedded derivative still exists as part of the modco arrangement that is required to be bifurcated and recognized at fair value with changes in fair value recognized currently in earnings.

9.10 *Reinsurance of existing blocks of life insurance contracts*

Insurance entities may assume existing blocks or lines of business from other insurance entities. In some instances, particularly for life insurance entities, the existing liabilities for the block of business will be assumed, and the assuming entity may then begin writing new business on its own policies for the line of business through the ceding entity's distribution channel. The reinsurance is often be done

on an indemnity basis, whereby an insurer is not relieved of its obligation to policyholders, and policyholders are usually unaware of the reinsurance arrangement. Reinsurance of the existing block may also be done on an assumption basis, whereby the assuming entity contractually agrees to assume the unexpired portion of the risk of the original policyholders on a portfolio of contracts representing a block of business. The ceding entity's liability to policyholders is legally extinguished in this latter arrangement, as evidenced by assumption certificates signed by policyholders or other evidence as required by applicable statute or regulations (often referred to as a novation).

Transactions in the insurance industry may take various legal forms. It is not uncommon for a transaction to include one or more indemnification or novation reinsurance transactions along with the acquisition of renewal rights, the purchase of certain legal entities, the purchase of assets, or various combinations thereof. In many cases, the acquired items taken as a whole, including the reinsurance components, may meet the definition of a business and, therefore, will be accounted for as a business combination under ASC 805. Factors to consider in making that determination include whether the rights and obligations of the in-force block of insurance and investment contracts have been transferred, and whether various other components of the business have been transferred, such as the employees and staff, the policy administration function, financial reporting functions, or distribution systems. When the transaction is determined to be a combination of a reinsurance transaction and a sale/purchase of a business by the seller/acquirer, the total consideration paid/received should be allocated to the components based on their relative fair values, which in some instances, may differ from the amounts specified in the various agreements that are contemporaneously exercised. This is required to ensure the appropriate valuation and subsequent amortization/recognition of amounts relating to each of the components.

Reinsurance contracts are sometimes written such that they specify an effective date for coverage that is prior to the date on which the agreement has been finalized. Reinsurance contracts assumed (or ceded) should be reflected in the financial statements of the reinsurer (cedant) on the date a legally enforceable contract is finalized. Any amounts exchanged that are characterized in form as assumed (or ceded) premium or assumed (or ceded) losses for periods prior to contract finalization should be viewed as an adjustment to the consideration received or paid that would form part of the cost/price of reinsurance and would not be presented in the income statement as premiums and claims.

9.10.1 *Ceding entity accounting for assumption/novation reinsurance*

For the ceding entity, transactions in which the reinsurance contract is a legal replacement of one insurer by another extinguishes the ceding entity's liability, and, in accordance with the accounting for assumption reinsurance (refer to ASC 944-20-40-3 through ASC 944-20-40-5), a gain or loss would be recognized at the date of the transaction. Although ASC 944-40-25-33 permits immediate recognition by the ceding entity of gains associated with reinsurance contracts to the extent that there is a legal replacement of one insurer by another, it does not provide any guidance to determine when an insurer's liability to policyholders has been entirely extinguished. Such a determination is a legal question, dependent upon an examination of all the facts and circumstances. See ASC 944-20-40-5 and ASC 405-20-40 for guidance on liability extinguishment. Entities should use accounting methods consistent with coinsurance or other forms of reinsurance, as appropriate, pending completion of the assumption transaction (i.e., until the liability has been entirely extinguished).

9.10.2 *Assuming entity accounting for reinsurance of existing block of long-duration contracts*

For the assuming entity, facts and circumstances regarding the reinsurance contract and any other associated agreements in the transaction will determine whether a reinsurance transaction of an existing block of business is accounted for as a business combination under ASC 805 or as reinsurance. ASC 805-10-65-1 states that a business combination "is a transaction or other event in which an acquirer obtains control of one or more businesses." ASC 805 defines a business as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return..." Refer to BCG 1.2 for further information. If the entity acquired an existing block without any other components, the transaction would generally not be viewed as a continuation of the activities of a business. Specific insurance industry considerations for business combinations are discussed in IG 12. Considerations related to assuming reinsurance not related to a business combination are discussed in IG 9.7.1.

9.11 *Discontinued operations treatment for long-duration reinsurance*

An insurer may have a disposal strategy that involves the "run-off" of operations (i.e., to cease accepting new business but to continue to provide service under existing contracts until they expire or are terminated). Under ASC 360-10-45-15, a component of an entity that is to be abandoned through the run-off of operations should not be reported as held for sale or discontinued operations (if qualifying) until all operations, including run-off operations, cease. The insurer will be conducting the activities of meeting claim obligations and investing in assets until all obligations have been extinguished. Therefore, the insurance entity will not report run-off operations as discontinued operations until the run-off is completed.

A component that is expected to be disposed of via a stock sale or a novation would be subject to the criteria for classification as assets held for sale under ASC 360-10-45-9, and the results of operations for a component that qualifies as held for sale is reported as discontinued operations in the income statement in accordance with ASC 205-20-45-1. ASC 360-10-45-9(b) requires that the asset (disposal group) be available for "immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups)." Insurers may agree to sell an operation through a novation agreement that becomes effective at some point in the future because policyholder approval is needed to legally transfer policies from the seller to the buyer. Until the novation is effective, the two parties often enter into a 100% indemnity reinsurance agreement, which transfers the underlying economics of the policies being sold, but does not result in the extinguishment of the seller's policy obligations. Although legal requirements for effecting a novation may differ among states, we expect that satisfaction of the criteria in ASC 360-10-45-9(b) prior to the effective date of the novation will be rare given the requirement for policyholder approval.

Reinsurance transactions that do not qualify for sale treatment under reinsurance accounting (e.g., 100% indemnity reinsurance agreements with no expectation of sale/novation) will not result in classification of a component as held for sale and, therefore, will not be reported as discontinued operations.

For certain run-off transactions executed prior to 2002, prior accounting literature may have permitted classification as discontinued operations. Such transactions were grandfathered upon the adoption of the guidance that now prohibits discontinued operations presentation.

Insurers may sometimes sell a legal entity and simultaneously assume back the risk relating to a subset of the sold business through a reinsurance transaction (e.g., a product line that the purchaser has no interest in continuing) in two separate agreements. If the agreements are negotiated together in contemplation of each other, the combined total consideration exchanged for both transactions should be determined and allocated on a relative fair value basis to the proceeds from the sale of the subsidiary and the proceeds for assuming the reinsurance. This fair value allocation is important to ensure that the gain or loss on sale of the subsidiary, and separately, amounts relating to the assumed reinsurance (i.e., claim liabilities and any intangible asset or deferred gain), are appropriately recognized. The reinsurance agreement is considered a new transaction as the insurer has been relieved of its primary obligation to the policyholder. In some situations, the reinsurance agreement may have been executed prior to the sale (e.g., as an intercompany transaction between the entity sold and a reinsurance subsidiary of the parent). We believe it is appropriate for the insurer to fair value the reinsurance transaction as if it was newly executed at the sale/disposition date, given that it becomes a transaction with an entity outside the insurer's control group at that date. The decision to retain what was formerly an intercompany reinsurance transaction upon sale of the cedant is analogous to issuing a new reinsurance contract with the purchaser at the date of the sale.

***Chapter 10:
Presentation and disclosure—
updated May 2022***

10.1 *Presentation and disclosure – chapter overview*

ASC 944, *Financial Services–Insurance*, provides guidance on the financial statement presentation of long-duration and short-duration insurance contracts written by insurance entities. In addition to the information provided on the face of the financial statements, certain disclosures must be included in the notes.

The objective of the ASC 944 presentation and disclosure requirements for short-duration and long-duration contracts is to provide users with decision-useful financial information that helps them understand the amount, timing, and uncertainty of risks arising from insurance contracts.

SEC Regulation S-X, Article 7 sets forth the financial statement requirements for insurance entities and provides rules for the form and content of insurance entity financial statements filed with the SEC. The SEC requirements are in addition to meeting all of the GAAP requirements. Some nonpublic insurance entities and reinsurance entities voluntarily comply with Regulation S-X, Article 7 since GAAP is silent on certain presentation matters.

This chapter discusses the presentation and disclosure considerations that are specific to insurance entities. See FSP for general guidance on financial statement presentation.

10.2 *Financial statement presentation for long-duration contracts*

ASC 944 provides specific guidance on the appropriate presentation of certain items related to long-duration contracts in the balance sheet, income statement, and statement of other comprehensive income of an insurance or reinsurance entity.

A long-duration contract is one that generally is not subject to unilateral changes in its provisions and requires the performance of various functions and services (including insurance protection) for an extended period. Long-duration contracts or their additional features are classified into the following broad categories based on the product terms for accounting and presentation guidance in ASC 944.

- Traditional insurance contracts and limited-payment contracts
- Universal life-type contracts
- Annuitization, death, or other insurance benefits
- Investment-type contracts
- Market risk benefits
- Variable annuity and variable life insurance separate account structures
- Participating life insurance contracts

The category dictates the accounting model as well as the applicable presentation requirements in ASC 944.

10.2.1 Presentation — traditional insurance and limited-payment contracts

Premiums on nonparticipating traditional long-duration insurance contracts are recorded in revenue when due. The liability for future policyholder benefits is recorded in the balance sheet using a net level premium measurement approach, which means the liability is accrued in proportion to the premium revenue recognized, with the amount being included as benefit expense. However, in the limited-payment model, the collection of premium does not represent the completion of the earnings process, so any gross premium received in excess of net premium must be deferred in accordance with ASC 944-605-25-4A. The deferred revenue amount is known as the deferred profit liability (DPL). The guidance does not specify how to present the DPL. The DPL is generally recorded within the liability for future policy benefits in the balance sheet with an offset to premium revenues. Subsequent amortization of the deferred profit would then be reflected as premiums. Alternatively, in the absence of guidance, it would also be acceptable to record the offset to the DPL as benefit expense, with subsequent amortization recorded as a reduction of benefit expense. Insurance entities must record subsequent amortization of the DPL within the same revenue or expense category used to record it initially (i.e., premium or benefit expense). Refer to IG 5.3 for further discussion of the limited-payment model.

10.2.1.1 Separate presentation — liability remeasurement gains/losses for certain long-duration contracts

Remeasurement gains and losses arise as a result of updating assumptions in the net premium ratio (sometimes referred to as unlocking) as of the beginning of the current reporting period, as required in ASC 944-40-35-6A. Refer to IG 5.2.4 for further guidance related to the meaning of “beginning of the current reporting period” when remeasuring the liability for future policy benefits. Presentation of these remeasurement gains or losses separate from total benefit expense is required in the income statement for the following long-duration contracts and benefits:

- Nonparticipating traditional insurance contracts
- Limited-payment contracts
- Death or other insurance benefits
- Annuitization benefits

The presentation is intended to provide transparency to users of the financial statements as to the effect in the current period of actual and expected policyholder activity separate from changes due to updates in assumptions related to future cash flows.

The remeasurement gains or losses resulting from the unlocking of the liability for future policy benefits, the deferred premium liability on limited-payment policies, and liabilities for annuitization benefits and death or other insurance benefits are permitted to be combined in the remeasurement gains/losses income statement line item or the amounts can be disclosed parenthetically as part of total benefits expense.

Reinsurance recoverable amounts that are remeasured using the net premium approach should also be included in the remeasurement gain or loss.

Cash flows from premiums and claims relating to traditional long duration contracts and limited payment contracts are classified as operating cash flows in the statement of cash flows.

10.2.1.2 Presentation — changes in discount rate for certain long-duration contracts

The discount rate used to measure the liability for future policy benefits for nonparticipating traditional and limited-payment contracts is required to be a “single A” interest yield that reflects the duration characteristics of the liability. The contract/cohort inception date discount curve is locked in for benefit expense (interest accretion) recognition purposes. However, the liability for future policy benefits is required to be remeasured at each reporting date based on a single A interest rate curve. The difference between the liability measured using the locked-in discount rate and the liability measured at the current curve is presented in accumulated other comprehensive income (AOCI), and the change for the period is presented in the statement of other comprehensive income (OCI).

Question IG 10-1

Is the change in discount rate related to the remeasurement of ceded reinsurance recoverables recorded in OCI?

PwC response

Yes. Ceded reinsurance transactions of nonparticipating traditional contracts and limited-payment contracts are required to be recognized and measured in a manner consistent with the underlying direct insurance contracts, including using consistent assumptions (e.g., locked-in discount rate for the income statement and updated discount rate for balance sheet remeasurement) in accordance with ASC 944-40-25-34. Therefore, a change in measurement of the reinsurance recoverable due to a change in the current period discount rate should also be recorded in OCI.

The changes can be netted with the change recorded for the underlying direct insurance contracts. Market risk benefits (MRBs) can be present in both insurance and reinsurance contracts. Refer to IG 5.6 for further discussion on the measurement of reinsured MRBs.

10.2.2 Presentation — universal-life type contracts

The revenue recorded on a universal life-type contract consists of mortality (or other insurance) fees and contract administration assessments. Such revenue is generally recorded when due as policy charges and fee income. Unlike traditional insurance contracts, the premiums collected are considered deposits and not recorded as revenue. The premiums are part of the account balance of the policyholder and recorded on the balance sheet as a liability.

ASC 944-40-30-14 specifies that the liability for policyholders’ account balances related to universal life type contracts is equal to the sum of the following four elements:

- Benefit of the policyholder at the balance sheet date (e.g., stated account balance or similar internal explicit or implicit contract value)
- Amounts previously assessed against policyholders for services to be performed in the future (e.g., deferred revenue, including front-end or initiation fees)
- Amounts previously assessed against policyholders that are refundable on contract termination

- Any amounts provided for premium deficiencies

The most significant component of a universal life-type contract is the policyholder account balance, as the other remaining elements may not always be present.

The policyholder's account balance changes each period for deductions for fees and assessments and increases for interest credited to the policyholder's account balance. Any interest credited to the policyholder's account balance is as an expense within the income statement in the period it is credited to the policyholder account.

Any fees and assessments collected from the policyholder in advance of services rendered are deferred as an unearned revenue reserve on the balance sheet in the liability for policyholders' account balances and recognized in income over the period benefitted in policy charges and fee income.

Insurance benefits (e.g., death and surrender benefits) in excess of the account balance are generally recognized as expenses in the period they are incurred unless the design of the product is such that future charges are insufficient to cover the benefits. In this case, an additional liability is accrued over the life of the contract generally within the liability for future policy benefits. See IG 10.2.3 for presentation considerations for the additional liability.

Universal life-type contracts can also contain features that would be classified as an embedded derivative or MRB, which would require bifurcation under ASC 815 or separate accounting under ASC 944, respectively. Embedded derivatives are generally recorded on the balance sheet and in the income statement with the host instrument. MRBs are required to be separately presented in the financial statements. See IG 10.2.5 for further information on the presentation of MRBs.

Premiums and returns of account balance payments are classified as financing activities in the statement of cash flows. There is diversity in practice on how the ultimate payment to the policyholder of accrued interest and assessments are classified.

10.2.3 Presentation — additional liability for annuitization, death, or other

The additional liability represents insurance benefits (death or surrender benefits) or annuitization benefits (two-tiered annuity) that are in excess of the related account balance and future charges are insufficient to cover benefits. The additional liability for annuitization, death, or other insurance benefits is recorded on the balance sheet as a liability for future policy benefits based on a benefit ratio (present value of total expected excess payments or annuitization benefits over the present value of total expected assessments).

Estimates used to establish the additional liability must be evaluated at each reporting date and updated if actual experience suggests earlier assumptions should be revised. When revising estimates, the benefit ratio must include historical experience from the issue date to the balance sheet date and estimated experience thereafter. Consistent with the traditional insurance and limited-payment model, the remeasurement gains/losses on the additional liability for annuitization, death, or other insurance benefits must be disclosed as a separate component of benefit expense on the income statement. However, the remeasurement gains and losses of the additional liability for annuitization, death, or other insurance benefits may be combined in the same line as those remeasurement gains and losses on traditional insurance and limited payment contracts. See IG 10.2.1.1 for the guidance on the presentation of remeasurement gains/losses on traditional insurance and limited-payment contracts.

Unlike the traditional insurance and limited-payment models, the discount rate is not required to be locked-in at inception for additional annuitization, death, or other insurance benefits, but is reflected in the benefit ratio used to determine benefit expense. Alternatively, an entity may use the contract rate in effect at inception of the book of contracts to discount certain expected cash flows, with no remeasurement of the liability through OCI.

Benefits paid in excess of account balances are classified as operating cash flows in the statement of cash flows.

10.2.4 Presentation — investment contracts

ASC 944-825-25-1 through ASC 944-825-25-2 requires that long-duration insurance contracts, which have been classified as investment contracts, be accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments that result in payments received being recorded as liabilities and not as revenue. If the investment contract has a stated account balance, it should generally be accrued as the liability for policyholders' account balances.

In accounting for investment contracts in a manner similar to other interest bearing obligations, revenue represents investment income generated by the investment of the funds received from the policyholder and surrender charges. Expenses are comprised primarily of interest credited to the policyholder's account balance.

Embedded derivatives and market risk benefits can exist in these contracts and require bifurcation under ASC 815 and ASC 944. See IG 10.2.5 for the presentation requirements for market risk benefits.

Premiums received and return of premiums upon maturity and surrender payments are classified as financing activities in the statement of cash flows. Interest paid is classified as operating cash outflows.

10.2.5 Presentation — market risk benefits (MRBs)—updated March 2023

Insurance entities are required to present the carrying amount of the MRB liability and MRB asset separately on the face of the balance sheet. Because market risk benefits follow a fair value recognition and measurement model, which is different from the “spreading” model used to measure the liability for future policyholder benefits or the deposit model used for policyholder account balances, these measurements have to be presented separately in the balance sheet.

The changes in the fair value of MRB assets and liabilities are also required to be presented as a separate line in both the income statement and statement of other comprehensive income for the applicable changes in fair value of MRB assets and liabilities. The changes in fair value are recognized in the income statement each period, except for the component of the change relating to the instrument-specific credit risk of MRBs, which is recognized in OCI.

MRB assets and liabilities must be separately presented on the balance sheet since there is no legal right of offset between the contracts.

Many preparers reinsure or economically hedge exposures to certain MRBs. The assets and liabilities from the reinsurance or derivatives used to economically hedge MRBs cannot be netted against MRB assets and liabilities in the balance sheet since there is no legal right of offset between them. However, we believe it is appropriate to include the changes in the value of the reinsurance asset (or liability) or derivatives that economically hedge MRBs within the MRB income statement line item.

Payments of MRB benefits are generally classified as financing activities in the statement of cash flows unless the payments are associated with death benefits in excess of account balances released, in which case they should generally be classified as operating activities.

10.2.6 Presentation — separate account structures (variable annuity and life)

Separate account assets and liabilities must be included in an insurance entity's financial statements as the insurance entity owns the assets and is contractually obligated to pay the amount to the policyholders. For separate account arrangements that meet the criteria in ASC 944-80-25-2, separate account assets and liabilities have to be presented separately, each as a single line, on the balance sheet. The qualifying separate account assets are measured at fair value. Therefore, the disclosures required by ASC 820, *Fair Value Measurements*, apply to separate account assets.

ASC 944-80-45-2 requires that separate account liabilities be reported on the balance sheet at an amount equal to the amount credited to the contract holder, which is typically determined as the contract holder deposits less withdrawals, less fees and charges assessed, plus or minus the change in fair value of the corresponding separate account assets. This is not equivalent to a fair value measurement of the contract, as it does not consider the fair value associated with other components of the contract, such as annuity purchase rate guarantees, minimum account guarantees, and future fees and other assessments. Therefore, ASC 820 does not apply to the valuation of separate account liabilities.

For qualifying separate account arrangements, ASC 944-80-45-3 requires that the related investment performance (i.e., investments, dividends, realized gains/losses, changes in unrealized gains/losses) and the corresponding amount credited to the contract holder be offset within the same income statement line.

For separate account structures that do not meet the criteria in ASC 944-80-25-2, the assets and liabilities associated with the arrangement should be measured, presented, and disclosed consistent with the other general account assets and liabilities of the reporting entity.

See IG 10.3.4 for further information on the required disclosures for qualifying separate accounts.

10.2.7 Presentation — participating life insurance contracts

Participating life insurance contracts include certain contracts issued by mutual life insurance entities and certain stock life insurance entities that pay dividends to policyholders based on the actual experience of the insurance entity.

The premiums are recorded in revenue when due. The liability for future policyholder benefits is recorded in the balance sheet for the contracts using a net level premium measurement approach. This is similar to the accounting for nonparticipating traditional insurance contracts except that the net premium ratio is based on locked-in assumptions based on contractual terms (including a terminal dividend). The offset for the liability is reflected as benefit expense in the income statement. Because the net premium ratio is not required to be updated, there is no remeasurement gain/loss recorded in income. The annual dividends are accrued and recognized in the income statement as a policyholder expense when declared.

Cash flows from participating life insurance contracts are classified as operating cash flows in the statement of cash flows.

10.3 *Disclosure requirements for long-duration contracts*

ASC 944 requires specific disclosures for long-duration contracts.

Insurance entities subject to Article 7 of SEC Regulation S-X may be required to make additional disclosures based on the requirements of Regulation S-X, Rule 7-03 through Regulation S-X, Rule 7-05.

10.3.1 *Disaggregated rollforwards – non-participating long-duration contracts*

Year-to-date disaggregated tabular rollforwards are required in both annual and interim reporting periods in accordance with ASC 944-40-50-6, ASC 944-40-50-7A, ASC 944-40-50-7B, ASC 944-80-50-2, and ASC 944-30-50-2B for the following balances associated with nonparticipating long-duration contracts:

- future policy benefits,
- additional liability for annuitization, death or other insurance benefits,
- policyholder account balances,
- market risk benefits,
- separate account liabilities, and
- deferred acquisition costs (and balances amortized on a basis consistent with DAC).

Each disaggregated rollforward must reconcile to the aggregate ending carrying amount included in the balance sheet and/or amounts included in the income statement, as appropriate. For example, for annual reporting, the beginning and ending balances in the rollforward must reconcile to the balance sheet, and the activity within the rollforward must reconcile to the corresponding income statement amounts. For interim reporting, the beginning and ending balance must agree to the balance sheet and the activity must reconcile to the year-to-date income statement. We believe the comparative periods presented in the rollforwards should highlight the comparative year-to-date activity and should reconcile to the corresponding income statement amounts.

The disaggregated rollforwards of DAC (and balances amortized on a basis consistent with DAC) are required for all long-duration contracts. The remaining rollforwards are required for all nonparticipating long-duration contracts that are written, assumed, or ceded by insurance entities and reinsurance entities.

Refer to ASC 944-40-50-8 and ASC 944-805-50 for the disclosure requirements applicable to participating long-duration contracts, including those contained within closed blocks.

See IG 10.3.1.2 through IG 10.3.1.6 for various illustrations of these disaggregated rollforwards and IG 10.3.2 for additional long-duration contract disclosures relating to key judgments and assumptions.

10.3.1.1 *Level of aggregation of disaggregated rollforwards*

The guidance does not prescribe the level of disaggregation and indicates the level of aggregation or disaggregation will depend on the specific facts and circumstances. ASC 944-40-50-5A states that disaggregation should be at a level that does not obscure useful information by including a large amount of insignificant detail and aggregation should not combine items with significantly different characteristics.

In determining the extent of disaggregation, the following information should be considered in accordance with ASC 944-40-55-13G:

- Disclosures presented outside the financial statements (e.g., Management’s Discussion and Analysis in Annual Reports on Form 10-K, earnings releases, or statutory filings)
- Information regularly viewed by the chief operating decision maker for evaluating financial performance
- Other information that management or financial statement users use to evaluate the insurance entity’s financial performance or that is used to make resource allocations (e.g., supplemental schedules provided to investors)

ASC 944-40-55-13H provides examples of disaggregated categories to consider and notes that reporting entities should not aggregate amounts from different reportable segments.

ASC 944-40-55-13H

Examples of categories that might be appropriate to consider to aggregate or disaggregate disclosures include the following:

- a. Type of coverage (for example, major product line)
- b. Geography (for example, country or region)
- c. Market or type of customer (for example, individual or group lines of business).

When applying the guidance in paragraphs ASC 944-30-50-2A through 50-2B, 944-40-50-6 through 50-7C, and 944-80-50-1 through 50-2, an insurance entity should not aggregate amounts from different reportable segments according to Topic 280, if applicable.

The rollforwards of DAC (and balances amortized on a basis consistent with DAC) are required to be disaggregated in a manner that is consistent with the related liability disclosures.

Insurance entities are not required to include disclosure for “insignificant categories” of liabilities, but if omitted, these categories would be included in the reconciliation to the applicable balance sheet amounts. Judgment will be needed to assess what is insignificant in the context of the financial statements.

10.3.1.2 Disaggregated rollforwards – Liability for future policy benefits and additional liability

The disaggregated tabular rollforwards of the liability for future policy benefits and additional liability for annuitization, death, or other insurance benefits are required to be presented on a year-to-date basis, within the notes, for all annual and interim reporting periods. See IG 10.3.1.1 for considerations on the level of disaggregation. These disaggregated rollforwards must be reconciled to the aggregate ending balance on the balance sheet and/or amounts included in the income statement, as appropriate. Amounts included within the rollforwards are required to be presented gross of any related reinsurance recoverables.

ASC 944-40-50-6 requires that each disaggregated rollforward of the liability for future policy benefits and additional liability for annuitization, death, or other insurance benefits that is presented within the notes include the following information either as a component of the rollforward or as accompanying information:

- Undiscounted and discounted ending balance of expected future gross premiums and expected future benefits and expenses (for traditional and limited-payment contracts)
- Actual experience during the period for mortality, morbidity, and lapses, compared with what was expected for the period
- Amount of revenue and interest recognized in the income statement (disaggregated amounts must be reconciled to the amounts recognized in the income statement for the period, but interest recognized does not need to be reported as a separate line within the income statement)
- Weighted average duration of the liability
- Weighted average interest rates for accretion and current discounting relating to the liability for future policy benefits, a description of the techniques used to determine the interest rate assumption, and information about any adjustments to observable market information

For traditional and limited-payment contracts, expected future net premiums and expected future benefits must be separately included in the rollforwards.

Items that may be included within the rollforwards of the liability for future policy benefits or additional liability for annuitization, death, or other insurance benefits are provided in ASC 944-40-55-13I.

Excerpt from ASC 944-40-55-13I

- a. Issuances
- b. Interest accrual
- c. Net premiums or assessments collected
- d. Benefit payments
- e. Derecognition (lapses or withdrawals)

- f. Effect of actual variances from expected experience
- g. Effect of changes in cash flow assumptions
- h. Effect of changes in discount rate assumptions.

Insurance entities should consider the information that is most useful for users of the financial statements when determining which of the suggested lines to include in the rollforwards. Information necessary to prepare the disaggregated rollforwards may already be compiled as part of supplemental external reporting (e.g., investor supplements) or as part of internal reporting.

Figure IG 10-1 illustrates disaggregated rollforwards and accompanying information for the liability for future policy benefits and indicates which line items within the rollforwards are required per ASC 944-40-50-6 versus suggested within ASC 944-40-55-13I or illustrated within ASC 944-40-55-29E.

Figure IG 10-1

Illustrative disaggregated rollforwards of the liability for future policy benefits

Note X: Liability for future policy benefits

[For example purposes, two major product lines (term life and whole life) are illustrated and the applicable ASC references are provided. Additional product lines may be disclosed depending on the insurance entity's insurance products.]

The following table presents the balances and changes in the liability for future policy benefits.

[Required by ASC 944-40-50-6a]

		December 31,				
		20X2		20X1		
		PwC observations	Term life	Whole life	Term life	Whole life
Present value of expected net premiums	Balance, beginning of year	(1) Required – ASC 944-40-50-6a	\$TTT*	\$UUU*	\$XXX	\$XXX
	Beginning balance at original discount rate	(1) Illustrated – ASC 944-40-55-29E	RRR*	SSS*	XXX	XXX
	Effect of changes in cash flow assumptions	(2) Suggested – ASC 944-40-55-13I	XXX	XXX	XXX	XXX
	Effect of actual variances from expected	(3) Required – ASC 944-40-50-6b-2	XXX	XXX	XXX	XXX
	Issuances	(4) Suggested – ASC 944-40-55-13I	XXX	XXX	XXX	XXX
	Interest accrual	(5) Suggested – ASC 944-40-55-13I	XXX	XXX	XXX	XXX
	Net premiums collected	(6) Suggested – ASC 944-40-55-13I	(XXX)	(XXX)	(XXX)	(XXX)

		December 31,				
		20X2		20X1		
		PwC observations	Term life	Whole life	Term life	Whole life
	Derecognition (lapses)	(7) Suggested – ASC 944-40-55-13I	(XXX)	(XXX)	(XXX)	(XXX)
	Ending balance at original discount rate	(1) Illustrated - ASC 944-40-55-29E	VVV*	WWW*	RRR*	SSS*
	Effect of changes in discount rate	Suggested - ASC 944-40-55-13I	XXX	XXX	XXX	XXX
	Balance, end of year	(1) Required - ASC 944-40-50-6a	\$YYY*	\$ZZZ*	\$TTT*	\$UUU*
Present value of expected future policy benefits	Balance, beginning of year	(1) Required - ASC 944-40-50-6a	\$TTT*	\$UUU*	\$XXX	\$XXX
	Beginning balance at original discount rate	(1) Illustrated - ASC 944-40-55-29E	RRR	SSS	XXX	XXX
	Effect of changes in cash flow assumptions	(2) Suggested - ASC 944-40-55-13I	XXX	XXX	XXX	XXX
	Effect of actual variances from expected	(3) Required in – ASC 944-50-6b-2	XXX	XXX	XXX	XXX
	Issuances	(4) Suggested - ASC 944-40-55-13I	XXX	XXX	XXX	XXX
	Interest accrual	(5) Suggested - ASC 944-40-55-13I	XXX	XXX	XXX	XXX
	Benefit payments	(8) Suggested - ASC 944-40-55-13I	(XXX)	(XXX)	(XXX)	(XXX)
	Derecognition (lapses)	(7) Suggested - ASC 944-40-55-13I	(XXX)	(XXX)	(XXX)	(XXX)
	Ending balance at original discount rate	(1) Illustrated - ASC 944-40-55-29E	VVV*	WWW*	RRR*	SSS*
	Effect of changes in discount rate	Suggested - ASC 944-40-55-13I	XXX	XXX	XXX	XXX
	Balance, end of year	(1) Required in ASC 944-40-50-6a	\$YYY*	\$ZZZ*	\$TTT*	\$UUU*
	Net liability for future policy benefits	(9) Required - ASC 944-40-50-6a	\$CCC*	\$DDD*	\$AAA*	\$BBB*
	Related reinsurance recoverable	(10) Required - ASC 944-40-50-6b-4	XXX	XXX	XXX	XXX

	December 31,				
	PwC observations	20X2		20X1	
		Term life	Whole life	Term life	Whole life
Weighted-average liability duration of the liability for future policy benefits (years)	(11) Required - ASC 944-40-50-6b-5	XX	XX	XX	XX

* These balances should agree to other balances identified with the same letters within this table or in other tables within the footnote.

The following is a reconciliation of the net liability for future policy benefits to the liability for future policy benefits in the consolidated balance sheet. **[Required by ASC 944-40-50-6c]**

	December 31,	
	20X2	20X1
Term life (9)	\$CCC	\$AAA
Whole life (9)	DDD	BBB
Other	XXX	XXX
Total	\$XXX	\$XXX

The following table presents the amount of undiscounted expected future benefit payments and expected gross premiums. **[Required by ASC 944-40-50-6b-1]**

	December 31,	
	20X2	20X1
Term life		
Expected future benefit payments	\$XXX	\$XXX
Expected future gross premiums	\$XXX	\$XXX
Whole life		
Expected future benefit payments	\$XXX	\$XXX
Expected future gross premiums	\$XXX	\$XXX

The following table presents the amount of revenue and interest recognized in the income statement. **[Required by ASC 944-40-50-6b-3 and ASC 944-40-50-6c]**

	Gross premiums			Interest accretion		
	December 31,			December 31,		
	20X2	20X1	20X0	20X2	20X1	20X0
Term life	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX
Whole life	XXX	XXX	XXX	XXX	XXX	XXX
Other	XXX	XXX	XXX	XXX	XXX	XXX
Total	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX

The following table presents the weighted-average interest rate. [Required by ASC 944-40-50-6b-6]

	December 31,		
	20X2	20X1	20X0
Term life			
Interest accretion rate	XXX%	XXX%	XXX%
Current discount rate	XXX%	XXX%	XXX%
Whole life			
Interest accretion rate	XXX%	XXX%	XXX%
Current discount rate	XXX%	XXX%	XXX%

Table footnotes:

The liability rollforward for the liability for future policy benefits provided in the FASB example in 944-40-55-29E is illustrative and therefore does not provide instructions on specific line items. An entity's disclosures need to, at a minimum, satisfy the requirements in ASC 944-40-50-6 and ASC 944-40-50-7. An entity will need to apply judgment to determine the presentation and components that allow users to understand the amount, timing, and uncertainty of future cash flows arising from the liability. The line items in the table above and the explanations in the footnotes below are just an example.

1. **Balance, beginning of year** and **Beginning balance at original discount rate** in 20X2 should agree to the **Balance, end of year** and **Ending balance at original discount rate** in 20X1, respectively, for each major category. **The Balance, end of year** by major category should also agree to the amounts included in the reconciliation to the balance sheet carrying amount.
2. **Remeasurement gain/loss - Effect of changes in cash flow assumptions** and **Remeasurement gain/loss - Effect of actual variances from expected experience** (#3 below), together represent the year-to-date remeasurement gain/loss on the liability that is required to be presented separately in the income statement. See IG 5.2.4 for a discussion on updating of cash flow assumptions. The remeasurement gain/loss, also referred to as the retrospective catch up adjustment, is recognized as of the beginning of the current reporting

period, which is the beginning of the quarter for SEC filers. The disaggregated rollforwards are presented on a year-to-date basis. Therefore, annual and year-to-date remeasurement gains or losses included in the rollforwards will be the sum of each interim (e.g., quarter) period remeasurement gains or losses. For example, the third quarter notes to the financial statements of a calendar SEC filer will include the total remeasurement gain or loss recorded for first, second, and third quarters, if any, since the disaggregated rollforward is presented on a year-to-date basis.

The effect of changes in the cash flow assumptions component of the total remeasurement gain/loss represents the effect on the liability of changes in expected future cash flows due to updates in actuarial assumptions applied to the beginning of the period balance at the original locked in discount rate. Although this line item is not listed as required in the ASC 944-40-50-6 disaggregated rollforward guidance, it is suggested in ASC 944-40-55-13I and illustrated in the ASC 944-40-55-29E rollforward example. ASC 944-40-50-7 requires that changes in significant inputs, judgments, and assumptions during the period and the effect on the measurement of the liability be disclosed in the notes, so presenting this line item will assist in satisfying this requirement. Insurance entities should also consider providing narrative disclosures as to the major products or geographies driving the remeasurement gain or loss.

3. **Remeasurement gain/loss - Effect of actual variances from expected experience** is the component that together with the **Remeasurement gain/loss - Effect of changes in cash flow assumptions** (#2 above) comprises the year-to-date remeasurement gain/loss on the liability. Year-to-date results will equal the sum of quarterly results. For each quarter (which will then be totaled to a year-to-date amount), the exact content of this line depends on the frequency of net premium updates. See IG 5.2.4 for a discussion on updating for actual experience.
 - (a) If, for example, the net premium ratio is updated for actual experience every quarter, this line will include the difference between actual net premiums or benefits for each quarter and their expected amounts, the effect of the change in future net premiums and benefits due to actual amounts in force that differ from the amounts expected, and the effect of updating the net premium ratio for those differences. This line then satisfies the ASC 944-40-50-6 requirement to disclose “Actual experience ... compared with what was expected for the period.”
 - (b) If the net premium ratio is updated only in certain quarters, in those quarters this line will show the effect of updating the net premium ratio. In periods when the net premium ratio is not updated and therefore there is no remeasurement gain/loss, the ASC 944-40-50-6 requirement to disclose “Actual experience ... compared with what was expected for the period,” will need to be shown elsewhere, “as a component of the rollforward or as accompanying information.” For example, in a period when the net premium ratio is not updated, and death benefits are \$1,000 in excess of expected amounts, the \$1,000 could be shown in an “experience variance” line item within the benefits section of the rollforward.
4. **Issuances** is not specifically defined. We believe it is generally understood to represent net premiums expected to be collected on new contracts/cohorts. Given the expected future net premiums and expected future benefits must be separately disclosed in the disaggregated rollforwards for traditional and limited-payment contracts, the present value of all future net premiums and the present value of future benefit payments for all new contracts/cohorts need

to be presented gross within the rollforward sections, but in theory should be the same equal and offsetting amounts.

5. **Interest accrual** is not specifically defined. We believe interest accrual represents the amount of interest accreted on the expected future net premiums and interest expense accreted on the expected future benefits, respectively. The net amount of interest is recognized as part of benefit expense.
6. **Net premiums collected (due)** represents the portion of actual gross premiums collected from policyholders that is required to provide for all benefits and expenses. This amount is recognized as benefit expense. Revenue is recognized when due; therefore, we believe “net premiums collected” represents amounts due during the current period from policyholders. The difference between the expected net premiums included within the liability for future policy benefits and the actual net premium payments in the period would be captured in the “Effect of actual variances from expected experience” (#3 above) if an entity updates the net premium ratio for current experience every quarter. If an entity did not update the net premium ratio for experience in the quarter, the difference between actual net premiums collected presented in this line and expected amounts could be presented in an “experience variance” line item within the net premiums section of the rollforward.
7. **Derecognition (terminations)** is not specifically defined. The content of this line will depend on update frequency described in #3 above. If an entity updates for current experience every quarter, this line will be zero unless an entity decides to identify the impact of derecognition on new policies issued during the year separately.

For quarters in which an entity does not update the net premium ratio for current experience, this derecognition line would be used to reflect the impact of derecognition experience, meaning unexpected terminations, which can be more or less than expected terminations. For example, assume an excess death benefit was shown in a separate “experience variance” line item, and that unexpected death led to a decrease in future net premiums of \$200 and a decrease in future benefits of \$250. In the net premium section of the rollforward, the derecognition line would show a decrease of \$200, and in the benefits section, the derecognition line would show a decrease of \$250.

8. **Benefit payments** is not specifically defined. We believe it represents the actual benefit payments during the period. The difference between the expected benefit payments included within the liability for future policy benefits and the actual benefit payments in the period would be captured in **Effect of actual variances from expected experience** (#3 above) if an entity updates the net premium ratio for current experience every quarter. If an entity did not update the net premium ratio for experience in the quarter, the difference between actual benefit payments presented in this line and expected amounts could be presented in an “experience variance” line item within the benefits section of the rollforward.
9. **Net liability for future policy benefits** represents the liability for future policy benefits recorded on the balance sheet for the particular category in each disaggregated rollforward. The liability typically represents the difference between the balance at the end of the period for the “Present value of expected net premiums” and the “Present value of expected future policy benefits.” However, an additional reconciling line item may be needed when application of ASC 944-40-35-7B guidance requires an adjustment to floor the liability at zero. The net

liability for future policy benefits must be reconciled to the aggregate ending balance on the balance sheet.

10. **Reinsurance recoverable** represents the recoverable for the particular category in each disaggregated rollforward. The rollforward guidance requires the disaggregated rollforwards to be presented gross of any related reinsurance, but does not require the reinsurance recoverable amounts in each disaggregated rollforward to be reconciled to the balance sheet. We believe the reinsurance balances included within the rollforwards should be consistent with balances included in an insurance entity's reinsurance disclosures in the notes.
11. **Weighted-average duration of the liability** represents the weighted-average expected length of time to payment of the liability and must be disclosed for each disaggregated rollforward either as accompanying information in the rollforward or in the notes.

Question IG 10-2

Is the deferred profit liability (DPL) on limited-payment contracts required to be rolled forward separately from the rollforwards of the liability for future policy benefits?

PwC response

No. ASC 944 does not require a separate tabular rollforward for the DPL. However, if the DPL is included in the liability for future policy benefits line on the balance sheet, the DPL balances would, at a minimum, be required to be included in the disclosures to reconcile the rollforward for the liability for future policyholder benefits to the carrying amount in the balance sheet and income statement, as required by ASC 944-40-50-6(c). If the DPL is voluntarily included within the rollforward, we believe companies should ensure that the inclusion of the DPL in the rollforward does not obfuscate the rollforward information required for the liability for future policy benefits.

Question IG 10-3

Can the additional liability for annuitization, death, or other insurance benefits be combined with the liability for future policy benefits into a single disaggregated rollforward?

PwC response

It depends. ASC 944-40-50-6 requires disaggregated rollforward disclosures for each balance. Judgment will therefore have to be applied to determine whether the aggregation of these two balances violates the principle outlined in ASC 944-40-50-5A, which states that no entity shall aggregate items with significantly different characteristics if the balances are material. Immaterial balances could be presented as a reconciling item within the disaggregated rollforwards so as to reconcile to the carrying amount on the balance sheet or amounts in the income statement as appropriate. However, insurance entities may prefer to create separate rollforwards for the additional liability since only the disaggregated rollforwards for the liability for future policy benefits for traditional and limited-payment contracts must present expected gross and net future premiums and expected future benefits separately.

Furthermore, certain of the suggested line items or disclosures within the liability for future policy benefits may need to be modified or tailored for the additional liability for annuitization, death, or other insurance benefits. For example, instead of expected net premiums collected, the additional

liability is calculated considering the expected assessments over the life of the contract, which can include charges assessed against the policyholder as well as investment margin earned on the assets of the contract.

10.3.1.3 Disaggregated rollforwards – Policyholders’ account balances

The disaggregated tabular rollforwards of the liability for policyholders’ account balances are required to be presented on a year-to-date basis, within the notes, for all annual and interim reporting periods. The disclosure requirements for the liability for policyholder account balances in ASC 944-40-50-7A refer to the accrued account balance described in ASC 944-40-25-14. In addition, if other items are included in the liability for policyholder account balances (e.g., embedded derivatives), the rollforwards must reconcile to the ending carrying amount included in the balance sheet. Separate account liabilities are not included in the disaggregated rollforwards of the liability for policyholders’ account balances. See IG 10.3.1.1 for considerations on the level of disaggregation and IG 10.3.1.5 for the disclosure requirements for the disaggregated rollforwards of the separate account liability.

ASC 944-40-50-7A requires that each disaggregated rollforward of the liability for policyholders’ account balances that is presented within the notes include the following information either as a component of the rollforward or as accompanying information:

- Weighted-average crediting rates
- Guaranteed benefit amount in excess of current account balances
- Cash surrender value

A tabular schedule of policyholders’ account balances by range of guaranteed minimum crediting rates and the related range of the difference between the rates being credited and the respective guaranteed minimums must also be provided.

Items that may be included within the rollforwards of the liability for policyholders’ account balances are provided in ASC 944-40-55-13J.

Excerpt from ASC 944-40-55-13J

- a. Issuances
- b. Premiums received
- c. Policy charges
- d. Surrenders and withdrawals
- e. Benefit payments
- f. Transfer from or to separate accounts
- g. Interest credited.

Insurance entities should consider the information that is most useful for users of the financial statements when determining which of the suggested lines to include in the rollforwards. Information necessary to prepare the disaggregated rollforwards may already be compiled as part of supplemental external reporting (e.g., investor supplements) or as part of internal reporting.

Figure IG 10-2 illustrates the disaggregated rollforwards and accompanying information for the liability for policyholders' account balances and indicates which line items within the rollforwards are required per ASC 944-40-50-7A versus suggested within ASC 944-40-55-13J.

Figure IG 10-2

Illustrative disaggregated rollforwards of the liability for policyholders' account balances

Note X: Policyholders' account balances

[For example purposes, two major product lines (universal life and fixed annuity) are illustrated and the applicable ASC references are provided. Additional product lines may be disclosed depending on the insurance entity's insurance products.]

The following table presents the balances and changes in policyholders' account balances. **[Required by ASC 944-40-50-7A-a]**

	PwC observations	December 31,			
		Universal life	Fixed annuity	Universal life	Fixed annuity
Balance, beginning of year	(1) Required – ASC 944-40-50-7A-a	\$AAA*	\$BBB*	\$XXX	\$XXX
Issuances	(2) Suggested -ASC 944-40-55-13J	XXX	XXX	XXX	XXX
Premiums received		XXX	XXX	XXX	XXX
Policy charges (a)		(XXX)	(XXX)	(XXX)	(XXX)
Surrenders and withdrawals		(XXX)	(XXX)	(XXX)	(XXX)
Benefit payments	(3) Suggested - ASC 944-40-55-13J	(XXX)	(XXX)	(XXX)	(XXX)
Net transfers from(to) separate account		XXX	XXX	XXX	XXX
Interest credited		XXX	XXX	XXX	XXX

Other	(4) Suggested - ASC 944-40-55-13J	XXX	XXX	XXX	XXX
Balance, end of year	(1) Required - ASC 944-40-50-7A-a	\$CCC*	\$DDD*	\$AAA*	\$BBB*
Weighted-average crediting rate	Required - ASC 944-40-50-7A-b1	X.XX%	X.XX%	X.XX%	X.XX%
Net amount at risk	(5) Required - ASC 944-40-50-7A-b2 ⁵	\$XXX	\$XXX	\$XXX	\$XXX
Cash surrender value	Required - ASC 944-40-50-7A-b3	\$XXX	\$XXX	\$XXX	\$XXX

(a) Contracts included in the policyholder account balances are generally charged a premium and/or monthly assessments on the basis of the account balance.

* These balances should agree to other balances identified with the same letters in this table or other tables within the footnote.

The following table presents the reconciliation of policyholders' account balances to the policyholders' account balances' liability in the consolidated statement of financial position. **[Required by ASC 944-40-50-7A-c]**

	December 31,	
	20X2	20X1
Universal life (1)	\$CCC	\$AAA
Fixed annuity (1)	DDD	BBB
Other	XXX	XXX
Total	\$XXX	\$XXX

The following table presents the balance of account values by range of guaranteed minimum crediting rates and the related range of the difference, in basis points, between rates being credited to policyholders and the respective guaranteed minimums. **[Required by ASC 944-40-50-7A-d]**

December 31, 20X2						
	Range of guaranteed minimum crediting rate	At guaranteed minimum	1 to 50 basis points above	51 to 150 basis points above	Greater than 150 basis points above	Total
Universal life	X.XX%–X.XX%	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX
	X.XX%–X.XX%	XXX	XXX	XXX	XXX	XXX
	Greater than X.XX%	XXX	XXX	XXX	XXX	XXX
	Total	\$XXX	\$XXX	\$XXX	\$XXX	\$CCC
Fixed annuity	X.XX%–X.XX%	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX
	X.XX%–X.XX%	XXX	XXX	XXX	XXX	XXX
	Greater than X.XX%	XXX	XXX	XXX	XXX	XXX
	Total	\$XXX	\$XXX	\$XXX	\$XXX	\$DDD
December 31, 20X1						
	Range of guaranteed minimum crediting rate	At guaranteed minimum	1 to 50 basis points above	51 to 150 basis points above	Greater than 150 basis points above	Total
Universal life	X.XX%–	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX
	X.XX%–	XXX	XXX	XXX	XXX	XXX
	Greater than	XXX	XXX	XXX	XXX	XXX
	Total	\$XXX	\$XXX	\$XXX	\$XXX	\$AAA
Fixed annuity	X.XX%–	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX
	X.XX%–	XXX	XXX	XXX	XXX	XXX
	Greater than	XXX	XXX	XXX	XXX	XXX
	Total	\$XXX	\$XXX	\$XXX	\$XXX	\$BBB

Table footnotes:

1. **Balance, beginning of year** in 20X2 should agree to the **Balance, end of year** in 20X1 for each major category. The **Balance, end of year** by major category should also agree to the amounts included in the reconciliation to the balance sheet carrying amount.
2. **Issuances** is not specifically defined. We believe it represents premiums collected on new contracts written during the period. Some insurance entities may not currently track premiums collected on new business separately within their systems, and may want to consider gathering that information if it is considered relevant to the users of the financial statements. If an insurance entity elects to include the entire amount paid by the contract holder, gross of any amounts attributed to MRBs or embedded derivatives, the amounts

allocated to those other accounting units should be included in a separate line item in the roll forward.

3. Premiums received, Policy charges, Benefit payments, Surrenders and withdrawals, Net transfers from (to) separate account, and Interest credited are not specifically defined in the guidance. Policyholder account balances are generally charged fees in various forms, including periodic flat dollar amounts, percent of premium amounts, cost of insurance, and rider charges. If an insurance entity elects to include the amounts gross of activity attributed to other accounting units (e.g., MRBs or embedded derivatives), or in the case of interest credited, excluding the interest related to the accretion of the discount created by the initial allocation of compensation to other accounting units, the differences should be included in a separate line item in the roll forward.
4. **Other** may represent the adjustment between (1) line items that represent policyholder activity recorded within the policyholder administrative systems and shown on the policyholder statements (e.g., persistency bonus accruals), (2) activity attributed to the other accounting units that were separated at each contract's inception (if the amounts were shown gross in other lines), and (3) the accretion of the discount created by other accounting units (if the contractual interest credited was included in the earlier line).
5. **Net amount at risk** is generally defined as the current guaranteed minimum benefit in excess of the current account balance at the balance sheet date. A reporting entity may want to include a reconciliation or discussion in the notes to explain where in the balance sheet the total net amount at risk disclosed is presented (e.g., market risk benefit, additional liability for annuitization, death, or other insurance benefits). There may be multiple net amounts at risk if there are multiple GMXBs in the policies included in the roll forward.

Question IG 10-4

Are contracts without insurance risk (such as funding agreements) required to be included in the liability for policyholders' account balances rollforwards?

PwC response

No. The disaggregated rollforward requirements in ASC 944 are not applicable to liabilities accounted for under other GAAP guidance. Funding agreements are not accounted for under ASC 944, even though in practice they are sometimes included in the same balance sheet line item as the liability for policyholders' account balances. However, we believe an insurance entity would not be precluded from including funding agreements within the disaggregated rollforwards for the liability for policyholders' account balances. This may be helpful to users of the financial statements to the extent the balance of funding agreements is material. Even if not included in the rollforwards, the amount of funding agreements would be disclosed to reconcile the disaggregated balances to the financial statement line item.

10.3.1.4 Disaggregated rollforwards – Market risk benefits (MRBs)

The disaggregated tabular rollforwards of MRBs are required to be presented on a year-to-date basis, within the notes for all annual and interim reporting periods. These rollforwards must reconcile to the ending carrying amount included in the balance sheet by reconciling to those in an asset position and those in a liability position. However, separate rollforwards for MRBs in an asset position and those in

a liability position are not required. See IG 10.3.1.1 for considerations on the level of disaggregation. Disaggregated amounts should be presented gross of any derivatives or other financial instruments that may be used to economically hedge these features. While the guidance is silent, we believe the disaggregated rollforwards should be presented gross of reinsurance for MRBs. See Figure IG 10-3 for additional observations on the components of the disaggregated rollforwards.

ASC 944-40-50-7B requires that each disaggregated rollforward of MRBs that is presented within the notes include the following information either as a component of the rollforward or as accompanying information:

- Guaranteed benefit amounts in excess of the current account balances (for example, the net amount at risk)
- Weighted average attained age of contract holders of MRBs

Items that may be included within the rollforwards of market risk benefits are provided in ASC 944-40-55-13K.

Excerpt from ASC 944-40-55-13K

- a. Issuances
- b. Interest accrual
- c. Attributed fees collected
- d. Benefit payments
- e. Effect of changes in interest rates
- f. Effect of changes in equity markets
- g. Effect of changes in equity index volatility
- h. Actual policyholder behavior different from expected behavior
- i. Effect of changes in future expected policyholder behavior
- j. Effect of changes in other future expected assumptions
- k. Effect of changes in the instrument-specific credit risk

Insurance entities should consider the information that is most useful for users of the financial statements when determining which of the suggested lines to include in the rollforwards. Information necessary to prepare the disaggregated rollforwards may already be compiled for purposes of analyzing the effectiveness of the economic hedging programs for certain MRBs or as part of internal reporting.

The suggested lines for the disaggregated MRB rollforwards in ASC 944-40-55-13K is an extensive list that may not be relevant for every type of MRB and, as a result, each insurance entity should tailor those line items to their individual facts and circumstances.

Additionally, since MRBs are carried at fair value, these tabular rollforwards may satisfy certain of the disclosure requirements in ASC 820-10-50. If that is the case, an insurance entity is not required to duplicate the related fair value disclosures. See IG 10.3.3 for a comparison of ASC 820 fair value disclosures and MRB required disclosures.

Figure IG 10-3 illustrates the disaggregated rollforwards and accompanying information for market risk benefits and indicates which line items within the rollforwards are required per ASC 944-40-50-7B versus suggested within ASC 944-40-55-13K or illustrated within ASC 944-40-55-29G.

Figure IG 10-3

Illustrative disaggregated rollforwards of market risk benefits

Note X: Market risk benefits

[For example purposes, disaggregated rollforwards of market risk benefits associated with two major product lines (variable annuities and indexed annuities) are illustrated and the applicable ASC references are provided. Additional product lines may be disclosed depending on the insurance entity's products.]

The following table presents the balances and changes in market risk benefits associated with variable and indexed annuities. **[Required by ASC 944-40-50-7B]**

	PwC observations	December 31, 20X2		December 31, 20X1	
		Variable annuities	Indexed annuities	Variable annuities	Indexed annuities
Balance, beginning of year	(1) Required - ASC 944-40-50-7B-a	\$AAA*	\$FFF*	\$XXX	\$XXX
Balance, beginning of year, before effect of changes in the instrument-specific credit risk	(1) Illustrated - ASC 944-40-55-29G	XXX	XXX	XXX	XXX
Issuances	(2) Suggested - ASC 944-40-55-	XXX	XXX	XXX	XXX
Interest accrual	(3) Suggested - ASC 944-40-55-13K	XXX	XXX	XXX	XXX
Attributed fees collected	(2) Suggested - ASC 944-40-55-13K	XXX	XXX	XXX	XXX
Benefit payments	(2) Suggested - ASC 944-40-55-13K	(XXX)	(XXX)	(XXX)	(XXX)
Effect of changes in interest rates	(4) Suggested - ASC 944-40-55-13K	XXX	XXX	XXX	XXX
Effect of changes in equity markets	(4) Suggested - ASC 944-40-55-13K	XXX	XXX	XXX	XXX
Effect of changes in equity index volatility	(4) Suggested - ASC 944-40-55-13K	XXX	XXX	XXX	XXX

	PwC observations	December 31, 20X2		December 31, 20X1	
		Variable annuities	Indexed annuities	Variable annuities	Indexed annuities
Actual policyholder behavior different from expected behavior	(4) Suggested - ASC 944-40-55-13K	XXX	XXX	XXX	XXX
Effect of changes in future expected	(4) Suggested - ASC 944-40-55-13K	XXX	XXX	XXX	XXX
Effect of changes in other future expected	(4) Suggested - ASC 944-40-55-13K	XXX	XXX	XXX	XXX
Balance, end of year, before effect of changes	(1) Suggested - ASC 944-40-55-13K	XXX	XXX	XXX	XXX
Effect of changes in the instrument-specific credit risk	(5) Suggested - ASC 944-40-55-13K	XXX	XXX	XXX	XXX
Balance, end of year	(1) Required - ASC 944-40-50-7B-a	\$GGG*	\$LLL*	\$AAA*	\$FFF*
Reinsured MRB, end of year	(7) Illustrated - ASC 944-40-55-29G	\$XXX	\$XXX	\$XXX	\$XXX
Net amount at risk	(6) Required - ASC 944-40-50-7B(b)	\$XXX	\$XXX	\$XXX	\$XXX
Weighted average attained age of contract holders	Required - ASC 944-40-50-7B(b)	XX	XX	XX	XX

* These balances should agree to other balances identified with the same letters in this table or other tables within the footnote.

The following is a reconciliation of market risk benefits by amounts in an asset position and in liability position to the market risk benefits amount in the consolidated statement of financial position.

[Required by ASC 944-40-50-7B-c]

	December 31, 20X2			December 31, 20X1		
	Asset	Liability	Net	Asset	Liability	Net
Variable annuities (1)	\$XXX	\$XXX	\$GGG	\$XXX	\$XXX	\$GGG
Indexed annuities (1)	XXX	XXX	\$LLL*	XXX	\$XXX	\$FFF*
	\$XXX	\$XXX	\$NNN*	\$XXX	\$XXX	\$MMM*

Table footnotes:

1. **Balance, beginning of year** and Balance, beginning of year, before effect of changes in the instrument-specific credit risk in 20X2 should agree to the Balance, end of year and Balance, end of year, before effect of changes in the instrument-specific credit risk in 20X1, respectively, for each major category. The Balance, end of year by major category should also agree to the amounts included in the reconciliation to the balance sheet carrying amount.
2. **Issuances, Attributed fees collected, and Benefit Payments** are not specifically defined. However, those terms are comparable to the requirement to disclose purchases, sales, issues, and settlements within a rollforward of Level 3 assets and liabilities in accordance with ASC 820-10-50-2. It is unclear how **Issuances** would be applied to MRBs that do not have a day one value associated with them (e.g., GMXBs on variable annuity contracts). Insurance entities may need to consider what line is the most appropriate for the MRBs written.
3. **Interest accrual** is not specifically defined. Calculating the amount of interest on a fair value instrument can be complex and insurance entities should consider the relevance of this line item when explaining changes in the fair value of MRBs to the users of the financial statements in the disaggregated rollforwards.
4. The other **Effect of changes...** lines within the rollforwards represent changes in fair value due to various changes in assumptions and experience used to determine the fair value of the MRBs. Isolating the portion of the change in fair value of MRBs for each of these assumptions may be challenging given their interdependency. ASC 820-10-50-2 only requires that the total gains and losses for the period that have been recognized in the income statement be included as a line within the Level 3 rollforward. Insurance entities may want to consider aligning the information used with the key inputs used and monitored in their economic hedging programs for these MRBs.
5. **Effect of changes in the instrument-specific credit risk** represents the portion of the change in fair value of the MRB that is required to be recorded in OCI. ASC 820-10-50-2 also requires that the Level 3 rollforward include a line for total gains and losses for the period that have been recognized within OCI.
6. **Net amount at risk** is the requirement outlined in ASC 944-40-50-7B(b) to disclose the guaranteed benefit amounts in excess of the current account balances. This amount must be presented for each of the rollforwards. The disclosure should align with the related requirement within the policyholders' account balance rollforwards. See IG 10.3.1.3 for additional information.
7. **Reinsured MRBs** represents the reinsurance asset or liability resulting from the cession of MRBs as part of a reinsurance contract. The guidance is silent as to whether the disaggregated rollforwards are required to be presented gross of reinsurance. However, the illustration of the disaggregated rollforwards of MRBs is presented gross of reinsurance with a reconciling item for the reinsured MRBs in ASC 944-40-55-29G. We believe each disaggregated rollforward should be presented gross of reinsurance since the disaggregated rollforwards must be reconciled to the carrying amount on the balance sheet and reinsurance is not allowed to be presented net on the balance sheet given there is no right to offset with the MRB contracts. Insurance entities may wish to include the reinsured MRBs as a separate category within the disaggregated rollforwards, as reinsured MRBs are recorded at fair value and need to comply

with the disclosures required by ASC 820. See Figure IG 10-8 which outlines the disclosures required by ASC 820 and compares them to the required MRB disclosures.

Figure IG 10-4 illustrates disaggregated rollforwards in which reinsured MRBs are presented in a separate category.

Figure IG 10-4

Illustrative excerpt of disaggregated rollforwards of MRBs with reinsurance as a separate category

Note X: Market risk benefits

[For example purposes, an excerpt of disaggregated rollforwards of market risk benefits associated with two major product lines (variable annuities and indexed annuities) as well as the reinsurance of indexed annuities is illustrated. Additional lines in the rollforwards or categories may be disclosed depending on the insurance entity's products and reinsurance agreements.]

The following table presents the balances and changes in market risk benefits associated with variable annuities, indexed annuities, and reinsured indexed annuities.

	December 31, 20X2		
	Variable annuities	Indexed annuities	Reinsured MRB – Indexed annuities
Balance, beginning of year	\$AAA	\$FFF	\$XXX
Balance, beginning of year, before effect of changes in the instrument-specific credit risk	XXX	XXX	XXX
Issuances/Cessions	XXX	XXX	(XXX)
Benefit payments/Receipts	(XXX)	(XXX)	XXX
Effect of changes in interest rates	XXX	XXX	(XXX)
Effect of changes in the instrument-specific credit risk	XXX	XXX	
Effect of changes in counterparty credit risk			XXX
Balance, end of year	\$GGG	\$LLL	\$XXX

10.3.1.5 Disaggregated rollforwards – Separate account liabilities

The disaggregated tabular rollforwards of separate account liabilities are required to be presented on a year-to-date basis, within the notes for all annual and interim reporting periods. These rollforwards must reconcile to the ending carrying amount included in the balance sheet. See IG 10.3.1.1 for considerations on the level of disaggregation of the rollforwards. Each disaggregated rollforward of the separate account liability must include the related cash surrender values. Insurance entities must also

disclose the general nature of the contracts reported in the separate accounts, including the extent and terms of any minimum guarantees (e.g., market risk benefits).

There are no specific lines required to be included within the rollforwards. Insurance entities should focus on the information that is most useful for users of the financial statements when determining which line items to include in their rollforwards. Information necessary to prepare the disaggregated rollforwards may already be compiled as part of supplemental external reporting (e.g., investor supplements) or as part of internal reporting. ASC 944-80-55-18 provides illustrative rollforwards that insurance entities can use as a basis for determining the line items to include in their rollforwards.

Figure IG 10-5 illustrates the disaggregated rollforward and accompanying information for the separate account liability and indicates which line items within the rollforward are required per ASC 944-80-50-2 versus illustrated in ASC 944-80-55-18.

Figure IG 10-5

Illustrative disaggregated rollforwards of the separate account liability

Note X: Separate Account Liabilities

[For example purposes, disaggregated rollforwards of two major product lines (variable universal life and variable annuities) are illustrated and the applicable ASC references are provided. Additional product lines may be disclosed depending on the insurance entity's insurance products.]

The following table presents the balances and changes in separate account liabilities. **[Required by ASC 944-80-50-2a]**

	December 31,				
		20X2		20X1	
	PwC observations	Variable universal life	Variable annuities	Variable universal life	Variable annuities
Balance, beginning of year	(1) Required – ASC 944-80-50-2a	\$BBB*	\$AAA*	\$XXX	\$XXX
Premiums and deposits	(4) Illustrated - ASC 944-80-55-18	XXX	XXX	XXX	XXX
Policy charges	(4) Illustrated - ASC 944-80-55-18	(XXX)	(XXX)	(XXX)	(XXX)
Surrenders and withdrawals	(4) Illustrated - ASC 944-80-55-18	(XXX)	(XXX)	(XXX)	(XXX)
Benefit payments	(4) Illustrated - ASC 944-80-55-18	(XXX)	(XXX)	(XXX)	(XXX)
Investment performance	(3) Illustrated - ASC 944-80-55-18 ³	XXX	XXX	XXX	XXX
Net transfers from (to) general account	(4) Illustrated - ASC 944-80-55-18	XXX	XXX	XXX	XXX

	December 31,				
		20X2		20X1	
	PwC observations	Variable universal life	Variable annuities	Variable universal life	Variable annuities
Other charges	(4) Illustrated - ASC 944-80-55-18	(XXX)	(XXX)	(XXX)	(XXX)
Balance, end of year	(1) Required - ASC 944-80-50-2a	\$DDD*	\$CCC*	\$BBB*	\$AAA*
Cash surrender value	(2) Required - ASC 944-80-50-2b	\$XXX	\$XXX	\$XXX	\$XXX

* These balances should agree to other balances identified with the same letters in this table or other tables within the footnote.

The following is a reconciliation of separate account liabilities to the separate account liability balance in the consolidated statement of financial position. **[Required per ASC 944-80-50-2-c]**

	December 31,	
	20X2	20X1
Variable universal life (1)	\$DDD	\$BBB
Variable annuity (1)	CCC	AAA
Other	XXX	XXX
Total	\$XXX	\$XXX

Table footnotes:

1. **Balance, beginning of year** in 20X2 should agree to the **Balance, end of year** in 20X1 for each major category. The **Balance, end of year** by major category should also agree to the amounts included in the reconciliation to the balance sheet carrying amount.
2. **Cash surrender value** represents the amount of the contract holder's account balances distributable at the balance sheet date less applicable surrender charges.
3. **Investment performance** represents the change in fair value of the corresponding separate account assets that is credited to the policyholder.
4. The other lines within the rollforwards are consistent with the policyholder activity tracked within typical policy administration systems and information included within the financial statements of the separate accounts.

See IG 10.3.4 for additional required separate account disclosures.

10.3.1.6 *Disaggregated rollforwards – Deferred acquisitions costs (and other balances)*

The disaggregated tabular rollforwards of DAC are required to be presented on a year-to-date basis, within the notes, for all annual and interim reporting periods. These rollforwards must reconcile to the ending carrying amount included in the balance sheet.

There are balances that are required to be amortized on a basis consistent with DAC, such as deferred sales inducements (DSI) and unearned revenue liability (URR). The balances amortized on a basis consistent with DAC are required to be included in a disaggregated rollforward unless they are already included in another long-duration contract liability rollforward prepared in accordance with ASC 944-40-50.

The disaggregation level within the tabular DAC rollforwards (and balances amortized on a basis consistent with DAC) should be consistent with the disaggregation level in the rollforwards of the related liability disclosures. While the disaggregated liability rollforwards are not required for participating contracts, the disaggregated rollforwards of DAC (and balances amortized on a basis consistent with DAC) are required for all long-duration contracts. See IG 10.3.1 and IG 10.3.1.1 for additional information on the disaggregated rollforwards and level of disaggregation.

There are no specific lines required to be included within the DAC rollforwards. ASC 944-30-55-2 provides illustrative rollforwards that insurance entities can use as a basis for determining the line items to include in their rollforwards. Insurance entities should focus on the information that is most useful for users of the financial statements when determining which line items to include in their rollforwards.

Figure IG 10-6 illustrates the disaggregated rollforwards for deferred acquisition costs and indicates which line items within the rollforwards are required per ASC 944-30-50-2B versus illustrated within ASC 944-30-55-2.

Figure IG 10-6

Example disaggregated rollforwards of the deferred acquisition costs

Note X: Deferred acquisition costs

[For example purposes, disaggregated rollforwards of DAC associated with three major product lines (whole life, universal life, and variable universal life) are illustrated and the applicable ASC references are provided. Additional product lines may be disclosed depending on the insurance entity's products.]

The following tables present the balances and changes in deferred acquisitions costs.

		As of December 31, 20X2			
	PwC observations	Whole life	Universal life	Variable universal life	Total
Balance, beginning of year	(1) Required - ASC 944-30-50-2B	\$AAA*	\$BBB*	\$CCC*	\$DDD*
Capitalizations	(2) Illustrated - ASC 944-30-55-2	XXX	XXX	XXX	XXX

As of December 31, 20X2					
	PwC observations	Whole life	Universal life	Variable universal life	Total
Amortization expense	(3) Illustrated - ASC 944-30-55-2	(XXX)	(XXX)	(XXX)	(XXX)
Experience adjustment	(4) Illustrated - ASC 944-30-55-2	(XXX)	(XXX)	(XXX)	(XXX)
Balance, end of year	(1) Required - ASC 944-30-50-2B	\$EEE*	\$FFF*	\$GGG*	\$HHH*

* These balances should agree to other balances identified with the same letters in this table or other tables within the footnote.

As of December 31, 20X1					
	PwC observations	Whole life	Universal life	Variable universal life	Total
Balance, beginning of year	(1) Required - ASC 944-30-50-2B	\$XXX	\$XXX	\$XXX	\$XXX
Capitalizations	(2) Illustrated - ASC 944-30-55-2	XXX	XXX	XXX	XXX
Amortization expense	(3) Illustrated - ASC 944-30-55-2	(XXX)	(XXX)	(XXX)	(XXX)
Experience adjustment	(4) Illustrated - ASC 944-30-55-2	(XXX)	(XXX)	(XXX)	(XXX)
Balance, end of year	(1) Required - ASC 944-30-50-2B	\$AAA	\$BBB	\$CCC	\$DDD

Table footnotes:

- Balance, beginning of year** in 20X2 should agree to the **Balance, end of year** in 20X1 for each major category. The **Balance, end of year** by major category should aggregate to the balance sheet carrying amount or agree to amounts included in the reconciliation to the balance sheet carrying amount.
- Capitalizations** represents new acquisition costs capitalized during the period.
- Amortization expense** represents the amount of acquisition costs charged to expense during the period.
- The **Experience adjustment** line within the rollforwards represents the amount that DAC was reduced during the period for actual experience incurred in excess of expected experience (e.g., unexpected contract terminations). There may be other acceptable approaches for determining current period DAC amortization that do not result in recording an experience adjustment. For example, if an entity revises its estimates of persistency during

the period, it may decide to reflect the revised persistency rate in its current period amortization rate and therefore in its Amortization expense line. Refer to IG 3.5 for further guidance related to the amortization of DAC.

Question IG 10-5

If a reporting entity were to cede a block of business and receive a ceding commission that represented a recovery of acquisition costs, how would that change be reflected in the DAC disaggregated rollforward?

PwC response

ASC 944-30-35-64 requires that proceeds from reinsurance transactions that represent a recovery of acquisition costs reduce the applicable unamortized acquisition costs. This results in only net acquisition costs being reported on the balance sheet. For the period in which the reinsurance arrangement was effective and the ceding commission was recorded, the reporting entity would need to include a line for the recovery of acquisition costs within the disaggregated rollforward.

Question IG 10-6

If GAAP is silent as to the amortization pattern for other assets/ liabilities and the insurance entity analogizes to DAC and follows the simplified DAC amortization approach, are disaggregated rollforwards required for those balances?

PwC response

No. Insurance entities may elect, but are not required, to amortize on a basis consistent with DAC, balances such as contract intangible assets and liabilities acquired in a business combination (e.g., present value of future profits or PVFP) or cost of reinsurance. If an insurance entity analogizes to DAC and follows the simplified DAC amortization approach, the insurance entity may elect to include those balances within separate disaggregated rollforwards. However, we believe an insurance entity is not required to do so. PVFP and cost of reinsurance balances cannot be combined in the DAC disaggregated rollforwards.

Insurance entities that are SEC registrants are required to provide certain disclosures on PVFP balances in accordance with ASC 944-20-S99-2, including a rollforward of the PVFP balance for each year an income statement is presented. There is no specific requirement in GAAP to rollforward the cost of reinsurance. However, if the amount is material, it may be helpful for users of the financial statements to understand changes in the balance each period.

10.3.2 Additional disclosures — key judgments and assumptions

Insurance entities are required to disclose significant inputs, judgments, assumptions, and methods used in measuring the long-duration liabilities, MRBs, DAC, sales inducement costs, and premium deficiency losses, as well as any related changes and their effect on measurement.

Figure IG 10-7 provides a summary of required disclosures for long-duration contracts related to key judgments and assumptions.

Figure IG 10-7
Required long-duration contract disclosures

Disclosure requirement	Contracts impacted	ASC reference	Periods of disclosure
Nature and amounts of the costs deferred (deferred acquisition and sales inducements)	All long-duration contracts	ASC 944-30-50-1 and ASC 944-30-50-2A	Annual periods (1)
Information about inputs, judgments, assumptions and methods, changes during the period, and effect of those changes on measurement of DAC and DSI	All long-duration contracts	ASC 944-30-50-2A	Annual periods (1)
Information about inputs, judgments, assumptions and methods, changes during the period, and effect of those changes on measurement of the related asset or liability	Traditional, limited-payment contracts and MRBs	ASC 944-40-50-7, ASC 944-40-50-7C	Annual periods (1)
Qualitative and quantitative discussion about adverse development that resulted in a charge to current period benefit expense because of net premiums exceeding gross premiums	Nonparticipating traditional and limited-payment contracts	ASC 944-40-50-6	Both annual and interim periods
Information about the methodology used when performing PVFP recoverability testing	Nonparticipating traditional and limited-payment contracts	ASC 944-60-50-2	Annual periods (1)
Any liability established as a result of PVFP recoverability testing and a description of the factors that led to the impairment	Nonparticipating traditional and limited-payment contracts	ASC 944-60-50-2	Annual periods (1)
Whether anticipated investment income was considered when performing PVFP recoverability testing and, if so, the assumption utilized	Nonparticipating traditional and limited-payment contracts	ASC 944-60-50-2	Annual periods (1)
Information about the methodology used when performing premium deficiency testing	All long-duration contracts, except for nonparticipating traditional and limited-payment contracts (e.g., participating (including closed block) and universal life-type contracts)	ASC 944-60-50-2	Annual periods (1)

Disclosure requirement	Contracts impacted	ASC reference	Periods of disclosure
Any liability established as a result of a premium deficiency and loss recognition testing and a description of the factors that led to the liability	All long-duration contracts, except for nonparticipating traditional and limited-payment contracts (e.g., participating (including closed block) and universal life-type contracts)	ASC 944-60-50-2	Annual periods (1)
Whether anticipated investment income was considered when performing premium deficiency testing and, if so, the assumption utilized	All long-duration contracts, except for nonparticipating traditional and limited-payment contracts (e.g., participating (including closed block) and universal life-type contracts)	ASC 944-60-50-2	Annual periods (1)
Results of premium sufficiency or deficiency determined as part of the premium deficiency test in ASC 944-60-25-7 through ASC 944-60-25-9	Participating long-duration contracts included in a closed block	ASC 944-805-50-3	Annual periods (1)

(1) ASC 944 only requires this disclosure to be made annually unless there is a significant change or event that would require disclosure under ASC 270.

See IG 10.3.1.2 through IG 10.3.1.6 for information on the disaggregated tabular rollforwards required for long-duration contracts for all annual and interim periods. Also, see IG 10.3.1.3 for information on the tabular presentation of policyholders' account balances by range of guaranteed minimum crediting rates and the related range of the difference between the rates being credited and the respective guaranteed minimums that is required to be disclosed in the notes for all long-duration contracts with policyholders' account balances (e.g., universal life-type and fixed annuity contracts) at each annual and interim period.

10.3.3 Comparison of required MRB disclosures to ASC 820 disclosures

As noted in IG 10.2.5, MRBs are carried at fair value and ASC 944-40-55-13K states that to the extent the tabular rollforwards satisfy the disclosure requirements in ASC 820-10-50, then an insurance entity is not required to duplicate the related fair value disclosures. Insurance entities may include all of the required disclosures outlined in ASC 820 within the MRB note to provide users with one comprehensive footnote related to MRBs. However, insurance entities should clearly state where all the information on assets and liabilities carried at fair value is contained within the notes.

MRBs are typically measured using significant unobservable inputs and as a result are classified as Level 3 within the fair value hierarchy. Insurance entities will need to include a disclosure on the fair value levelling classification in the MRB note or other fair value notes. While the Level 3 rollforward is only required for public business entities, the MRB disclosures are required for all insurance entities with MRBs. MRB assets and liabilities are typically classified as Level 3, and therefore the rollforwards would not have any transfers into or out of the rollforwards due to leveling changes (i.e., they will remain as Level 3 throughout their terms).

Figure IG 10-8 outlines how MRB disclosures compare to those required in ASC 820. See FSP 20.3.1 and FSP 20.3.2 for additional information on fair value disclosure requirements.

Figure IG 10-8**Comparison of ASC 820 fair value disclosures to MRB disclosures under ASC 944**

Fair value disclosure requirement	Related MRB disclosure
<p>The Level 3 rollforward of beginning and ending balances is required in ASC 820-10-50-2(c), separating the following items:</p> <ul style="list-style-type: none"> □ Total gains or losses for the period in income □ Total gain or losses for the periods in OCI □ The line item in the income statement or statement of comprehensive income that includes the gains and losses <ul style="list-style-type: none"> □ Purchases □ Sales □ Issues □ Settlements 	<p>Disaggregated rollforwards, by major category, of the changes in fair value of MRBs are required at each annual and interim period in accordance with ASC 944-40-50-7B (See IG 10.3.1.4).</p> <hr/> <p>The changes in fair value of MRBs are required to be presented in a separate line in the income statement each period, except for the component of the change related to instrument-specific credit risk, which is recognized as a separate line in OCI.</p> <hr/> <p>ASC 944 does not prescribe the specific lines to be included within the disaggregated rollforwards of MRBs, but suggests that insurance entities include the following lines, which generally align to ASC 820 requirements for Level 3 rollforwards:</p> <ul style="list-style-type: none"> □ Issuances □ Attributed fee collected □ Benefit payments <p>The other suggested lines in ASC 944-40-55-13K represent the remaining changes in fair value for MRB assets and liabilities. See IG 10.3.1.4 for additional details on the MRB rollforwards.</p>
<p>For recurring Level 3 fair value measurements, ASC 820-10-50-2(d) requires the disclosure of:</p> <ul style="list-style-type: none"> □ Unrealized gains or losses for the period included in income and OCI □ The line item in the income statement and OCI where the unrealized gains or losses are recognized 	<p>Entities must present changes in fair value of the MRBs through income each period in a separate line, except for the component of fair value representing the change in instrument specific credit risk, which is recognized in OCI in a separate line.</p> <p>Additionally, MRB disclosure must include disaggregated rollforwards, which should include line items that describe the changes in fair value of the MRBs within the rollforwards. See IG 10.3.1.4 for additional details on the MRB rollforwards.</p>
<p>For recurring Level 3 fair value measurements, ASC 820-10-50-2(bbb)(1) requires a description of the valuation technique(s) and the significant unobservable inputs used in measurement.</p> <p>If the reporting entity has changed its valuation approach or valuation technique, the change and the reason for making it should be disclosed.</p> <p>(For further discussion, see FSP 20.3.2.1.)</p>	<p>ASC 944-40-50-7C requires information about inputs, judgments, assumptions, and methods to be disclosed as well as any changes during the period and effect of those changes on measurement of the related asset or liability be disclosed within the notes.</p>
<p>For Level 3 fair value measurements, quantitative information about all significant unobservable inputs used in the fair value measurement, including the range and weighted average of the inputs (the</p>	<p>ASC 944 requires disclosure of inputs, judgments, assumptions, and methods, changes during the period, and the effect of those changes on measurement of the related asset or liability.</p> <p>ASC 944 also requires a disaggregated rollforwards of MRBs each annual and interim period, which could include lines as suggested in</p>

Fair value disclosure requirement	Related MRB disclosure
<p>“table of significant unobservable inputs”) must be disclosed in accordance with ASC 820-10-50-2(bbb)(2).</p> <p>A narrative description of the uncertainty of the fair value measurement at the reporting date from use of the significant unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement is also required for Level 3 fair value measurements in accordance with ASC 820-10-50-2(g).</p>	<p>ASC 944-40-55-13K, with quantitative information about the significant unobservable inputs. See IG 10.3.1.4 for additional information on the disaggregated rollforwards of MRBs.</p> <p>Additional quantitative and qualitative information may be necessary either within the MRB note or other fair value notes to comply with ASC 820-10-50-2(bbb)(2) and ASC 820-10-50-2(g).</p>

10.3.4 *Separate account asset disclosures*

Because separate account assets are recorded at fair value, all of the ASC 820 disclosure requirements apply. The ASC 820 fair value disclosures are not required for separate account liabilities because they are not recorded at fair value. See IG 10.2.6 for information on the presentation of separate account assets and liabilities on the balance sheet.

An insurance entity is not precluded from providing additional disclosure regarding the linkage between the separate account asset and separate account liability valuation, including disclosures of the amounts pertaining to separate account assets and related separate account liabilities that economically offset each other. The disclosures could explain that the investment performance of separate account assets and the corresponding amounts credited to the separate account liability are offset within the same statement of operations line item netting to zero.

While ASC 820 does not directly apply to the valuation of separate account liabilities, there may be embedded derivatives or MRBs associated with separate account contracts that are not presented with the separate account liabilities line item and accounted for under ASC 815 or ASC 944, respectively, at fair value through income. See FSP 20.3.1 for general fair value disclosure requirements for those features accounted for as embedded derivatives and IG 10.3.3 for additional information on MRB disclosures.

In addition to the ASC 820 fair value disclosures for the separate account assets, an insurance entity must disclose additional information for their qualifying separate account arrangements. Figure IG 10-9 outlines the disclosures requirements for separate accounts.

Figure IG 10-9
Required separate account disclosures

Disclosure requirement	ASC reference	Periods of disclosure
General nature of the contracts reported in the separate accounts including the extent and terms of any minimum guarantees (e.g., market risk benefits)	ASC 944-80-50-1a	Annual periods (1)

Basis of presentation for both separate account assets and liabilities and related separate account activity	ASC 944-80-50-1b	Annual periods (1)
Aggregate fair value of assets, separately by major investment asset category, supporting the separate accounts	ASC 944-80-50-1e	Both annual and interim periods
Amount of gains and losses recognized on those assets transferred to separate accounts	ASC 944-80-50-1f	Both annual and interim periods

(1) ASC 944 only requires this disclosure to be made annually unless there is a significant change or event that would require disclosure under ASC 270.

See IG 10.3.1.5 for information on the disaggregated tabular rollforwards required for separate account liabilities at all annual and interim periods.

10.4 *Financial statement presentation for short-duration contracts*

The short-duration disclosure guidance is applicable to certain types of insurance contracts written by insurance entities, as defined in ASC 944. With the exception of the unpaid claims liability rollforward guidance, the additional disclosures pertain to short-duration insurance contracts only including most property and liability insurance contracts and certain types of accident and health insurance. The accounting classification of a contract as short- versus long-duration, rather than the settlement period or tail of the claim liability, dictates whether the claims development and related disclosures are applicable.

Life insurers may write certain types of coverages, such as group life, group long-term disability, and group short-term disability products that are classified as short duration and are therefore subject to the disclosure requirements in ASC 944-40-50-4A through ASC 944-40-50-4I. In contrast, for contracts that qualify as long-duration contracts, such as certain types of long-term disability and long-term care policies that are expected to remain in force for an extended period, the claims development table and discounting disclosures described in IG 10.5.2 are not required. This is true even though the unpaid claims liabilities for these contracts may be outstanding for a long period of time, similar to short-duration claim liabilities.

10.5 *Disclosure requirements for short-duration contracts*

ASC 944 requires specific disclosures for short-duration insurance contracts. Insurance entities subject to SEC Regulation S-X Article 7 may be required to make additional disclosures based on the requirements of Regulation S-X Rule 7-03 through Regulation S-X Rule 7-05.

10.5.1 *Annual and interim rollforward disclosure requirements*

A rollforward is required for insurance contracts that have an unpaid claims liability, including long-duration and short-duration contracts. However, as discussed in IG 5.2.3.3, subsequent to the adoption of ASU 2018-12, the “present value of estimated future benefits to be paid to or on behalf of policyholders and certain related expenses” referred to in ASC 944-40-25-8 represents all payments

under the contract, including future expected claims and claims for which the disability, morbidity, or other insurance event has occurred, but for which claims have not yet been paid. This eliminates the need for a separate claim liability measurement.

ASC 944-40-50-4B requires incurred and paid claims information to be disclosed separately, with further detail regarding the claim activity relating to the current accident year (year-to-date amounts) and development relating to prior accident years. Any reinsurance recoverable is presented as a reconciling item to the beginning and ending balances.

ASC 944-40-50-3

For annual and interim reporting periods, all of the following information about the liability for unpaid claims and claim adjustment expenses shall be presented in a tabular rollforward:

- a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning of each fiscal year presented in the statement of income, and the related amount of reinsurance recoverable on unpaid claims
- b. Year-to-date incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years
- c. Year-to-date payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years
- cc. The ending balance in the liability for unpaid claims and claim adjustment expenses and the related amount of reinsurance recoverable.

...

In addition, an insurance entity shall disclose the reasons for the change in incurred claims and claim adjustment expenses recognized in the income statement attributable to insured events of prior fiscal years and indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects.

Figure IG 10-10 provides an example of a rollforward of liabilities for unpaid claims and claim adjustment expenses from ASC 944-40-55-7.

Figure IG 10-10

Rollforward of liabilities for unpaid claims and claim adjustment expenses

	Required by	20X2	20X1
Balance at January 1	ASC 944-40-50-3a	\$7,030	\$6,687
Less reinsurance recoverables	ASC 944-40-50-3a	1,234	987

	Required by	20X2	20X1
Net balance at January 1		5,796	5,700
Incurred related to:			
Current year	ASC 944-40-50-3b	2,700	2,600
Prior years	ASC 944-40-50-3b	(171)	96
Total incurred		2,529	2,696
Paid related to:			
Current year	ASC 944-40-50-3c	781	800
Prior years	ASC 944-40-50-3c	2,000	1,800
Total paid		2,781	2,600
Net balance at December 31	ASC 944-40-50-3cc	5,544	5,796
Plus reinsurance recoverables	ASC 944-40-50-3cc	1,255	1,234
Balance at December 31		\$6,799	\$7,030

10.5.2 *Claims development table and related information*

ASC 944-40-50-4B requires disclosure of up to ten years of claims development information. The claims development information for all periods preceding the most recent reporting period and the historical claims payout percentage disclosure is considered required supplementary information (RSI).

The claims development table is required to be presented:

- Annually, as of the date of latest statement of financial position
- On a disaggregated basis (as a result, multiple tables will usually be required)
- On an undiscounted basis
- By accident year for the number of years for which claims are typically outstanding (but need not exceed 10 years)
- Net of reinsurance

- With tabular amounts of incurred claims and allocated claim adjustment expenses separate from paid claims and claim adjustment expenses.

Figure IG 10-11 provides an example that illustrates the information an insurance entity with one major short-duration product line (Homeowners' insurance) would disclose in its financial statements to meet the requirements in ASC 944-40-50-4B through ASC 944-40-50-4D for incurred and paid claims and the reconciliation to the balance sheet.

Figure IG 10-11

Claims development table disclosures and reconciliation to balance sheet

Homeowners' insurance											As of December 31, 20Y6	
Incurred claims and allocated adjustment expenses, net of reinsurance											Total of incurred but not reported liabilities plus expected development on reported claims	Cumulative number of reported claims
For the years ended December 31												
Accident year	20X7*	20X8*	20X9*	20Y0*	20Y1*	20Y2*	20Y3*	20Y4*	20Y5*	20Y6		
20X7	\$10,000	\$9,900	\$9,700	\$9,800	\$9,750	\$9,750	\$9,600	\$9,650	\$9,575	\$9,500	\$5	39
20X8		10,950	11,000	10,500	10,750	10,850	10,600	10,250	10,150	10,250	30	37
20X9			12,000	11,750	11,500	10,900	10,900	10,850	10,750	10,500	90	38
20Y0				12,250	12,500	12,550	12,400	12,200	12,150	12,000	300	36
20Y1					12,300	12,500	12,650	12,750	12,800	12,850	900	35
20Y2						12,800	12,900	12,750	12,700	12,700	1,100	34
20Y3							13,000	13,250	13,100	13,150	1,500	31
20Y4								13,150	13,250	13,300	2,100	29
20Y5									13,500	13,250	3,100	26
20Y6										13,750	5,000	22
*unaudited										Total	\$121,300	

Cumulative paid claims and allocated claim adjustment expenses, net of reinsurance										
For the years ended December 31										
Accident year	20X7*	20X8*	20X9*	20Y0*	20Y1*	20Y2*	20Y3*	20Y4*	20Y5*	20Y6
20X7	\$3,000	\$5,000	\$5,500	\$6,000	\$6,800	\$7,500	\$8,500	\$9,000	\$9,050	\$9,075
20X8		3,500	5,750	6,500	7,500	7,750	8,250	8,500	9,000	9,500
20X9			3,750	6,000	6,500	7,500	7,900	8,250	8,950	9,700
20Y0				3,750	6,250	7,250	7,750	8,900	9,700	9,950
20Y1					4,250	5,500	6,750	8,000	8,950	9,250
20Y2						4,125	5,250	7,000	8,000	9,000
20Y3							4,500	5,750	7,250	7,750
20Y4								4,600	6,000	6,950
20Y5									4,750	6,125
20Y6										4,850
									Total	\$82,150
									All outstanding liabilities before 20X7, net of reinsurance	1,400
*unaudited									Liabilities for claims and claim adjustment expenses, net reinsurance	\$40,550

The net incurred and paid claims development tables for the liability for future policy benefits are required to be reconciled to the balance sheet in ASC 944-40-50-4C.

December 31, 20Y6

Net outstanding liabilities	
Homeowners' insurance	\$40,550
Other short-duration insurances lines	1,976
Liabilities for unpaid claims and claim adjustment expenses, net of reinsurance	42,526
Reinsurance recoverable on unpaid claims	
Homeowners' insurance	13,880
Other insurance lines	283
Total reinsurance recoverable on unpaid claims	14,163
Insurance lines other than short-duration	3,315
Unallocated claims adjustment expenses	2,420
Other	10

	5,745
Total gross liability for unpaid claims and claim adjustment expense	\$62,434

10.5.2.1 Level of aggregation of claims development tables

The disclosures should provide financial statements users information to understand the amount, timing, and uncertainty of cash flows arising from the liabilities. ASC 944-40-50-4A requires an entity to aggregate or disaggregate the information “so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have significantly different characteristics.” Insurers should not aggregate amounts from different reportable segments.

In determining the level of disaggregation at which to present the required claims development information, insurers should consider how their liabilities for unpaid claims and claim adjustment expenses have been presented for other purposes, including outside of the financial statements (e.g., MD&A in Annual Reports on Form 10-K, earnings releases, annual or statutory reports, supplementary disclosures of global loss triangles) and information reviewed by chief operating decision makers. Insurers should disaggregate their claims development information into categories, such as type of coverage, geography, reportable segment, market or type of customer, and claim duration.

Insurers need not disclose claims development for insignificant categories of liabilities, but if omitted, these categories would be included in the claims development reconciliation. Judgment is needed to assess what is insignificant in the context of the financial statements.

10.5.2.2 Incurred but not reported claims and claim frequency disclosures

For each accident year presented in the claims development tables, for the most recent reporting period presented, the insurer is required to disclose the following information as an accompanying disclosure to the annual claims development tables:

- The sum of IBNR plus expected development on reported claims (referred to as “IBNR+”)
- Cumulative claim frequency information, unless impracticable to do so

Because insurers have various methodologies for determining the IBNR+ and claim frequency information, potentially even within the same entity for different categories of claims development tables, a description of the methodologies used for determining these amounts is required for each table. An explanation of significant changes in the methodologies used for determining both the IBNR+ amounts and claim frequency amounts is also required.

As differences may exist in how claim frequency is measured, the required disclosures include whether claim frequency is measured by claim event or individual claimant, and how the insurer considers claims that do not result in a liability (e.g., those below a deductible). For example, a car accident with three claimants could be considered one loss event (i.e., a single claim count) or three (one for each claimant). Separately, an aggregate high deductible policy will have a large number of losses payable by the insured prior to reaching the insurer’s attachment point. In such cases, some insurers may

consider claims under the deductible to be reported claims, since they may develop into the insured layer over time, while other insurers may only consider claims in the insured layer as reported claims.

Where impracticable to disclose claim frequency information, an insurer is required to disclose this fact and the reason why the disclosure is impracticable. Impracticable means that after making every reasonable effort to do so, an entity is unable to apply the requirement. For example, impracticable situations may include assumed reinsurance or participation in residual market pools, where an entity does not have access to claim frequency information.

Claim frequency disclosures should be disaggregated at the same level as the claims development table disclosures, which could prove challenging in certain situations. An entity chooses to disaggregate at a product level could define claim frequency. However, if a category is based on geographical location, which may include both direct and assumed business, and various product lines, an entity may determine that obtaining the quantitative claim frequency information is impracticable.

While the FASB's objective was to provide information to allow users to calculate average severity of reported claims and to compare that information between insurers, this goal may not be achieved in practice. The IBNR+ amount will typically be derived by subtracting "known case reserves" from total incurred claim liabilities. However, "known case reserves" is not a defined accounting term in US GAAP and thus insurers may measure them differently. For example, claims adjusters may establish claims in dispute at a small dollar amount based on litigation concerns or to incentivize claim adjudication behavior. In other instances, claim adjusters may set known case reserves based on expected modes, probable minimums, or probable maximums. In addition, because the disclosure was changed from including claim count to claim frequency, the amount disclosed might be a percentage (e.g., number of claims per insured vehicle). Therefore, it may not be possible to calculate severity from the disclosed information.

10.5.2.3 Other disclosure considerations

The guidance does not specifically address how the impact of business modifications (e.g., acquisitions, disposals, commutations, spin-offs, retroactive reinsurance agreements, other means to enter or exit business) or foreign currency translation should be reflected in the development table information. The AICPA Insurance Expert Panel explored the appropriate acceptable alternatives and received feedback from the SEC and FASB staff as to which alternatives to business modifications and foreign currency would be acceptable.

Required supplementary information

The claims development information for all periods preceding the most recent reporting period and the historical claims payout percentage disclosure will be considered required supplementary information (RSI).

The guidance does not prescribe a particular location for RSI, which may be presented as a supplementary schedule outside of the basic financial statements, with only the current period information included in the notes to the financial statements. Alternatively, RSI may be presented within the notes to the financial statements, accompanied by a clear distinction of what is required supplementary information, such as labeling the RSI as unaudited.

Business modifications

Business modifications can distort claims development for a user. For example, in a business combination, including the acquired business by accident year in subsequent years' tables but not prior years' could make it appear that there is adverse development if the acquired business is material. Similarly, in a disposition, if the table is not restated to remove amounts relating to disposals, the table could be distortive in subsequent post-disposal periods given that cumulative amounts relating to the disposed business would be static, thus inappropriately tempering any development on the remaining business.

For business combinations, the SEC staff noted that a retrospective approach would best achieve the disclosure objectives of the guidance by presenting the acquiree's historical incurred and paid accident year claim information in its claims development tables for all periods presented and related disclosures. In applying this approach, it would be appropriate to either present the incurred and paid claim information of the acquiree separately or combined with the claims development information of the acquirer using the disaggregation principles as required by the guidance. The SEC staff noted that a prospective approach, where the incurred and paid accident year claim information of the acquiree is presented separately from the acquirer as of the acquisition date and in subsequent periods in a separate table or tables as appropriate, could meet the disclosure objectives of the guidance. Under this method, the acquired liabilities as of the acquisition date would be presented in the fiscal year that includes the acquisition date by individual accident year in the incurred section of a table, with subsequent activity presented separately in the incurred and paid sections of that table.

For dispositions, the SEC staff noted that a retrospective approach would be consistent with the disclosure objectives of the guidance. In this approach, an entity would exclude incurred and paid claims information for the disposed business from the claims development tables for all years presented (i.e., exclude the disposed business from prior and current periods' rows and columns). In addition, the SEC noted it would be inappropriate to present a reduction in the unpaid claim liabilities relating to dispositions as a net reduction to amounts in the incurred activity or alternatively a net increase in the amounts in the paid claims activity in the year of disposition column.

Foreign currency translation

Foreign currency should be presented to result in an “apples to apples” comparison for each accident year in order to have a useful year by year comparison of claims development information. The SEC staff noted that an approach which uses current year-end balance sheet rate to translate all amounts in the table for all periods presented would be consistent with the disclosure objectives of ASC 944, as it would eliminate the effects of changes in foreign currency translation rates from the incurred and paid claims information in the claims development tables. They noted that another approach that includes separate claims development tables for each functional currency would also be consistent with the objectives of the standard. Finally, the SEC staff noted that a presentation that did not use the same exchange rate for all of the data in the table, that is for all accident years and for both incurred and paid, would be inconsistent with the requirements of the standard.

10.5.3 *Historical average annual percentage claims payout*

ASC 944-40-50-4G requires presentation of the historical average annual percentage payout of claims as of the end of the most recent reporting period at the same level of disaggregation as presented in the claims development tables. The historical average payout should be calculated on an accident year basis for each development year.

As the calculation of the historical average is based on the historical paid claim information from the claims development tables, it is similarly considered RSI. If there were multiple significant categories and thus multiple claims development tables, a corresponding payout pattern table for each claim development table would be required. Due to the very short duration of health insurance claim settlement period, health insurance claims are exempt from this requirement. Refer to ASC 944-40-55-9F for an example of the average annual percentage payout of incurred claims disclosure.

The guidance illustrates how an entity can calculate the payout percentages based on the information in the claims development tables. If, for example, an entity was calculating the percentage in year 3, it would divide the claims paid in year 3 for each accident year (derived by subtracting the cumulative paid amounts in year 2 from the cumulative paid amounts in year 3 from the claims development table), by the most recently re-estimated incurred claims for each accident year, also taken from the claims development table. It would then average these percentages of claims paid for the third year of each accident year to arrive at the percentage included in the disclosure.

10.5.4 *Discounting unpaid claims and claim adjustment expenses*

If a reporting entity discounts the liability for unpaid claims and claim adjustment expenses, ASC 944-40-50-5 requires disclosure of the carrying amounts of the discounted liability for unpaid claims and claim adjustment expenses and the range of interest rates used to discount the liability. An entity is also required to disclose the effects of discounting on the comparative annual financial statements, including the aggregate amount of discount deducted from the claim liability, the amount of interest recognized during the period, and the line item in which interest accretion is classified.

The disclosures are required to be presented on a disaggregated basis as discussed in IG 10.5.2.1. We believe there may be circumstances where the disaggregation categories used for the discounting disclosure may differ from those used for the claims development tables. For example, if workers' compensation liabilities are discounted, this might be an appropriate level of disaggregation for the discounting disclosure, even if workers' compensation claims are presented at a different grouping level for purposes of the claims development table.

10.5.5 *Changes in methodologies and assumptions*

Several analytical techniques are typically utilized in estimating the liability for unpaid claims. One or more techniques may be used for a liability grouping, and techniques may be changed over time based on new information.

For the most recent annual reporting period, entities are required to disclose information about significant changes in methodologies and assumptions used in calculating the liability for unpaid claims and claim adjustment expenses. This includes the reasons for the change and the effects on the financial statements. The guidance is not explicit as to whether the effects of the change need to be disclosed quantitatively or qualitatively. Some discussion at the disaggregated level would be appropriate when there is significant change in methodologies and assumptions during the years.

***Chapter 11:
Effective date and transition:
long-duration contract
guidance—updated May 2022***

11.1 Effective date and transition – chapter overview

This chapter discusses the effective date and transition guidance for Accounting Standards Update 2018-12, *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts* (ASU 2018-12).

Overall, there may be a significant impact to reported earnings and increased earnings volatility. Additionally, the implementation effort will require significant changes to systems, processes, and controls, and likely require the accumulation of data that has not previously been captured and included in actuarial models in the format and grouping needed for measurement.

11.2 Effective date

On September 30, 2020, in response to implementation challenges resulting from COVID-19, the FASB affirmed its decision to defer the effective date of ASU 2018-12 and to provide transition relief if early application is elected. ASU 2020-11, *Insurance (Topic 944): Effective Date and Early Application*, was issued in November 2020 with the revised effective dates.

Calendar year-end SEC filers other than smaller reporting companies (SRCs), as defined by the SEC, are required to adopt ASU 2018-12 on January 1, 2023. Other calendar year-end entities will be required to adopt the ASU on January 1, 2025. Early application will be permitted. If early application is not elected, the transition date will be the beginning of the earliest period presented. To facilitate early application, an early adopter may elect that the transition date be either the earliest period presented or the beginning of the prior period presented in order to align the early application transition date with the standard transition date for SEC filers. For example, if an SEC filer early adopts on January 1, 2022, it may elect a transition date of January 1, 2021, the same transition date that would apply if the insurer were instead to adopt on the standard adoption date of January 1, 2023. This special provision to align the transition dates between early and standard adoption is meant to provide an insurer with a fixed transition date for purposes of calculating the transition adjustment early in its implementation process while maintaining flexibility to decide at a later date whether or not to early adopt the guidance. Alternatively, an early adopter may elect the transition date to be the earliest period presented. For example, an SEC filer early adopting on January 1, 2022 may elect a transition date of January 1, 2020, so that all three income statements presented are on a comparable basis. The guidance in this chapter assumes that the deferral will be finalized as noted above. The one-time determination of whether an entity is eligible to be an SRC is based on an entity's most recent determination under SEC regulations as of November 15, 2019.

11.3 Transition guidance

The default method for adoption of the provisions relating to the liability for future policy benefits and deferred acquisition costs (DAC) (including other financial statement line items amortized on a basis consistent with DAC) is the modified retrospective approach; however, the full retrospective approach can be elected provided specified criteria are met. The transition method for market risk benefits is full retrospective.

11.3.1 Transition for liability for future policy benefits

The new measurement guidance for traditional and limited-payment contract liabilities is required to be applied to contracts in force as of the transition date on the basis of their existing carrying amounts,

adjusted for the removal of any related amounts in AOCI. This is referred to as a modified retrospective transition approach. An entity may elect a full retrospective transition approach if actual historical experience information is available as of contract inception.

11.3.1.1 **Modified retrospective adoption of ASU 2018-12**

During the deliberations of ASU 2018-12, the FASB received comments from insurance entities that applying the new guidance on a retrospective basis would be challenging given that many of the contracts were written decades ago. In an effort to alleviate these concerns, the default method for adoption of the provisions relating to the liability for future policy benefits is a modified retrospective approach. Under this approach, an insurer would “pivot” off, or carry over, the existing liability at the transition date.

An insurer would apply the guidance to all in-force contracts at the transition date using the existing carrying amount of the liability, adjusted for the removal of any amounts in AOCI (e.g., any “shadow” premium deficiency liabilities recognized). Separately, after the net premium ratio is recalculated and any additional liability recognized relating to loss recognition, a balance sheet remeasurement will be required using the current upper-medium grade discount rate.

Figure IG 11-1 details how to “pivot” off the transition date balances for a traditional insurance contract.

Figure IG 11-1

Pivoting off of the balance at transition – traditional insurance contract

Start with the pre-adoption liability for future policy benefits (inclusive of any related premium deficiency). For a calendar year-end SEC filer (other than an SRC), this would be the balance at 12/31/20 (the transition date would be 1/1/21).

Step 1: Remove any previous AOCI adjustment

Step 2: Determine appropriate cohorts and their respective carrying amounts

Step 3: Allocate any existing premium deficiency to identified cohorts

Step 4: Calculate revised net premium ratio (using expected cash flows from transition date forward) for each cohort	=	Present value* of the updated future benefits and related claim expenses from transition date forward - carrying amount of the transition date liability (after removal of AOCI adjustment)
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Revised net premium ratio	=	Present value* of the updated future gross premiums from transition date forward
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*Present value is determined using the carryover locked-in interest rate assumption rather than the transition date upper-medium grade yield.

Step 5: If net premium ratio >100%, record loss for excess of net premiums over gross premiums as a debit to opening retained earnings (except that for limited-payment contracts, the deferred profit liability would first be reduced to zero).

Step 6: Remeasure liability using current single A discount rate and adjust AOCI (see Example IG 11-3).

At transition, the discount rate would not be reset for purposes of calculating the net premium ratio and future net premiums and interest accretion. As such, an insurer will continue to use the carryover locked-in interest rate assumption for determining benefit expense in current and future periods.

For existing traditional insurance contracts at transition, to the extent that the revised net premiums exceed revised gross premiums (i.e., a loss is expected), the liability for future policy benefits will be increased and the opening retained earnings balance would be decreased.

Existing liabilities will need to be divided into cohorts at transition that are subject to an annual cohort limitation. As such, it is possible that upon applying the annual cohort limitation to contracts that are currently grouped at a level above the annual cohort for premium deficiency purposes, a net premium ratio in excess of 100% could occur even though unamortized DAC is no longer included in the premium deficiency test. In this case, there would be a charge to opening retained earnings.

In periods subsequent to transition, in updating assumptions on a retrospective catch-up basis for contracts that were in force at transition, the transition date would be considered the revised contract issue date. For example, if an updated net level premium ratio was calculated in the fourth quarter of 2024 for business that was in force at an insurer's January 1, 2021 transition date, the calculation would include historical benefit expense and gross premiums from 2021 through the date of the update, future benefits and gross premiums for 2025 and beyond, and total benefits would be reduced by the January 1, 2021 transition liability.

Question IG 11-1

When the net premium ratio at transition is greater than 100%, would the transition date carrying amount used subsequent to transition to recompute the net premium ratio be inclusive of the loss recognized at the transition date?

PwC response

No. For existing traditional insurance contracts at the transition date, when the updated present value of future benefits and related claim expenses less the transition date carrying amount exceeds the present value of future gross premiums, this results in a net premium ratio at transition greater than 100%, resulting in a loss for the cohort. In this situation, the liability for future policy benefits is increased and the opening retained earnings balance is decreased at the transition date. Additionally, the net premium ratio would be reset to 100% by including both the transition liability and the additional liability recognized at the transition date in the numerator of the net premium ratio until the next measurement date. However, that transition date increase in the liability for future policy benefits is not part of the transition date liability in subsequent updated calculations of the net premium ratio. See Example IG 11-1 for a numerical example.

Example IG 11-1 provides a numerical example of the accounting at transition and subsequently when the net premium ratio is greater than 100% at the transition date.

EXAMPLE IG 11-1**Net premium ratio exceeds 100% at transition**

Insurer will adopt ASU 2018-12 on January 1, 2023, with a transition date of January 1, 2021. For a given cohort at the transition date:

PV of future benefits and related claim adjustment expenses	\$210
PV of future gross premiums at the transition date	\$100
Transition date liability	\$102

How would Insurer calculate the net premium ratio at the transition date and subsequently when a loss is recognized at the transition date?

Analysis

At transition, in accordance with ASC 944-40-65-2(d)(2), the present value of future benefits and related expenses less the transition date carrying amount would be compared to the present value of future gross premiums to calculate the updated net premium ratio.

NPR calculation at the transition date:

$$\text{Net premium ratio} = \frac{(\text{PV of future benefits and related claim adjustment expenses} - \text{transition date liability})}{\text{PV of future gross premiums}}$$

$$\text{Net premium ratio} = \frac{(\$210 - \$102)}{\$100}$$

$$\text{Net premium ratio} = 108\%$$

Because the net premium ratio is greater than 100%, Insurer would recognize a charge to retained earnings and an increase in the liability for future policy benefits for \$8 million, the amount the numerator exceeds the denominator, bringing the total liability for future policy benefits at the transition date to \$108 million. The net premium ratio would be reset to 100% by including both the \$102 million transition liability and the additional \$8 million in the numerator until assumptions are updated at the next measurement date.

NPR calculation at the transition date after recognizing additional liability:

$$\text{Net premium ratio} = \frac{(\text{PV of future benefits and related claim adjustment expenses} - \text{transition date liability} - \text{additional liability})}{\text{PV of future gross premiums}}$$

$$\text{Net premium ratio} = \frac{(\$210 - \$102 - \$8)}{\$100}$$

$$\text{Net premium ratio} = 100\%$$

In calculating the updated net premium ratio in periods subsequent to transition, the numerator in the updated net premium ratio for this cohort would include the transition date liability of \$102 million (i.e., the transition date liability remains \$102 million; it is exclusive of any loss recognized at transition). To the extent the updated calculation resulted in an additional loss (i.e., the net premium ratio is above 108%), it would be immediately recognized in income, with an increase to the liability for future policy benefits. To the extent the updated calculation resulted in a loss less than originally expected (i.e., net premium ratio decreases from 108% but still remains above 100%), the liability for future policy benefits would be reduced and the reversal of the loss would be immediately recognized in income. If the net premium ratio decreases to an amount below 100%, the entire reversal of the additional liability recognized at transition would be immediately recognized in income, while the remaining benefit of the net premium ratio decrease would be recognized through the retrospective catch up adjustment in the current period and future periods' revised margins.

Subsequent to the transition date:

Updated PV of future benefits and related claim adjustment expenses (historical and future) from the transition date forward	\$205
PV of future gross premiums at the transition date	\$100
Transition date liability	\$102

In accordance with ASC 944-40-65-2(d)(2), the present value of future benefits and related expenses less the transition date carrying amount would be compared to the present value of future gross premiums to calculate the updated net premium ratio:

NPR calculation subsequent to the transition date:

$$\text{Net premium ratio} = \frac{(\text{Updated PV of future benefits and related claim adjustment expenses} - \text{transition date liability})}{\text{PV of future gross premiums}}$$

$$\text{Net premium ratio} = \frac{(\$205 - \$102)}{\$100}$$

$$\text{Net premium ratio} = 103\%$$

The updated loss is \$3 million rather than \$8 million, resulting in a reduction in the liability for future policy benefits and an immediate credit to income of \$5 million to reflect the updated estimate of the liability in the current period. The net premium ratio would be reset to 100% by including both the \$102 million transition liability and the additional \$3 million in the numerator until assumptions are updated at the next measurement date:

NPR calculation subsequent to the transition date after recognizing additional liability:

$$\text{Net premium ratio} = \frac{(\text{Updated PV of future benefits and related claim adjustment expenses} - \text{transition date liability} - \text{additional liability})}{\text{PV of future gross premiums}}$$

$$\text{Net premium ratio} = \frac{(\$205 - \$102 - \$3)}{\$100}$$

$$\text{Net premium ratio} = 100\%$$

Question IG 11-2

Insurer adopts the new guidance for the liability for future policy benefits on a modified retrospective basis. If the “at inception” original assumptions (including the provision for adverse deviation) were more conservative than the new updated assumptions, the existing liability could be higher than the present value of the future benefits at the transition date, resulting in a negative net premium ratio.

How would this impact the calculation of the liability in future periods?

PwC response

The transition guidance requires an adjustment to the existing liability if future gross premiums are insufficient to cover future benefits. In this fact pattern, the existing liability is greater than what is ultimately needed. In future periods, the negative net premium ratio would be applied to gross premiums received, in effect creating a negative benefit expense that would reduce the liability over time to the amount needed for benefit payments.

Question IG 11-3

Under the modified retrospective transition approach, may an insurer change its methodology from using a single equivalent level investment yield rate to an investment yield curve (forward or spot) at the transition date? May it change from using an investment yield curve (forward or spot) to a single equivalent level investment yield rate?

PwC response

No, to both questions. As described in ASC 944-40-65-2, the modified retrospective approach requires that for the purposes of calculating the net premium ratio and future net premiums and interest accretion, an insurance entity should retain the discount rate assumption that was used to calculate the liability immediately before the effective date. As such, an insurance entity will continue to use the carryover locked-in interest rate assumption (be it a single rate, a spot curve, or a forward curve) to determine the rate at which interest accretes throughout the expected lifetime of the cohorts. It may not change from a rate to a curve or a curve to a rate.

Question IG 11-4

Under the modified retrospective transition approach, how would an insurance entity determine the locked-in carryover discount rate (or curve) for a cohort comprised of individual policies each having different discount rates?

PwC response

Given that under existing guidance and employing a seriatum approach, the insurance entity previously had a single rate or a curve for each policy (i.e., prior locked-in investment yield rates), it must now determine the discount rate or curve that is appropriate for the cohort (i.e., the new group of policies). We believe that a reporting entity could determine the carry over locked-in investment yield discount rate (or curve) for the cohort by calculating a weighted average rate or curve for the cohort based on the previously locked-in rates or curves and expected cash flows at transition. Such rate or curve would be utilized for calculating the net premium ratio at transition and future net premiums and interest accretion relating to

the liability for future policy benefits for the cohort. As noted in Question IG 5-7, in some instances an entity may instead deem it appropriate to use a discount rate or curve applicable for the issue date of each contract within the cohort.

Question IG 11-5

The new guidance amended ASC 944-40-30-15 to clarify that the expense assumptions used in estimating the liability for future policy benefits include termination and settlement costs, but exclude non-claim related costs such as policy maintenance costs. Prior to the adoption of the new guidance, some insurance entities may have included certain policy maintenance costs in the calculation of the present value of future policy benefits. How are policy maintenance costs previously included in estimating the liability for future policy benefits accounted for under the modified retrospective transition approach?

PwC response

Under the modified retrospective transition approach, the existing liability for future policy benefits at the transition date is carried over as of the transition date, adjusted for removal of any amounts in AOCI (i.e., any “shadow” premium deficiency liabilities recognized). There is no additional transition adjustment for the removal of previously included policy maintenance costs from the transition date liability for future policy benefits. However, for purposes of calculating the liability for future policy benefits at transition (and going forward), expected cash flows from the transition date forward exclude policy maintenance cost estimates. Maintenance costs after the transition date will be expensed as incurred.

Question IG 11-6

The new guidance amended ASC 944-40-30-7 to eliminate the requirement for a provision for adverse deviation (PAD) from the calculation of the present value of future policy benefits. How is the PAD previously utilized in estimating the liability for future policy benefits accounted for under the modified retrospective transition approach?

PwC response

Under the modified retrospective transition approach, the existing liability for future policy benefits at the transition date is carried over as of the transition date, adjusted for removal of any amounts in AOCI (i.e., any “shadow” premium deficiency liabilities recognized). There is no additional transition adjustment for the removal of the PAD from the transition date liability for future policy benefits. However, for purposes of calculating the liability for future policy benefits at transition (and going forward), expected cash flows from the transition date forward exclude any PADs, with the exception of any PADs applied to the discount rate.

In practice, some insurance entities apply a PAD to each individual assumption, including the discount rate (except for groups of contracts in premium deficiency). At transition, the discount rate is not reset for purposes of determining the benefit expense and for determining interest accretion on the liability balance subsequent to transition in accordance with ASC 944-40-65-2(d)(1). As such, an insurance entity will continue to use the carryover locked-in interest rate assumption, inclusive of any PAD, for accruing interest on the liability and determining benefit expense in periods subsequent to transition for existing blocks of business at transition.

Question IG 11-7

Should insurance entities include claim liabilities in the liability for future policy benefits transition balance and expected cash flows relating to incurred claims in net premium ratio calculations?

PwC response

Yes, cash flows used to derive the net premium ratio should include all cash flows, including those for claim liabilities. Therefore, the liability for future policy benefits transition balance should include what was previously carried as a claim liability.

Question IG 11-8

How would an insurance entity determine the carryover discount rate for claim liabilities under the modified retrospective transition approach?

PwC response

The transition relief in ASC 944-40-65-2(d)(1) extends to claim liabilities that are linked to the measurement of the net premium and liability for future policy benefits as of the transition date. The required transition may effectively be achieved by calculating a weighted average rate for the combined cash flows of the liability for future policy benefits and claim liability. As an alternative, an entity may retain the existing separate transition date discount rates when discounting future cash flows on claims incurred prior to the transition date. Claims reported after the transition date would, instead, be measured using the transition date liability for future policy benefits discount rate throughout the life of the contracts.

For business in-force at the transition date when the modified retrospective transition method is applied, subsequent to transition, presenting the claim liability separately or as part of the liability for future policy benefits should produce substantially similar results; differences could potentially arise depending on whether weighted discount rates or separate rates are used for the claim liability and liability for future policy benefits.

11.3.1.2 Full retrospective adoption election of ASU 2018-12

As described in ASC 944-40-65-2(e), if the necessary criteria are met, an insurer can make an entity-wide election to adopt the new liability for future policy benefit guidance through retrospective application. Under this approach, the cumulative effect of the change on periods prior to the transition date would be reflected in the carrying amounts of assets and liabilities at the transition date. An offsetting adjustment would be made to the opening balance of retained earnings at the transition date. AOCI would also be impacted (1) to the extent that any “shadow” premium deficiency adjustment is being reversed or (2) for the impact of switching to a current upper-medium grade discount rate for remeasurement of the liability for future benefits for balance sheet purposes at transition.

An insurer has the option to elect the retrospective transition approach for contract issue years only when actual historical information for an issue year cohort is available for all periods back to original contract inception for all applicable products entity wide. The election would be applied entity-wide (i.e., applied to all products and contracts) for that contract issue year and all subsequent contract issue years. Estimates of historical experience cannot be substituted for actual historical experience. Retrospective application

for all contract issue years would likely be extremely challenging for most entities, as it will require information relating to terminated contracts.

An entity can choose an election year later than the earliest year it has the necessary historical information. For contract issue years preceding the election year that are still in force at the transition date, an entity would apply the modified retrospective approach, using the carrying amount of the liability at the transition date (January 1, 2021 for calendar year-end SEC filers other than smaller reporting companies) to compute the revised net premium ratio and not at the election date.

If retrospective adoption is elected, it must be applied entity-wide and consistently to both the liability for future policy benefits and related DAC. Therefore, actual historical information relating to DAC would also be needed for all issue years for which retrospective application is elected.

Example IG 11-2 illustrates the retrospective adoption election.

EXAMPLE IG 11-2

Retrospective adoption election

Insurer A, a calendar year SEC filer that is not an SRC, has 3 product lines: whole life, term, and disability. Full historical data is available for disability contracts back to the beginning of 2000; however, full historical data is only available for its whole life contracts back to the beginning of 2010 and for its term life contracts back to the beginning of 2012.

Can Insurer A apply the retrospective transition method?

Analysis

Insurer A would have the option to apply the retrospective transition method to the 2012 issue year cohorts and all subsequent issue year cohorts for all 3 product lines. If it elected this approach, it would be required to apply the modified retrospective approach for contracts issued prior to 2012 using the carrying amount of the liability at the transition date (January 1, 2021).

Alternatively, Insurer A could decide not to apply the retrospective transition method at all; or, alternatively, it could select an election date of any year beginning in 2013 through 2020. To the extent the retrospective approach is applied, it would be required to be applied to any DAC balances for the same issue years.

11.3.2 Balance sheet remeasurement

For balance sheet remeasurement purposes at transition under either the modified retrospective or full retrospective approach, the liability for policy benefits will be remeasured using the current upper-medium grade fixed-income corporate instrument yield at the transition date. The difference in the liability measurement will be an adjustment to opening AOCI.

Example IG 11-3 illustrates the balance sheet remeasurement at transition.

EXAMPLE IG 11-3**Balance sheet remeasurement at transition**

Assume the carryover locked-in interest rate assumption is 4% for the existing transition date liability for future policy benefits and the revised upper-medium grade discount rate is 3.2%.

How would the balance sheet liability for future policy benefits at the transition date be remeasured?

Analysis

Present value of updated future benefits and related claim expenses from transition date onward @ 3.2%	\$6,280
Less: Present value of updated future net premiums from transition date onward @ 3.2%	(5,130)
	<hr/>
Liability for future policy benefits @ 3.2%	\$1,150
Less: Existing transition date liability for future policy benefits @ 4% (after removal of AOCI adjustments)	(1,000)
	<hr/>
	\$150

The adjustment would be recognized in AOCI at transition using the following entry:

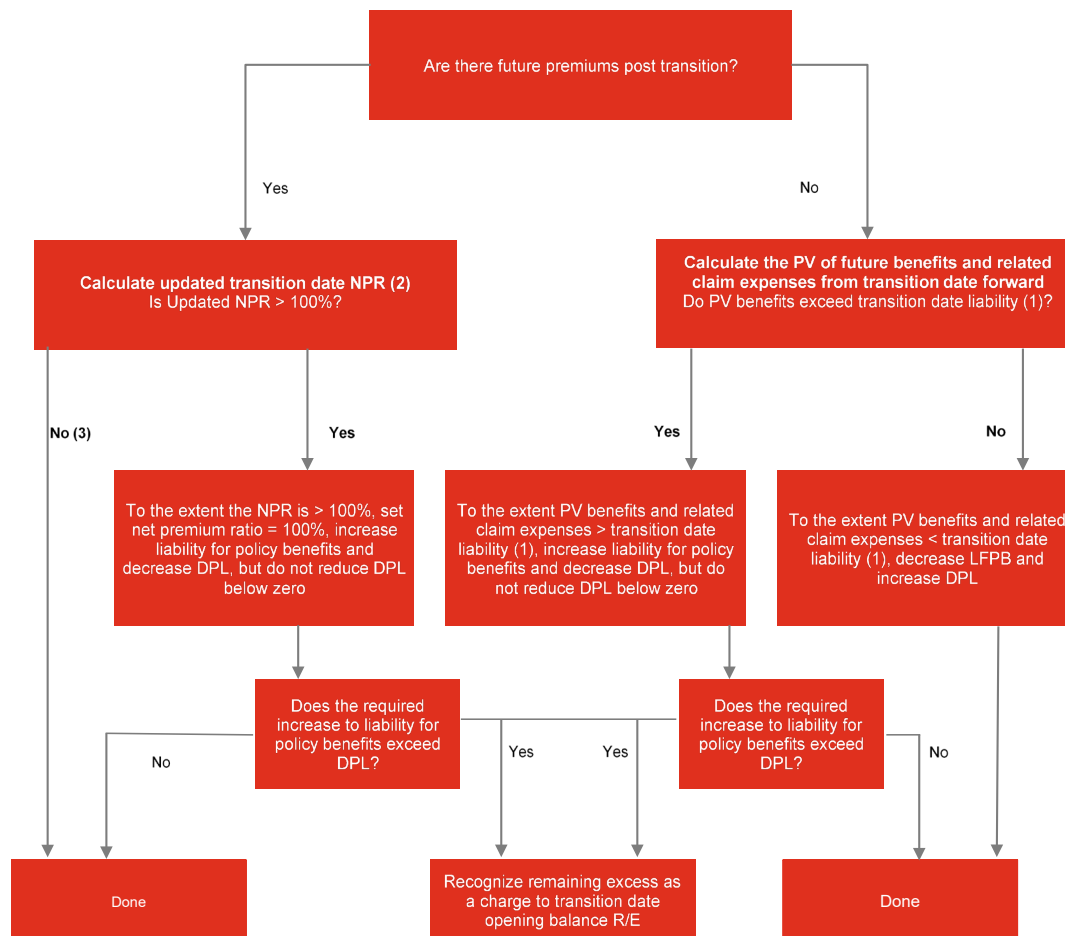
Dr. AOCI	\$150	
Cr. Liability for future policy benefits		\$150

11.3.3 Transition for limited-payment contracts

For limited-payment contracts, premiums are paid over a period shorter than the period over which benefits are provided. Profit margin associated with premiums received is deferred and recognized as a liability (DPL). For limited-payment contracts for which the modified retrospective adoption approach is used, the determination of transition date adjustments to the liability for future policy benefits and DPL will depend on whether the contracts in force at the transition date are expected to have future premium receipts. For limited-payment contracts with premiums expected in the post transition date period, absent a net premium ratio greater than 100%, the liability for future policy benefits and DPL balances will not be adjusted at the transition date, consistent with traditional payment contracts. For limited-payment contracts with no remaining premiums expected, absent a situation when the present value of future expected benefits and related claim adjustment expenses exceed the transition date liability for future policy benefits, the difference between the updated liability for future policy benefits and the carrying amount at the transition date would be recognized at the transition date, offset by a corresponding change in the DPL.

The decision tree in Figure IG 11-2 illustrates the potential transition date adjustments for these two types of limited-payment contract situations.

Figure IG 11-2
Decision tree for limited-payment contracts at transition



1. The transition date liability is the liability for policy benefits immediately before transition date, excluding DPL.

2. Updated transition date net premium ratio (NPR) =
$$\frac{\text{PV of future benefits and related claim expenses} - \text{transition date liability}}{\text{PV of future gross premiums}}$$

3. If the NPR < 0%, either decrease the liability for future policy benefits and increase DPL or allow the NPR to remain negative.

Under the modified retrospective approach, the present value of future premiums (if any) and future benefits and related claim adjustment expenses at transition and in future periods is determined using the carryover locked-in interest rate assumption rather than the new discount rate. The separate adjustment to AOCI for the remeasurement of the liability for future policy benefits using the current upper-medium grade discount rate is also required. Unamortized DPL will be accreted at the carryover locked-in interest rate assumption. The change in the remeasurement of the liability for future policy benefits due to using the upper-medium grade rate at transition will be recognized in the opening balance of AOCI and not as an adjustment to DPL.

Example IG 11-4 illustrates the transition of a single premium limited-payment insurance contract under the modified retrospective transition method.

EXAMPLE IG 11-4

Pivoting off of the balance at transition (limited-payment insurance contract):

Assume a single premium policy for which the premium was received prior to transition. Assume that the updated present value of future policy benefits at the transition date (January 1, 2020) is \$4,500 and the transition date liability for future policy benefits is \$4,800.

How would the adjustment to the liability for future policy benefits be calculated at transition assuming the modified retrospective transition approach is elected?

Analysis

Present value of updated future policy benefits and related claim expenses	\$4,500
Less: Transition date liability for future policy benefits (after removal of AOCI adjustments)	4,800
	(\$300)

The adjustment to the liability for future policy benefits and DPL at transition would be recognized using the following entry:

Dr. Liability for future policy benefits	\$300	
Cr. DPL		\$300

Prior to the adoption of ASU 2018-12, some insurers had recognized an “implicit DPL” which was included in the liability for future policy benefits. These insurers deferred excess premiums by determining a breakeven interest rate, calculated by determining the interest rate required to set the initial liability equal to the premiums less acquisition costs. Due to the differences in measurement requirements for the liability for future policy benefits versus the DPL introduced by ASU 2018-12, the historical measurement approach is no longer appropriate upon adoption of ASU 2018-12. Therefore, if this measurement approach was previously used by an insurer, at transition, it should be eliminated retroactively, and the interest accretion rate for the liability for future policy benefits immediately prior to the transition date should be determined by using assumptions that would have been used at contract inception had the DPL been separately calculated.

11.3.4 Transition for other annuitization benefits

Certain deferred annuity contracts contain non-traditional annuitization benefits that are required to be accounted for under ASC 944-40-30-26.

Under current guidance, the periodic future annuitization benefits expected to be paid during the annuitization phase are discounted back to the future annuitization date using an estimated investment yield to determine the excess benefit upon annuitization. This amount is then discounted to the current period using the contract liability discount rate. Use of the expected investment yield to discount the periodic payments is consistent with the rate used to discount future periodic annuity payments under the limited-payment model prior to adoption of ASU 2018-12. However, consistent with the change for the limited-payment model, the new guidance replaces the investment yield with the upper-medium grade (low credit risk) fixed-income instrument yield.

Unlike the limited-payment model, the discount rate is not locked-in for annuitization benefits subject to ASC 944-40-30-26. The rate is required to be updated each period consistent with other components of the annuitization benefit cash flows. Changes in the discount rate applied to the future annuitization payments will be reflected in the benefit ratio and recognized over time as the benefit ratio is applied to total assessments.

The transition date adoption methodology for the discount rate change is not specifically mentioned in the transition guidance in ASC 944-40-65. In the absence of any specific guidance, ASC 250 requires retrospective application, as outlined in ASC 250-10-45-3 through ASC 250-10-45-5. Under this approach, the cumulative effect of the change on periods prior to those presented would be reflected in the carrying amount of the liability at the transition date. An offsetting adjustment would be made to the opening balance of retained earnings. Because the existing annuitization benefit accounting is a retrospective catch up method, the cash flows needed to calculate the retrospective transition adjustment at the January 1, 2021 transition date should be available. The additional information required for the transition date adjustment would be the upper-medium grade fixed income instrument yield at the transition date.

Question IG 11-9

How did the new guidance change the calculation of assessments used as the denominator in the benefits ratio for the additional liability for death or other insurance benefits (commonly referred to as the “SOP 03-1 liability”)? How is this change reflected at the transition date?

PwC response

There are two potential changes in the assessments, as described further below. The transition date adoption methodology for the changes in assessments is not specifically mentioned in the transition guidance in ASC 944-40-65. In the absence of any specific guidance, ASC 250 requires retrospective application, as outlined in ASC 250-10-45-3 through ASC 250-10-45-5. Therefore, the transition methodology may differ between the two potential changes.

The first change in assessments relates to investment margins. ASC 944-40-30-22 was amended to clarify that investment margins included in total expected assessments should only be from policyholder balances. ASC 944-40-30-22 references ASC 944-40-25-14 for the term “policyholder balances,” which describes the policyholder accrued account balance or contract holder’s account. Currently, some insurance entities include investment margins from assets supporting the SOP 03-1 liability; however, the SOP 03-1 liability is not part of the accrued account balance. As the guidance is silent with respect to the applicable transition method to be used for the SOP liability, as explained above, a full retrospective approach is required, and the cumulative effect of the change in the other insurance benefit liability related to removing investment margins from assets supporting the SOP 03-1 liability will be recognized in opening retained earnings at the transition date.

The second change in assessments relates to the revised amortization pattern for any unearned revenue liability (URR) included in the assessments. ASC 944-605-35-2 requires URR to be amortized using the same method as DAC; therefore, the new guidance changed the amortization of URR to the simplified DAC model (constant level basis). Changes in URR can be adopted using either a modified retrospective or full retrospective method. Under the modified retrospective adoption method, pre-transition date URR is carried over and, post transition, will be amortized on a straight-line basis. Given that any change to the URR balance or amortization pattern will not occur until subsequent to the transition date under the modified retrospective approach, there is no adjustment to opening retained earnings at the transition date for this change to assessments. The change resulting from the revised amortization will be reflected in the post-transition income statements. If the full retrospective adoption method is elected, all URR assessments would use straight-line amortization from initial recognition, which would result in a cumulative adjustment in retained earnings at the transition date.

11.3.5 Transition for DAC and other balances amortized consistent with DAC

The same transition method utilized for the liability for future policy benefits (modified retrospective or retrospective) is required to be applied to DAC (and balances amortized on a basis consistent with DAC). Under the modified retrospective transition approach, the existing unamortized DAC amount at the transition date is carried over as of the transition date (as are all other balances that are amortized on basis consistent with the amortization of DAC, either as required by ASC 944 or as a result of an accounting policy election), adjusted to remove any amounts in AOCI relating to "shadow DAC" (and other similar "shadow" adjustments). The adjusted carrying amounts at transition will no longer accrete interest, and will be amortized on a constant basis over the remaining expected life of their related insurance contracts/cohorts.

Question IG 11-10

How are future renewal commissions that were previously factored into the amortization pattern, even though not yet incurred, accounted for under the modified retrospective transition approach?

PwC response

Under the modified retrospective transition approach, the existing unamortized DAC amount at the transition date is carried over as of the transition date, adjusted for removal of any amounts in AOCI relating to "shadow DAC." There is no additional transition adjustment for an insurance entity that previously factored the future renewal commissions into the DAC amortization schedule. Upon transition, the adjusted carrying amount at transition will no longer accrete interest, and will be amortized on a constant basis over the remaining expected life of the contracts. Future renewal commissions will be capitalized when those costs are incurred, and will be subsequently amortized over the expected term of the related contracts.

11.3.6 Full retrospective transition for DAC and other balances amortized consistent with DAC

If retrospective adoption is elected rather than modified retrospective adoption, the unamortized DAC would be recalculated from original contract issuance for the issue years elected using a constant level amortization methodology.

Any previous DAC impairments (write-downs) would be reversed, as DAC is no longer subject to impairment. Capitalizable expenses would be included in DAC amortization only as expenses are

incurred, no interest would accrue to the balance, and the pattern would be straight line (adjusted for expected terminations).

For contract intangible assets acquired in business combinations that are amortized on a basis consistent with DAC (e.g., the present value of future profits “PVFP”), the acquisition date is considered the contract issuance date. Under the retrospective approach, the cumulative effect of the change on periods prior to the transition date would be reflected in the carrying amounts of the asset at the transition date. An offsetting adjustment would be made to the opening balance of retained earnings (and AOCI, as applicable) at that date. AOCI would be impacted to the extent that any “shadow” PVFP adjustments are being reversed.

An insurer has the option to elect the retrospective transition approach for contract issue years only when actual historical information is available for all periods back to original contract inception (see Example IG 11-2). Estimates of historical experience cannot be substituted for actual historical experience. Retrospective application for all contract issue years would likely be extremely challenging for most entities.

Question IG 11-11

Insurer M is a mutual insurance company whose business consists principally of participating life insurance contracts that are not impacted by the amended guidance for the liability for future policy benefits under ASU 2018-12. May Insurer M adopt the new DAC amortization guidance relating to its participating business using retrospective application?

PwC response

Yes, Insurer M may adopt the new DAC amortization guidance relating to its participating business, using retrospective application for those issue years in which it has all actual historical information necessary to do a retrospective application back to contract inception for all of its policies, both participating and nonparticipating. For example, to the extent that it has existing nonparticipating business, it would need to have the necessary historical information for any DAC and other balances amortized consistent with DAC, as well as any liabilities subject to the new guidance relating to the liability for future policy benefits. It would need to apply the retrospective adoption method to the same issue years for all businesses and balances that are subject to the new guidance entity wide.

11.3.7 Transition for market risk benefits

ASC 944-40-65-2(f) requires market risk benefits to be measured at fair value at the transition date via a retrospective application. The contract features that now meet the definition of a market risk benefit (MRB) may have previously been accounted for at fair value as a derivative or embedded derivative under ASC 815 or as an additional liability for annuitization benefits or death or other insurance benefits under ASC 944. The transition adjustment representing the difference between the pre-adoption carrying amounts of contract features that meet the definition of an MRB and any pre-adoption host adjustments for features accounted for as derivatives and fair value of the MRB at the transition date, excluding the effect of changes in the instrument-specific credit risk relating to the MRB valuation, is recognized as an adjustment to the opening balance of retained earnings. For example, if an insurance entity identifies an option-based MRB (i.e., it has a fair value of other than zero at inception), the transition adjustment should reflect any adjustments to the host insurance or investment contract as well as the reversal of any previously existing SOP 03-1 liability. The cumulative effect of changes in the instrument-specific credit

risk of the MRB between contract issuance date and the transition date is recognized in the opening balance of AOCI.

If an insurance entity adopted the new DAC guidance using a modified retrospective transition approach, we do not believe that DAC amortization prior to the transition date is required to be adjusted to reflect the revised estimated gross profits pattern that would have resulted from full retrospective adoption for MRBs. Similar considerations would apply to other balances amortized on a basis consistent with DAC, either as required or as a result of a policy election, such as PVFP. Question IG 11-15 in IG 11.3.8 addresses the retrospective transition impact on PFVP affected by MRBs.

11.3.8 *The terms of MRBs and considerations for deriving attributed fees*

Reporting entities will need to develop the terms of each MRB that were not previously measured at fair value at inception of each contract and its fair value at the transition date. If the entity uses the attributed fee method of identifying the terms of the MRB, the basis points attributed as the fee for the benefits will be determined based on the fair value of the future benefits at contract inception, which will be some point in the past. As this attributed fee becomes a fixed term of the MRB, it is needed for the fair value measurement of the MRB in all subsequent periods. In addition, the entity-specific credit risk component will need to be identified in order to establish the adjustment to opening AOCI at the transition date.

In determining the original contract issue date attributed fee, an insurer should maximize the use of relevant observable information as of contract issuance and minimize the use of unobservable information for the appropriate date. The use of hindsight is permitted when assumptions in a prior period are unobservable or otherwise unavailable and cannot be independently substantiated.

Question IG 11-12

When and how can an insurance entity use hindsight when deriving the attributed fee in applying the retrospective transition for MRBs?

PwC response

In response to preparers' concerns over the difficulties of determining the MRB attributed fees at inception, the FASB decided that insurance entities may use hindsight when assumptions in a prior period are unobservable or otherwise unavailable and cannot be independently substantiated. The overall objective in deriving the attributed fee is premised on fair value concepts, and therefore represents an accounting estimate that would have been generated at contract inception to determine the attributed fee, using all available market and internal information.

Before implementing the use of hindsight, reasonable efforts should be made to determine whether retrospective information is available from other sources, pricing models, or other models. The determination of whether the use of hindsight is allowed should be made separately for each assumption and input. When hindsight is utilized, actual historical experience (i.e., a single deterministic approach) cannot be used as the sole basis for deriving the attributed fee as to do so would be inconsistent with fair value principles, since it would ignore market participants' consideration of volatility. As a result, when hindsight is used, considerations around volatility should be incorporated.

The information available to derive the attributed fee will vary from entity to entity, but it is important to recognize that this is an accounting estimate. Hindsight may be utilized for any assumptions, including both market assumptions (e.g., interest rate or equity volatility) and actuarial assumptions (e.g., lapse or

mortality), however, it would be expected that market-based assumptions would generally be available. Additionally, it is expected that an insurance entity would use all information that was available at contract inception, even if not previously utilized. When deriving the attributed fee for MRB features that were not previously accounted for at fair value, insurance entities may be able to leverage attributed fee assumptions utilized for embedded derivative features that were accounted for at fair value provided the assumptions are appropriately adjusted to consider relevant differences between the features that may affect the valuation. This interpretation is consistent with the views expressed by the FASB staff on their November 2018 webcast, *IN FOCUS: FASB Accounting Standards Update on Insurance*.

Question IG 11-13

When an entity is adopting the MRB guidance in ASU 2018-12 at the transition date, is it required to use the current definition of fair value when determining the retrospective fair value of MRBs at the inception date? The fair value guidance in ASC 820 changed in 2008 to more explicitly require the consideration of margins and non-performance risk of liabilities.

PwC response

Yes. ASC 944-40-30-19c and ASC 944-40-65-2(f) require MRB measurement at fair value as defined in the FASB glossary, which is the current fair value definition incorporating ASC 820 (FAS 157) valuation considerations. Upon adoption of the MRB guidance under the ASU, which requires retrospective application, the attributed fee would need to be determined back to contract inception using the post FAS 157 (ASC 820) definition if margins and nonperformance risk were not considered in pre 2008 fair value measurements. Any resulting difference between fair value and the existing transition balance would be recognized as part of the cumulative effect adjustment upon transition (i.e., retained earnings, and AOCI for any non-performance risk adjustment).

Some entities may not have used the current definition of fair value when identifying the attributed fees for embedded derivatives that were issued prior to the adoption of ASC 820 that are now MRBs under the ASU (e.g., embedded derivatives, such as GMABs). Similarly, the attributed fee for these features would need to be redetermined back to contract inception using the current definition of fair value with any differences recognized as part of the cumulative effect adjustment.

Question IG 11-14

If an insurance entity had previously elected the fair value option for an insurance contract, is that election able to be reversed upon the adoption of the new guidance? Conversely, if an insurance entity had not previously elected the fair value option for an insurance contract, is the insurance contract eligible for the election of the fair value option upon the adoption of the new guidance?

PwC response

No. As required under ASC 825-10-25-2, the fair value option election is irrevocable unless a new election date occurs. ASC 825-10-25-4 provides election dates on which an entity may elect the fair value option, but the adoption of new accounting standard would not qualify as a new election date. Additionally, the new guidance did not provide any specific ability for an insurance entity to elect the fair value option upon adoption. However, an insurance entity may elect the fair value option for eligible new insurance and reinsurance contracts.

Question IG 11-15

Can the retrospective transition guidance for MRBs affect other accounts/balances such as the present value of future profits (PVFP) and result in a transition adjustment for those accounts/balances?

PwC response

Yes, retrospective application requires the insurance entity to consider the accounting as if the MRB had been accounted for upon contract issue/acquisition date. As a result, other accounts, such as SOP 03-1 balances and PVFP, may have transition impacts/adjustments as a result of the MRB retrospective transition requirements.

Consider a fact pattern whereby an insurance entity consummated a business combination in a period prior to the transition date of ASU 2018-12. As a result of the business combination, the insurer recognized a group of annuity contracts along with a PVFP asset relating to such contracts. In accordance with the required retrospective adoption for MRBs, the insurance entity applies the MRB guidance to the acquired contracts at the acquisition date. In applying the guidance, the insurance entity has identified certain MRBs in the acquired annuity contracts. The following are the liabilities and PVFP amounts at the acquisition date, pre and post adoption of ASU 2018-12 resulting from the retrospective adoption of the guidance for MRBs. The balances are taken from the business combination numerical examples in Example IG 12-2 and Example IG 12-3 in IG 12.3.3.

Acquisition date balances	Pre-adoption of ASU 2018-12	Post-adoption of ASU 2018-12
Fair value of entire group of contracts	\$107,000	\$107,000
Allocation of fair value between components in accordance with ASC 944-805-30-1:		
Account balance liability, as proxy for the amount invested by the policyholder	\$115,000	\$115,000
SOP 03-1 liability pre-adoption /MRB post-adoption	\$3,000	\$4,000
Total contract liability	\$118,000	\$119,000
PVFP = Total contract liability less fair value of entire contract	\$11,000	\$12,000

The acquisition date accounting would be retrospectively adjusted to increase both the total contract liability and PVFP by \$1,000 as a result of the retrospective adoption of the MRB requirements. The insurance entity must consider PVFP amortization impacts since the date of acquisition as a result of changing the *amount* of PVFP. Additionally, the insurance entity must consider the potential impact of the change from SOP 03-1 accounting to MRB accounting on estimated gross profits and the potential

resulting impact on the *pattern* of PVFP amortization from the acquisition date to the transition date. When PVFP is and will continue to be amortized using estimated gross profits after transition, the PVFP amortization pattern will be impacted to the extent that estimated gross profits are impacted by the MRB accounting. However, if the entity has decided to adopt the simplified DAC amortization approach for its PVFP from the transition date forward under the modified retrospective approach, we do not believe the previous PVFP amortization pattern from the acquisition date to the transition date is required to be adjusted to reflect the change in estimated gross profits as a result of full retrospective adoption for MRBs. However, the adjustment to the amortization amount each period from the acquisition date to the transition date to reflect the change in the beginning PVFP balance would result in an adjustment to retained earnings and the PVFP balance at the transition date.

11.3.9 Transition for premium deficiency/loss recognition balances

The accounting for the transition for premium deficiency and loss recognition balances will depend on whether the contracts are traditional life or universal life.

Traditional life contracts

As cash flow assumptions are required to be updated regularly and the net premium ratio is capped at 100% (i.e., net premiums cannot exceed gross premiums), a premium deficiency test is no longer required for nonparticipating traditional and limited-payment insurance contracts. Expected benefits and claim-related costs in excess of premiums are expensed immediately. However, unamortized PVFP from past business combinations needs to be separately tested for recoverability for traditional and limited payment contracts. A premium deficiency test is still required for contracts other than traditional and limited-payment contracts such as universal life and participating insurance contracts.

Question IG 11-16

Under guidance prior to ASU 2018-12, the loss recognition cohort typically includes an aggregation of multiple issue years and occasionally a variety of products. As a result, the updated assumptions are developed for this unit of accounting and the additional loss recognition liabilities are measured in the aggregate. With the annual cohort limitation required under the new guidance, how should insurance entities determine the carry over liability basis at transition under the modified retrospective transition approach for blocks of business for which loss recognition had been recognized prior to transition?

PwC response

The new guidance does not prescribe a particular methodology for allocating the loss recognition liabilities recognized at a more aggregated level to the cohort groups. As such, a reasonable allocation methodology should be selected in order to allocate the loss recognition liability to the cohorts under the new guidance, with the objective being that the updated net premium ratio and subsequent profit emergence for each cohort should be consistent with the underlying economics of the cohorts. The allocation methodology should be disclosed in the reporting entity's financial statements.

Question IG 11-17

Insurer A adopts the new guidance for the liability for future policy benefits on a modified retrospective basis. Prior to adoption it had recognized a “profits followed by losses” liability on a group of contracts under ASC 944-60-25-9. How should the profits followed by losses liability be treated at the transition date?

PwC response

The profits followed by losses liability would be part of the transition date carrying amounts used in the calculation of the revised net level premium ratios at the transition date, similar to any existing premium deficiency liabilities at the transition date. At the transition date, the existing profits followed by losses liabilities would need to be allocated to the issue year cohort groupings used to calculate the net premium ratio, which is expected to be a lower level than the premium deficiency grouping levels.

Universal life-type contracts

At transition, an indirect impact of the adoption of ASU 2018-12 for universal life-type contracts will be that the profits followed by losses liability will need to be recalculated using future projections of profits and losses. First, as DAC is no longer subject to premium deficiency testing, it must be excluded from the calculation. The resulting change from excluding DAC should be recognized as a transition adjustment to retained earnings.

In addition, there are two changes to assessments, similar to those described for SOP 03-1 liabilities in Question IG 11-9, that must be considered. The first change, related to excluding investment margins from balances in excess of policyholders account balances, should be calculated retrospectively and recognized as a transition adjustment to retained earnings. Second, the new straight-line amortization basis for any unearned revenue liability will also require an adjustment. If a company uses a modified retrospective approach for the transition of unearned revenue liability, the impact of this change to the profits followed by losses liability will be reflected in the post-transition income statements.

11.3.10 Transition to ASU 2018-12 for reinsurance contracts

The new long duration guidance will impact the accounting for reinsurance contracts for both ceded and assumed reinsurance contracts and subject these contracts to the same transition approach as direct contracts.

Question IG 11-18

Assume an insurance entity uses the modified retrospective approach for the liability for future policy benefits for a group of contracts that has a net premium ratio that exceeds 100%, which results in an adjustment to the opening balance of retained earnings at transition. Is an adjustment to retained earnings also required for any related proportional reinsurance recoverable at transition?

PwC response

Yes. Under the modified retrospective transition approach applied to the direct contracts, the liability for future policy benefits is increased and the opening retained earnings balance is decreased to the extent that the revised net premium ratio exceeds 100% (i.e., a loss is expected). Ceded reinsurance transactions

were historically required to be recognized and measured in a manner consistent with underlying reinsured contracts, including using consistent assumptions. Assuming the agreement was proportional reinsurance, a corresponding increase to the transition carrying amount of the reinsurance recoverable and increase to opening retained earnings would be required. In situations involving non-proportional reinsurance, the amount of reinsurance offset would need to be determined considering the terms of the reinsurance agreement.

Question IG 11-19

Is the reinsurance recoverable for a ceded reinsurance contract that meets the definition of an MRB outside the scope of ASC 326 *Financial Instruments – Credit Losses*?

PwC response

Yes. A reinsurance contract that meets the definition of an MRB is required to be recognized at fair value with changes in fair value recognized in the income statement. Financial assets measured at fair value are outside the scope of the CECL model.

Question IG 11-20

In transition under the modified retrospective approach, is the remeasurement of ceded reinsurance recoverables due to changes from the locked-in discount rate to the transition date current rate recognized in opening AOCI or retained earnings?

PwC response

Under the modified retrospective approach, the remeasurement of the direct liability for policy benefits at transition using the current upper-medium grade fixed-income corporate instrument yield will be an adjustment to opening AOCI. Ceded reinsurance transactions are required to be accounted for using a similar model. Therefore, a corresponding change in measurement of the reinsurance recoverable to the current upper-medium grade fixed-income corporate instrument yield would also be an adjustment to opening AOCI.

Question IG 11-21

In transition under the retrospective approach, for features in ceded reinsurance contracts that meet the definition of MRBs, is the component of the remeasurement of the reinsured MRB relating to the reinsurance entity's credit risk (not the reporting entity's credit risk) recognized to opening AOCI or retained earnings?

PwC response

The adjustment would be recognized in opening retained earnings. Only fair value changes attributable to the credit risk of the reporting entity that issued the MRB are recognized in AOCI, which is not relevant to the reinsured MRB. There is no corresponding adjustment for the direct insurance entity's instrument-specific credit risk recognized to AOCI for the ceded reinsurance.

11.4 *Other insurance adoption date and transition matters*

This section addresses other adoption date and transition matters for the new long-duration insurance guidance, such as early adoption dates, method of transition for investees, method of transition for contracts sold prior to the effective date, and shadow transition adjustments.

Question IG 11-22

SEC filers reporting under US GAAP are permitted to adopt ASU 2018-12 early. Can an entity adopt the ASU in the second, third, or fourth quarters)?

PwC response

A public business entity that is adopting the ASU early should adopt the standard in its first fiscal quarter. The FASB indicated in ASC 250-10 that entities should adopt any accounting changes during the first interim period of a fiscal year whenever possible.

Question IG 11-23

At transition, must an investor and an equity method investee use the same transition method for the liability for future policy benefits and DAC?

PwC response

No. Upon adoption of the new standard, the method of transition for the investee does not need to be the same as the investor's. However, the investor will need to consider the impact of the equity method investee's election on its own financial statements. For example, if the equity method investee adopts the new guidance using the retrospective method for specified issue years but the investor used modified retrospective, the investor may need to recast the associated income or loss pickup for the prior periods presented, including all related metrics (e.g., earnings per share).

The investor may also need to recast the income or loss pickup for any market risk benefits given that the retrospective approach is required.

11.4.1 *Shadow accounting adjustments upon adoption of ASU 2018-12*

See IG 5.10 for a detailed explanation of "shadow" accounting, which requires that the carrying amount of certain assets and liabilities be adjusted to the amount that would have been reported if the unrealized holding gains and losses from AFS securities had been realized (often referred to as a "shadow" OCI adjustment). The new long duration guidance de-linked invested assets from the valuation of nonparticipating traditional insurance and limited payment contract liabilities and disconnected the amortization of certain assets and liabilities from the expected profit emergence pattern. Figure IG 11-3 analyzes accounts that may no longer require "shadow" adjustments based on the new guidance.

Figure IG 11-3

Balances that may no longer require “shadow” adjustments

Balance	Contract	Shadow required under the new guidance?	Reason
Deferred acquisition costs (DAC)	Universal-life type contracts	No	DAC is no longer amortized based on profit emergence
	Long-duration participating products	No	
Deferred sales inducements (DSI) amortization	Universal-life type contracts	No	DAC (and therefore DSI) is no longer amortized based on profit emergence
	Certain investment contracts	No	
Unearned revenue liability (URR) amortization	Universal life-type contracts	No	DAC (and therefore URR) is no longer amortized based on profit emergence
Other balances amortized on a basis consistent with the new DAC amortization model (e.g., present value of future profits (PVFP) and cost of reinsurance)	Universal-life type contracts	No	DAC (and therefore these other balances) are no longer amortized based on profit emergence
	Long duration participating contracts	No	
Other balances not amortized on a basis consistent with the new DAC amortization model (e.g., PVFP and cost of reinsurance)	Universal-life type contracts	Depends	If the policy election is to amortize balances based on profit emergence, “shadow” adjustments would still be required
	Long duration participating contracts	Depends	
PVFP loss recognition testing	Nonparticipating traditional and limited-payment contracts	Depends	The loss recognition test for the PVFP associated liability for future policy benefits will have a potential shadow adjustment only to the extent that investment yields continue to be used to project future cash flows

Balance	Contract	Shadow required under the new guidance?	Reason
			available in the recovery analysis
Premium deficiency loss recognition testing	Nonparticipating traditional and limited-payment contracts	No	The loss recognition test for the liability for future policy benefits is based on a net premium ratio cap and no longer incorporates consideration of investment yield
Certain additional liabilities for annuitization, death or other insurance benefits (formerly SOP 03-1 liabilities) that are MRBs under ASU 2018-12	Guaranteed minimum benefits in addition to account balance in variable annuities, general account annuities, and other products	No	These features are now required to be carried at fair value rather than measured using a benefit ratio that references investment margins
Terminal dividends	Certain participating life insurance contracts	No	Terminal dividends are no longer amortized based on estimated gross margins

The DAC balance for all types of long-duration contracts, as well as deferred sales inducement assets and unearned revenue liabilities associated with universal life-type contracts, are required to be amortized on a constant level basis following the guidance in ASC 944-30-35-3A. In addition, certain other balances, such as PVFP and the cost of reinsurance, are not required to be amortized on the same basis as DAC, but insurance entities may have made an accounting policy choice to do so and may continue to do so upon adoption of the new guidance. Given that the new amortization method is not impacted by realized gains and losses on investments, any “shadow” accounting previously recognized for these balances would no longer be appropriate. However, other insurance entities may decide to retain an amortization method based on profit emergence for PVFP or cost of reinsurance, in which case these balances would still have a shadow adjustment to the extent they are supported by available-for-sale securities with unrealized gains/losses.

The existing premium deficiency test for nonparticipating traditional and limited-payment contracts incorporates “book” investment yields. The existing shadow premium deficiency test incorporates the hypothetical realization of gains/losses on available-for-sale securities that contribute to that book yield. However, under the new guidance, the premium deficiency test to determine the need for an additional liability is based on a comparison of the present value of benefits to the present value of future gross premiums using a liability-based rate. As a result, there is no shadow adjustment. However, a recoverability test of PVFP relating to nonparticipating traditional and limited-payment contracts is still required and may incorporate investment yields. In this situation, shadow PVFP may still result.

The new guidance introduces the term “market risk benefits (MRBs)” and requires the features that meet the MRB definition to be carried at fair value. Since the MRB asset or liability is already measured at fair value, shadow adjustments would not be appropriate. Under current GAAP, entities may have been recording the liability for these features as an additional liability for annuitization, death, or other insurance benefits (SOP 03-1 liability) under ASC 944-40-30-26 and ASC 944-40-30-20. For features that upon transition meet the definition of an MRB and were previously accounted for as an SOP 03-1 liability, any related shadow adjustment in these balances and in AOCI will need to be reversed. For those SOP 03-1 liabilities that remain SOP 03-1 liabilities (e.g., certain no lapse guarantees), shadow accounting would still apply, as discussed in IG 5.10.

Any shadow adjustments at the transition date in the asset or liability balance that will no longer be impacted by unrealized gains/losses on available-for-sale securities and the corresponding AOCI balance must be reversed. This applies whether the guidance is adopted retrospectively or using the modified retrospective transition approach. If an affected asset or liability is under the modified retrospective transition approach, the reversal of any shadow adjustments from the balance and from AOCI is done at the transition date in determining the transition date carrying amount.

11.4.2 Accounting for contracts sold prior to the effective date of ASU 2018-12—added March 2023

In December 2022, the FASB issued ASU 2022-05, *Financial Services—Insurance (Topic 944): Transition for Sold Contracts*, which allows insurance entities to make an accounting policy election to exclude certain contracts from the transition guidance of ASU 2018-12 if (1) the contracts are fully derecognized due to a sale or disposal prior to the effective date of ASU 2018-12 and (2) the insurance entity has no significant continuing involvement with the derecognized contracts. Eligible contracts may have been sold or disposed of individually, in a group, or through the disposal of a legal entity. Insurance entities are allowed to elect the accounting policy on a transaction-by-transaction basis.

In assessing whether the criterion of no significant continuing involvement is met, insurance entities should assess significant influence using the guidance in ASC 323-10-15-6 through ASC 323-10-15-11. As such, insurance entities with an investment in a limited partnership accounted for under ASC 323-30-S99-1 that acquired the derecognized contracts are eligible to apply the accounting policy election.

ASU 2022-05 requires insurance entities that elect the accounting policy to disclose a qualitative description of each sale or disposal transaction to which the accounting policy election was applied. In addition, disclosure requirements that existed prior to the adoption of ASU 2018-12 are still applicable to the contracts to which the accounting policy election was applied.

11.5 Transition disclosures—updated March 2023

Transition adjustments and their presentation could vary depending on the contracts the insurance entity has written, reinsured, or assumed at the adoption of ASU 2018-12. For example, insurance entities must adopt the new MRB guidance in the ASU retrospectively. However, the change in accounting for the liability for future policy benefits will be adopted on either a modified retrospective basis or retrospective basis.

The transition date adoption methodology for some changes (e.g., impact of the discount rate change on certain deferred annuity contracts with non-traditional annuitization benefits that are required to be accounted for under ASC 944-40-30-26) is not specifically mentioned in the transition guidance in ASC 944-40-65. In the absence of any specific guidance, ASC 250, *Accounting Changes and Error*

Corrections, requires retrospective application, as outlined in ASC 250-10-45-3 through ASC 250-10-45-5. Under this approach, the cumulative effect of the change on periods prior to those presented would be reflected in the carrying amount of the liability at the transition date. An offsetting adjustment would be made to the opening balance of retained earnings.

Specific disclosures are required in the period in which a reporting entity adopts ASU 2018-12. A reporting entity must include the following disclosures in accordance with ASC 944-40-65-2(g) and ASC 944-40-65-2(h).

- Disaggregated tabular rollforwards
 - Disclosure should compare the ending balances of the reporting period prior to the transition date to the opening balances at the date of transition for selected insurance-related carrying amounts (e.g., future policyholder benefits, MRBs, DAC, additional liabilities for annuitization, death, or other insurance benefits). The level of disaggregation is required to be consistent with the disaggregated rollforwards required for annual and interim reporting periods.
- Qualitative and quantitative information about transition adjustments related to retained earnings, accumulated other comprehensive income, premium deficiencies, and other transition adjustments

If a reporting entity meets the criteria outlined in ASC 944-40-65-2(e) and elects to adopt the ASU for the liability for future policy benefits and DAC (and balances amortized on a basis consistent with DAC) on a retrospective basis for certain contract issue years and a modified retrospective basis for earlier contract issue years, the disaggregated rollforwards of the transition adjustments must be further disaggregated between the effects of retrospective application and modified retrospective application.

Figure IG 11-4 outlines the potential transition adjustments to be recorded and disclosed upon the adoption of the ASU under both the modified retrospective and retrospective transition methods assuming a January 1, 2020 transition date.

Figure IG 11-4

Schedule of potential transition adjustments that may be required to be disclosed in a disaggregated tabular rollforward.

Balance	Adjustment due to liability (or asset) upon adoption of the ASU	Where the offsetting impact on equity is recorded
Liability for future policy benefits	Pre-adoption 12/31/2019 balance	
	+/- Adjustments for the removal of any “shadow” adjustments	Opening AOCI
	+ Adjustments for loss contracts (with net premiums in excess of gross premiums) under the modified retrospective approach	Opening retained earnings

Balance	Adjustment due to liability (or asset) upon adoption of the ASU	Where the offsetting impact on equity is recorded
	+/- Adjustments for the cumulative effect of adoption of the new measurement guidance under the retrospective method for contract issue years from 20XX through 2019	Opening retained earnings
	+/- Effect of the remeasurement of the liability at current single A rate	Opening AOCI
	Post adoption 1/1/2020 balance	
MRBs	Pre-adoption 12/31/2019 carrying amount for features now classified as MRBs (1)	
	+/- Adjustments for the removal of any “shadow” adjustments	Opening AOCI
	+/- Adjustments for the cumulative effect of the changes in the instrument-specific credit risk between the original contract issuance date and the transition date	Opening AOCI
	+/- Adjustments to the host contract for differences between previous carrying amount and fair value measurement for the MRB under the option based method of valuation (2)	Opening carrying amount of host contract
	+/- Adjustments for the remaining difference (exclusive of the instrument specific credit risk change and host contract adjustments) between previous carrying amount and fair value measurement for the MRB	Opening retained earnings
	Post adoption 1/1/2020 balance	
DAC (or other balances amortized on a basis	Pre-adoption 12/31/2019 balance	
	+/- Adjustments for the removal of any “shadow” adjustments	Opening AOCI

Balance	Adjustment due to liability (or asset) upon adoption of the ASU	Where the offsetting impact on equity is recorded
consistent with DAC)	+/- Adjustments for the cumulative effect of adoption of the simplified amortization methodology under the retrospective method for contract issue years 20XX through 2019	Opening retained earnings
	Post adoption 1/1/2020 balance	
Other impacts (e.g., additional liability for annuitization, death, or other insurance benefits)	Pre-adoption 12/31/2019 balance classified as additional liabilities (3)	
	+/- Adjustments for the removal of any “shadow” adjustments	Opening AOCI
	+/- Adjustments for the cumulative effect of adoption of the ASU (4)	Opening retained earnings
	Post adoption 1/1/2020 balance	

Table footnotes:

1. The pre-adoption balance as of 12/31/2019 for MRBs represents the contract features that meet the definition of an MRB under ASU 2018-12 and the related carrying amount of those features prior to the ASU. Those contract features may have previously been accounted for at fair value as a derivative or embedded derivative under ASC 815 or as an additional liability for annuitization, death, or other insurance benefits under ASC 944.
2. If an insurance entity has an option-based MRB, then the initial fair value would have been other than zero at inception. Therefore, a retrospective transition adjustment would be required to the host insurance or investment contract. Refer IG 11.3.9 for further discussion of transition impact of MRBs.
3. The pre-adoption 12/31/2019 balance for the additional liability for annuitization, death, or other insurance benefits as of 12/31/2019 represents the amount that will continue to follow the additional liability model under ASC 944-after adoption of the ASU.
4. The ASU changed the calculation of assessments used as the denominator in the benefits ratio for the additional liability for death or other insurance benefits (commonly referred to as “SOP 03-1 liability”). The transition for the change is retrospective. Refer to IG 5.8 for further guidance related to the calculation of assessments used as the denominator in the benefits ratio for the additional liability for death or other insurance benefits.

Question IG 11-24

Is a disaggregated tabular rollforward required of the ending balances of the reporting period prior to the transition date to the opening balances at the date of transition for reinsurance recoverables impacted by the adoption of ASU 2018-12?

PwC response

Reinsurance recoverables are impacted by the adoption of the ASU because of the changes in the liability for future policy benefits and market risk benefits for the direct insurance contracts. Reinsurance recoverables related to the liability for future policy benefits have the same transition method as the liability for future policy benefits given that ceded reinsurance recoverables are required to be recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts. Reinsured MRBs are required to be carried at fair value after adoption of the ASU and must follow the retrospective adoption method similar to MRBs for the direct contracts.

The ASU is silent as to whether disaggregated rollforwards and other transition disclosures are required for the reinsurance recoverables impacted by the adoption of ASU 2018-12. Given the spirit of the ASU and the existing guidance in ASC 250 is to provide clear disclosure as to the effects of the changes, we believe rollforwards for reinsurance recoverables should be considered when such information is material to the users of the financial statements.

Question IG 11-25

Are SEC registrants required to provide all annual disclosure requirements of the ASU for each interim period in the initial year of adoption?

PwC response

Yes. Regulation S-X, Article 10 requires registrants to disclose material matters that were not disclosed in the most recent annual financial statements. Accordingly, when a registrant adopts the ASU in the first quarter, the registrant is expected to provide both the annual and the interim period disclosures prescribed by the standard, to the extent not duplicative. These disclosures should be included in each quarterly report in the year of adoption (that is, in the registrant's first, second, and third quarter Form 10-Q filings).

Question IG 11-26

The ASU requires various quantitative disclosures. For which period should these disclosures be provided?

PwC response

If a disclosure relates to a balance sheet account, the information should be provided for each period a balance sheet is presented that reflects adoption of the ASU. If a disclosure relates to an income statement account, the information should be provided for each period an income statement is presented that reflects adoption of the ASU. For example, the liability for future policy benefits is an account on the balance sheet. For an SEC filer that adopts the ASU in 2021, the disaggregated rollforwards and their related components, including income statement components, would only be required for the two balance

sheet periods presented in the financial statements (e.g., 2021 and 2020). However, entities may want to present the 2019 disaggregated rollforwards since that period would not have been previously disclosed.

Question IG 11-27

What information should SEC registrants disclose about the expected impact of the ASU prior to adoption (SAB 74 disclosures)?

PwC response

SEC registrants are required to disclose both quantitative and qualitative information regarding the expected impact of adopting the ASU. These disclosures should evolve and become more detailed as registrants progress in their implementation and should be aligned with information communicated to audit committees and investors.

SEC registrants should disclose known or reasonably estimable quantitative information about the expected impact of the ASU, even if such information is only available for a particular subset of the SEC registrant's products (e.g., impact of the change in DAC amortization or impact of recording MRBs at fair value). When assessing whether the impact of the ASU on an SEC registrant's financial statements is material, registrants should consider the new disclosures required by the standard in addition to the impact on the recognition, measurement, and presentation of insurance contracts.

If an SEC registrant does not know or cannot reasonably estimate the expected financial statement impact, then in addition to making a statement to that effect, the registrant should consider additional qualitative disclosures to assist the reader in assessing the impact of the ASU. Additional qualitative disclosures should include a description of the effects of the accounting policies that the SEC registrant anticipates applying, if determined, and a comparison to the SEC registrant's current accounting policies. For example, if an SEC registrant has not yet completed its analysis of the impact of the new ASU on its liability for future policy benefits for traditional insurance and limited-payment contracts, it should consider disclosing, at a minimum, the transition method expected to be elected (or if not yet known, transition alternatives being considered) and that the ASU will have an impact on the entity's results as it requires insurance assumptions to be updated at least annually with a retrospective catch up adjustment recorded for the impact of those changes to assumptions, which will result in different timing of profit emergence. An SEC registrant should also describe the status of its process to implement the new standard and the significant implementation matters yet to be addressed.

***Chapter 12:
Business combination
considerations—updated
November 2021***

12.1 Insurance industry business combinations guidance

This section highlights the key accounting issues that entities in the insurance industry may encounter when entering into a business combination.

12.1.1 Accounting for business combinations (insurance industry)

ASC 805 and ASC 944 provide some insurance-specific guidance for business combinations. Figure IG 12-1 has an index of the industry specific guidance.

Figure IG 12-1

Index of industry specific guidance for insurance entity business combinations

Guidance	Subject
ASC 805-30-55-3 through ASC 805-30-55-5	Requiring acquisition accounting for combinations of mutual entities
ASC 944-805-25-1	Considering insurance contracts acquired in a business combination as new contracts for measurement and accounting purposes
ASC 805-20-25-8 and ASC 944-805-25-2	Carrying forward the acquiree's classification of an acquired contract as an insurance or reinsurance contract or a deposit contract (and thus not evaluating whether the contracts transfer significant insurance risk)
ASC 944-805-30-1	Recognizing the fair value of the assets and liabilities arising from the rights and obligations of the insurance contract in two components
ASC 944-805-25-4 and ASC 944-805-25-5	Requiring contingent commissions and claim liability guarantees to be accounted for in the same manner as other non-insurance contract contingencies
ASC 944-805-35-1 through ASC 944-805-35-3	Requiring subsequent measurement of acquired insurance contract intangible assets (or other liability) on a basis consistent with the related insurance or reinsurance liability

The application of acquisition accounting to insurance transactions presents unique issues. These include:

- distinguishing between a business combination, a reinsurance transaction (including a portfolio transfer), or an asset acquisition,
- recognizing insurance contracts at fair value and determining the attribution between the insurance contract liabilities and related insurance contract intangible asset (or liability),
- identifying and recognizing any other separately identifiable intangible assets at fair value, including renewal rights on short-duration contracts, customer relationships, and distribution relationships,

- determining the post acquisition amortization approaches for the insurance contract intangible asset (or the liability) and for any other separately identified intangible assets, and
- accounting for claims indemnification agreements entered into contemporaneously with a business combination.

12.1.2 *Determining if a business combination exists*

Transactions in the insurance industry may take various legal forms. In addition to the purchase of the equity shares of an insurance entity, it is not uncommon for a transaction to include one or more indemnification or novation reinsurance transactions along with the acquisition of renewal rights, the purchase of certain legal entities, the purchase of assets, or various combinations thereof. In many cases, the acquired items taken as a whole, including the reinsurance components, may meet the definition of a business (as discussed in BCG 1) and, therefore, will be accounted for as a business combination under ASC 805. Factors to consider in making that determination include whether the rights and obligations of the in-force block of insurance and investment contracts have been transferred, and whether various other components of the business have been transferred, such as the employees and staff, the policy administration function, or distribution systems.

If the transaction does not qualify as a business combination, the accounting for assuming reinsurance and asset acquisitions is applied based on the fair value determined at the acquisition date. No goodwill is recognized, and assumed reinsurance of in-force blocks of insurance/investment contracts is assessed for contract classification in accordance with reinsurance risk transfer guidance. See IG 8.10 for short duration assumed reinsurance accounting and IG 9.7 for long duration assumed reinsurance accounting. The difference between the consideration received and the assumed reinsurance liabilities recognized is often presented as an intangible asset, similar to the accounting for business combinations. Asset acquisitions include the purchase of identifiable intangible assets and other assets, which are subject to the guidance in ASC 350 and ASC 360, respectively.

12.1.3 *Initial measurement of insurance/reinsurance contracts in a business combination*

Consistent with business combination accounting for non-insurance assets and liabilities acquired, insurance and reinsurance contracts are recognized at fair value as defined in ASC 820 and considered to be new contracts for measurement and accounting purposes (i.e., a fresh start basis applies). However, as discussed in ASC 805-20-25-8 and ASC 944-805-25-2, there is no reassessment of the classification of contracts as insurance, reinsurance, or deposit contracts on the acquisition date (i.e., no reassessment of whether the contracts transfer significant insurance risk), unless the contracts were modified substantively in the business combination. Identification of embedded derivatives and market risk benefit (MRB) features are required to be reassessed at the acquisition date. Consistent with the general notion of acquisition accounting and fair value, deferred acquisition costs, deferred retroactive reinsurance gains, and unearned premiums that do not represent future cash flows are not considered acquired assets and liabilities as discussed in ASC 944-805-30-1.

See FV 4 for a discussion of valuation techniques and approaches. Typically, insurance and reinsurance entities are considered the market participants for purposes of determining the fair value of insurance and investment contracts and broader financial institutions are considered the market participants for MRB and embedded derivative features.

12.1.4 *Initial measurement of insurance contract intangibles and related liabilities*

The fair value of acquired insurance contracts is attributed between two financial statement lines items representing: (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) the insurance contract intangible asset (or liability) recognized for the difference between the fair value of the insurance and reinsurance contracts and the amount recognized in accordance with the acquirer's existing accounting policies (hereafter referred to as the "insurance contract intangible asset"). Under ASC 944-805-30-1, the recognition of the insurance contract intangible asset may be an additional liability (rather than an asset) on those occasions when the fair value of the insurance contract exceeds the value of the insurance contract liability measured in accordance with the acquirer's accounting policies. The intangible asset or liability is typically called "value of business acquired" (VOBA) or "present value of future profits" (PVFP).

12.2 *Acquired non-life short duration insurance contracts*

The liability to pay future contract claims and expenses on the unexpired portion of the acquired contracts and the liability to pay incurred contract claims and claims expenses are acquired liabilities that should be measured in accordance with the acquirer's accounting policies. Such accounting policies for recognized liabilities for non-life short-duration contracts typically include both an unearned premium liability relating to the unexpired portion of an insurance contract and a claim liability (for reported claims as well as for incurred but not reported claims).

There is no reassessment of the classification of contracts as insurance, reinsurance, or deposit contracts on the business combination acquisition date, unless the contracts were modified substantively in the business combination. Therefore, all insurance contracts in the seller's past financial statements are not required to be evaluated by the acquirer to determine if they are deposits even if a substantial amount of the period of risk transfer or potential variability in cash flows has passed. However, insurance contracts acquired in a business combination are considered by the acquirer as new contracts for measurement and accounting purposes in accordance with ASC 944-805-25-1.

Question IG 12-1 discusses acquired retroactive reinsurance contracts (i.e., contracts that reinsure events under expired coverage of the underlying reinsured contracts).

Question IG 12-1

If an acquired insurer has a reinsurance contract previously accounted for as retroactive reinsurance (e.g., maintained a deferred gain and retrospectively unlocked the amortization of the gain based on subsequent recoveries of the underlying related claim liabilities), does the acquirer maintain the retroactive accounting for the reinsurance contract subsequent to the business combination?

PwC response

No. The acquirer is required to consider all acquired insurance contracts (including reinsurance contracts) as if they were new contracts for measurement and accounting purposes. Because they are considered to be newly acquired, they are considered prospective, even though the coverage relates to past events. The seller's retroactive accounting treatment is irrelevant. Deferred gains, similar to deferred acquisition costs (DAC), are not recognized in acquisition accounting as they do not represent

future cash flows. This is similar to the accounting required for a retrocession reinsurance contract entered into concurrently with the acquisition; the retrocession is accounted for as an indemnification agreement under ASC 805-20-25-27 through ASC 805-20-25-28 and ASC 805-20-30-18 through ASC 805-20-30-19, which is equivalent to prospective ceded reinsurance.

12.2.1 *Acquired incurred claim liabilities*

The acquired claims liability is measured at its fair value at the acquisition date. As discussed in IG 12.1.4, the fair value is presented initially in two components: the claim reserves measured consistent with the acquiring entity's accounting policies for claim liabilities and an intangible asset (or liability) for the difference. Many claim liabilities are measured at undiscounted best estimate cash flows, resulting in the intangible asset representing the discount effects used in fair value offset by the risk premium or margin a market participant would require above best estimate cash flows.

12.2.2 *Acquired liability for unexpired coverage (unearned premium)*

ASC 944-805-30-1 requires the acquirer to measure the fair value of the insurance assets and liabilities in a business combination in two components. The first component is recognized in accordance with the acquirer's accounting for policies that it issues or holds, and the second component is measured as the difference between the first component and the fair value. The first component can be determined by carrying forward the unearned premium liability from the acquiree. Another method for initially measuring the first component is to use the price the acquirer is currently charging for similar unexpired coverage. This approach results in subsequent premium revenue comparable to that of policies that were originated on the same day as the acquisition. In either approach, the amount will be amortized as premium revenue in subsequent periods in accordance with the premium recognition policy of the acquirer. While there is no prescribed method for amortizing the second component, it is required to be amortized on a basis consistent with the related insurance or reinsurance liability, and for long duration contracts, the amortization assumptions must be consistent with those used in the measurement of the liability for future policy benefits.

12.2.3 *Insurance contract intangible assets—subsequent measurement*

Under ASC 944-805-35-1, after a business combination, the insurance contract intangible asset (or liability) is required to be measured and thus amortized on a basis consistent with the related insurance or reinsurance liability.

For many property/casualty short-duration contracts, insurance contract intangible asset relating to the unearned premium component are typically amortized consistent with the amortization of the related unearned premium liability. The presentation of the amortization in the income statement is typically consistent with DAC amortization.

The insurance contract intangible asset associated with the claim liability is amortized over the claim settlement period, typically based on an actuarial projection of the claim settlement pattern. ASC 944-805-35-2 suggests that amortization of the insurance contract intangible asset associated with undiscounted claim liabilities using the interest method may be an appropriate method because a large component of the intangible asset includes the time value of money. In practice, amortization methods vary. Some entities use the effective yield method for amortizing the pure discount/time value of money element and a separate amortization schedule for the risk margin component, if separately determinable, under the premise that expiration of risk is not consistent with an effective yield approach.

Additionally, practice varies in subsequent periods when actual settlement patterns differ from expectations. Some entities unlock the pattern and/or term of amortization. Others establish an amortization pattern and term, and do not unlock unless there is a significant change in the expected life. When an unlocking method is used, some entities recognize the change using a retrospective method, while others use a prospective method.

Intangible assets recognized in acquisition accounting associated with long duration contracts are subject to impairment testing. Intangible assets related to unearned premium for short duration contracts are subject to premium deficiency testing. Intangible assets related to short duration claims liabilities are treated like a discount or premium on debt instruments and not subject to impairment or premium deficiency testing.

12.3 Acquired long duration insurance contracts

For long-duration life insurance contracts, entities have applied various approaches for recognizing the contract liability component of the fair value of the contract, depending on the type of contract (e.g., traditional whole-life contract, limited pay contract, universal life contract, or payout annuity).

12.3.1 Acquired traditional whole-life insurance contracts

The liability measurement for a traditional whole-life contract is a function of the premium. For an existing traditional whole-life contract that is part way through the premium-collection period, determining the liability using the traditional net premium method presents some practical challenges. Several methods are used in practice, including the defined initial reserve method and the defined valuation premium method.

The defined initial reserve method carries forward the existing acquiree liability for future policy benefits and computes a new net premium ratio (NPR) using the acquirer's assumptions (e.g., mortality, expense, and lapse assumptions and the current discount rate) at the acquisition date. The new NPR will be used in subsequent measurement of the liability for future policy benefits, updated as necessary as described after Figure IG 12-3 below. Figure IG 12-2 outlines the defined initial reserve method.

Figure IG 12-2

Determining the acquisition date liability using the defined initial reserve method

Liability for future policy benefits at acquisition date	=	Existing acquiree liability
NPR at acquisition date	=	Present value of updated future benefits and related expenses from the purchase date forward - existing acquiree liability for future policy benefits Present value of future gross premiums from the purchase date forward

The defined valuation premium method recomputes the liability for future policy benefits at the acquisition date using the acquirer's assumptions and using a net premium ratio based on margins observed for comparable business. Figure IG 12-3 outlines the defined valuation premium method.

Figure IG 12-3

Determining the acquisition date liability using the defined valuation premium method

NPR at acquisition date	=	NPR for similar business
Liability for future policy benefits at acquisition date	=	Present value of updated future benefits and related expenses from the purchase date forward - present value of future net premiums* from the purchase date forward
		*Net premiums = gross premiums from the purchase date forward x NPR at acquisition date

Under ASU 2018-12, subsequent measurement of the liability for future policy benefits requires the retrospective unlocking of the net premium ratio using updated cash flow projections from the acquisition date forward to recompute an “issue date” revised net premium ratio. This results in a cumulative catch up adjustment in the period of changed assumptions. For purchased blocks of business, the issue date of the contracts is the acquisition date of the business combination and not the original issue dates of the contract with the policyholders. The acquisition date liability for future policy benefits will be a component in the numerator of the NPR ratio when updating the NPR under the ASU 2018-12 retrospective unlocking methodology under both the defined initial reserve and the defined valuation premium methods. The revised NPR in future periods will be computed as detailed in Figure IG 12-4.

Figure IG 12-4

Revised NPR in future periods

Updated NPR	=	Present value of updated future benefits and related expenses from the <u>purchase date forward - acquisition date liability for future policy benefits</u> Present value of future gross premiums from the purchase date forward
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Under ASU 2018-12, the interest rate used at the acquisition date for calculation of the net premium ratio and the liability for future policy benefits is the upper-medium grade fixed-income instrument yield at the purchase date, which will serve as the locked in interest rate for interest accretion in subsequent periods. As a result, there is no opening AOCI adjustment related to purchased insurance liabilities.

12.3.2 *Acquired universal life type insurance contracts*

For a universal life contract, the recognized liability would typically be its account balance and if applicable, embedded derivatives and death or other benefits. After the effective date of ASU 2018-12, (MRBs may also exist. There is diversity in practice on how to establish acquisition “liabilities measured in accordance with the acquirer’s accounting policies for insurance contracts it issues” when there are policyholder liabilities in addition to the account balance. There is similar diversity in the allocation of fair value to other policyholder benefits liabilities (pre-Accounting Standard Codification SOP 03-1) and embedded derivatives.

Example IG 12-1 illustrates different allocations of fair value of an acquired non-traditional universal life contract between its various components in an acquisition.

EXAMPLE IG 12-1

Allocating fair value to different features of an acquired block of variable annuity contracts in a business combination

Insurance Company acquires a block of variable annuity contracts as part of the acquisition of a business assuming the acquisition is after the effective date of ASU 2018-12. The contracts have a guaranteed minimum accumulation benefit (GMAB) feature measured at fair value under MRB guidance. The seller’s total liability is \$150,000 and is comprised of the following:

Separate assets and liabilities	\$100,000
Seller’s GMAB liability (MRB)	<u>\$50,000</u>
Total seller’s liability	\$150,000
Fair value of the entire contract	\$110,000

How should Insurance Company recognize the opening liability balances in acquisition accounting (per ASC 944-805-30-1)?

Analysis

One alternative is to recognize an opening account balance liability for \$100,000 and opening MRB liability of \$50,000 and an insurance contract intangible asset (VOBA) of \$40,000. By carrying over the acquiree’s fair value MRB balance, this method preserves the seller’s original attribution of policyholder fees in identifying the MRB terms in the subsequent measurement of the GMAB MRB liability. The acquirer would need to consider if the own credit risk of the MRB has changed as a result of the transaction. No amount is presented in accumulated other comprehensive income for own credit at acquisition date; however, the own credit component will need to be determined for purposes of measuring the change in own credit in subsequent periods that will be presented in other comprehensive income. This alternative also recognizes that the acquired GMAB feature is of more value than at inception when the guaranteed amount is for an amount higher than those being offered in the market at the acquisition date.

Another alternative is to consider insurance contracts acquired in a business combination as new contracts for measurement and accounting purposes (per ASC 944-805-25-1) and apply practice used

in the initial writing of a variable annuity with a GMAB. At inception (and thus at acquisition) the GMAB is defined as the fair value of cash outflows under the feature less an equal amount of future fees that will be collected from the policyholder over the life of the contract. This results in an initial fair value of the GMAB equal to zero. If there are not enough fees projected to be collected, an additional liability would be accrued. This method would result in recognizing an opening account balance liability for \$100,000, opening MRB liability of \$0, and a VOBA liability of \$10,000, assuming insufficient future fees. The VOBA liability may be characterized as a beginning GMAB value or separately amortized over the life of the contract.

Had this acquisition occurred prior to the adoption of ASU 2018-12, the accounting would have been substantially the same except that the GMAB would have been accounted for as an embedded derivative rather than an MRB.

12.3.2.1 *Other potential embedded derivatives at acquisition*

Upon a business acquisition, acquired insurance and investment contracts need to be analyzed for any embedded derivatives which may need to be separated from the host contract in accordance with ASC 815. Embedded derivatives can exist due to minimum interest rate guarantees in acquired contracts. They can also exist for contracts that effectively have a substantial discount or premium. For example, contracts that were originally issued to policyholders in a higher interest rate environment than at the acquisition date. The embedded derivative related to the ability of the counterparty to lapse the contract or effectively put the contract must be assessed to determine if it is required to be separated.

12.3.3 *Acquired investment contracts*

There is diversity in practice as to whether the recognition of the fair value of an insurance contract in the two components noted in IG 12.1.4 is applicable to contracts that are classified as investment contracts rather than insurance contracts, such as a deferred annuity in the accumulation phase. For traditional fixed deferred annuities without embedded derivatives or MRBs, one component would be its account balance, with the remaining difference between that balance and its fair value recognized as an intangible asset (or other liability) in accordance with ASC 944 for insurance contracts. The intangible asset (or other liability) typically represents the difference between current market rates and contractual crediting rates of the instrument. Alternatively, the entire fair value is recognized as a liability, in accordance with financial instrument accounting.

Prior to codification of insurance business combination guidance into ASC 805, US GAAP addressed the accounting for the intangible asset recognized upon acquisition as representing the “present value of future profits” (PVFP) embedded in acquired insurance contracts. That guidance was applicable to life insurance contracts or “other long-duration contracts” covered by insurance accounting guidance. In practice, PVFP was often established for all long-duration contracts, including investment contracts. We do not believe the process of codification of insurance business combination guidance was meant to change this practice of establishing PVFP for investment contracts. In addition, there are other areas where the guidance for insurance contracts is followed for investment contracts as well, including the accounting for deferred acquisition costs. Entities should make a policy election and apply that policy consistently. If PVFP is presented as an asset for investment contracts, it would generally not be subject to a premium deficiency test or separate asset recoverability test, given that the investment contract’s PVFP is essentially a form of debt discount or premium associated with the investment contract liability.

When an entity chooses to recognize the entire fair value of the investment contract as a net liability (i.e., with no PVFP established) at the business combination date, the fair value may be less than the investment contract “account balance” that is payable on demand. If the subsequent accounting for the investment contract is amortized cost (i.e., the fair value option is not elected), the difference between the acquisition date fair value and the account balance is amortized to earnings in a systematic and rational manner. This approach is consistent with the subsequent accounting for liabilities arising from contingencies and with the accounting for the insurance contract intangible asset (or liability) discussed in IG 12.3.4.

Example IG 12-2 illustrates different allocations of fair value of an acquired non-traditional fixed indexed annuity contract between its various components in an acquisition prior to the adoption of ASU 2018-12. In order to illustrate the differences, Example IG 12-3 illustrates the allocation after adoption of ASU 2018-12.

EXAMPLE IG 12-2

Allocating fair value to different features of an acquired fixed indexed annuity contract in a business combination – Acquisition accounting prior to the adoption of ASU 2018-12

Insurance Company acquires a block of fixed indexed annuity contracts as part of the acquisition of a business. The contracts have an equity participation crediting feature as well as a guaranteed minimum withdrawal benefit (GMWB).

How is the fair value allocated in acquisition accounting to opening liability balances (per ASC 944-805-30-1 (a)) by Insurance Company before adoption of ASU 2018-12?

At the acquisition date, the seller’s balances are as follows:

Host contract (net of discount)	\$95,000
Embedded derivative (equity return)	22,000
SOP 03-1 liability (GMWB)	3,000
Total seller’s liability	\$120,000
Accumulated account balance used for fees and crediting to policyholder	\$115,000
Fair value of the entire contract	\$107,000

Analysis

The fair value of the acquired insurance contracts would be divided into two components as described in IG 12.1.4: the opening insurance liability balances and the insurance contract intangible asset (or liability). The opening liability balances may differ from the seller’s liability balances. There is no prescribed approach for determining these amounts. One approach applied in practice is to allocate the fair value of the contract of \$107,000 as follows:

- \$118,000 opening insurance liability balance measured in accordance with the acquirer’s accounting policies, consisting of:

- \$115,000 account balance liability as a proxy for the amount invested by the policyholder in the equity indexed contract and
 - \$3,000 SOP 03-1 liability for the additional GMWB benefit, measured using the defined initial reserve method (similar to that used for FAS 60 traditional liabilities as described in IG 12.3.1).
- \$11,000 for the ASC 944-805-30-1(b) insurance contract intangible asset (VOBA)

The \$3,000 additional liability would be established in the acquirer's balance sheet consistent with its existing accounting policies for similar liabilities. The \$115,000 equity indexed account balance would be separated into its components for accounting purposes. The equity return feature is an equity option embedded within the annuity contract (the hybrid debt instrument). In accordance with ASC 815-15-30-2, the embedded derivative would be recognized at its fair value of \$22,000. The host contract would be recognized at \$93,000 (the difference between the basis of the hybrid instrument of \$115,000 and the \$22,000 fair value of the embedded derivative feature). The acquirer would need to consider if the own credit risk of the embedded derivative has changed as a result of the transaction.

EXAMPLE IG 12-3

Allocating fair value to different features of an acquired fixed indexed annuity contract in a business combination – Acquisition accounting after adoption of ASU 2018-12

Insurance Company acquires a block of fixed indexed annuity contracts as part of the acquisition of a business. The contracts have an equity participation crediting feature as well as a guaranteed minimum withdrawal benefit (GMWB).

How is the fair value allocated in acquisition accounting to opening liability balances (per ASC 944-805-30-1 (a)) by Insurance Company after adoption of ASU 2018-12

At the acquisition date, the seller's balances are as follows:

Host contract	\$92,000
Embedded derivative (equity return)	22,000
Embedded MRB (GMWB)	4,000
Total seller's liability	\$118,000
Accumulated account balance used for fees and crediting to policyholder	\$115,000
Fair value of the entire contract	\$107,000

Analysis

The fair value of the acquired insurance contracts would be divided into two components as described in IG 12.1.4: the opening insurance liability balances and the insurance contract intangible asset (or liability). The opening liability balances may differ from the seller's liability. There is no prescribed approach for determining these amounts. One approach is to allocate the fair value of the contract of \$107,000 as follows:

- \$119,000 opening insurance liability balances measured in accordance with the acquirer's accounting policies
- \$12,000 for the ASC 944-805-30-1(b) intangible VOBA asset

This example approach combines the policyholder account balance (\$115,000) and the MRB fair value (\$4,000) to estimate the opening insurance liability balances. Another approach determines the fair value of each of the components of the instrument: the embedded derivative, the MRB, and the host debt instrument (with the host debt instrument valued as the present value of the guaranteed amount using crediting rates offered on similar debt instruments). A third approach solves for the opening liability balances by valuing the present value of future GAAP profits and adding that amount to the allocated fair value of \$107,000.

The \$119,000 investment in the contract would then be separated into its components for accounting purposes. The equity return feature is an equity option (embedded derivative) and the GMWB is an MRB embedded within the annuity contract. In accordance with ASC 815-15-30-2 and ASC 944-40-30-19D, the embedded derivative and embedded MRB would be recognized at their fair values of \$22,000 and \$4,000, respectively. The host contract would be valued at \$93,000 (the difference between the basis of the hybrid instrument of \$119,000 and the \$22,000 fair value of the embedded features). The acquirer would need to consider if the own credit risk of the MRB has changed as a result of the transaction.

12.3.4 Insurance contract intangible assets—subsequent measurement

Under ASC 944-805-35-1, any insurance or reinsurance contract intangible asset (or liability) is required to be subsequently measured “on a basis consistent with the related insurance or reinsurance liability.” No specific methods are prescribed, although in practice, prior to ASU 2018-12, the related DAC amortization method applicable to the contract (and related assumptions) was often used by analogy under the view that these amounts are fixed intangible assets or liabilities to be amortized. Entities that view acquired contract intangible assets and liabilities as similar to DAC continue to align amortization with their DAC amortization policy and thus use the simplified DAC amortization method prescribed by ASU 2018-02.

Others may view contract intangible assets and liabilities acquired in a business combination as different from DAC, given that such balances represent the residual measurement of future cash flows (i.e., the fair value of future contractual cash flows of purchased contracts less the GAAP liability established using ASC 944 principles). In many cases, the fair value of the contracts established in acquisition accounting is estimated using a discounted cash flow approach (i.e., discounting future premiums, benefits, fees, and expenses, which represent net profits), implying that the accretion of interest and amortization of the residual measurement based on estimated gross profits, premiums, or other methods may continue to be appropriate for the related acquired present value of future profits (PVFP) asset or liability. Acquired contracts are considered newly purchased contracts. As a result,

amortization of the insurance contract intangible asset is based on premiums or expected gross profit (or expected gross margins) from the acquisition date forward and not from the original policyholder contract inception date. For amortization methods that incorporate investment yields, see Figure IG 5-4 for shadow adjustment considerations.

The PVFP balances are contract cash flows and therefore should be included in premium deficiency tests for all types of long-duration models, including traditional insurance, limited-payment, universal life, and participating insurance contracts. See IG 7.3. That is, the guidance in ASC 944-60-25-7 regarding premium deficiency testing has a specific requirement to include the present value of future profits in the analysis. For traditional and limited-payment contracts, only the PVFP asset balance is subject to the premium deficiency test because the liability is subject to a separate loss recognition test (the ratio of benefits to premiums cannot exceed 100%) as described in IG 5.2.1.

Since PVFP represents an intangible asset, we believe it would not be appropriate to reverse any previous write downs of PVFP amounts for subsequent favorable development.

The requirements in ASC 944-60-25-3 and ASC 944-60-25-7 relating to PVFP recoverability testing have not changed with regard to either the level of aggregation at which the testing is performed or the interest assumptions used in estimating the present value of future cash flows. The guidance specifies that insurance contracts should be grouped consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts. The guidance refers to "investment yields" as one of the assumptions that may be used in assessing the recoverability of PVFP.

Question IG 12-2 discusses the level of aggregation to be utilized for the PVFP recoverability test for nonparticipating traditional and limited-payment contracts. Question IG 12-3 discusses the discount rate to be utilized for the PVFP recoverability test for nonparticipating traditional and limited-payment contracts.

Question IG 12-2

Is the recoverability test for the present value of future profits (PVFP) relating to nonparticipating traditional and limited-payment contracts required to be performed at the cohort level?

PwC response

It depends. The recoverability test for PVFP is required to be performed at the level at which an entity acquires, services, and measures profitability in accordance with ASC 944-60-25-3, which was not amended by ASU 2018-12. However, insurance entities should consider whether the application of this guidance may change the level at which profitability is measured for nonparticipating traditional and limited-payment contracts that are measured at the cohort level. If an entity believes that measuring profitability at the cohort level is a key/predominant indicator in the PVFP recoverability test, switching to a cohort grouping level may be appropriate.

Question IG 12-3

What discount rate should be used in the PVFP recoverability test relating to nonparticipating traditional policies or limited-payment policies? Is an entity required to use the same discount rate used in measuring the liability for future policy benefits (i.e., the upper-medium grade fixed-income instrument yield)?

PwC response

ASC 944-60-25-7 requires that a reporting entity assess PVFP for recoverability, but it does not prescribe a particular discount rate to be used in the assessment. It does mention “investment yields, along with mortality, morbidity, terminations, or expenses” as relevant assumptions in performing a loss recognition test, implying that investment yield may be an appropriate discount rate. However, some believe that the upper-medium grade fixed-income instrument yield is appropriate for the recoverability assessment, given that this is the discount rate used in measuring the liability for future policy benefits to which the PVFP relates. Others believe it may be appropriate to use the risk-adjusted rate used to estimate the fair value of the liability from which the PVFP was calculated (as described in IG 12.1.4) in the recoverability assessment. As a result of the lack of a prescribed rate, rates such as investment yield, the liability for future policy benefits upper-medium grade fixed-income instrument yield, or a risk-adjusted rate may all be considered as appropriate choices depending on the particular facts and circumstances of the purchased block and the entity. If investment yields are used, refer to Figure IG 5-4 for considerations related to shadow adjustments.

12.4 ***Acquired other intangible assets***

In a business combination, other intangible assets must be identified, recognized, and measured at fair value when a contractual relationship exists or the asset is capable of being separately transferable. See BCG 4. Employees do not meet these criteria. Business combinations involving insurance entities typically include the acquisition of various types of intangible assets, including:

- Customer relationships, such as renewal rights on short-duration insurance contracts, cross-selling opportunities, and customer/member lists
- Distribution channels, including the distributor’s ability to generate new business from new customers
- Insurance licenses
- Service contracts and provider contracts (particularly relevant for health insurers)
- Brand names and trade names
- Process technology and know-how

Issues involved in accounting for such intangibles, recognized in conjunction with a business combination or as stand-alone asset acquisitions, include identification, valuation, and post-combination accounting. Two major challenges include avoiding use of overlapping cash flows when determining the fair value for more than one intangible asset (e.g., customer relationships and distribution channels) and ensuring that all significant intangibles are identified. In terms of determining fair value, the most common methods used are the discounted cash flow method and the

market approach (i.e., market transaction multiple method). Estimating intangible assets relating to customer relationships can be an especially challenging valuation area, given that such estimates are based on customer behavior, which is often difficult to predict. Valuation specialists, including actuaries, will typically be required for this exercise. See BCG 4 and FV 7 for further information on the recognition and valuation of intangible assets.

Accounting issues in the post-combination period include the selection of an amortization pattern and term for finite-lived intangibles. The method of amortization for finite-lived intangibles should reflect the pattern in which the economic benefits of the asset are consumed. The assigned useful lives can vary considerably based on the type of intangible, the type of business, and the specifics of the acquired portfolios. Judgment is needed in selecting an appropriate useful life and pattern of amortization based on the nature of the intangible asset and the benefits derived from that asset.

In the post-combination period, both finite and indefinite-lived intangible assets are subject to impairment testing. Indefinite-lived intangible assets are subject to impairment testing at least annually, while finite-lived intangible assets are subject to impairment testing only upon a “triggering” event. Issues surrounding the impairment of indefinite-lived intangible assets and finite-lived intangible assets are discussed in BCG 8 and PPE 5, respectively.

Question IG 12-4 discusses the life of an intangible asset for contracts with insurance agents.

Question IG 12-4

What is the life of an intangible asset related to contracts with insurance agents?

PwC response

The life of the intangible asset for contracts with insurance agents is dependent on how long the insurance agents will stay under contract with the acquirer. The intangible asset for the insurance agents cannot be amortized over the life of the insurance contracts the agents are expected to sell.

12.5 Contingent commission arrangements

Acquired contingencies other than claim liability guarantees, such as contingent commissions paid to agents, are not part of the insurance or reinsurance contract. Therefore, such arrangements are required by ASC 944-805-25-4 to be accounted for under ASC 805 in the same manner as other noninsurance contingencies (e.g., as contingencies for contingent commissions arising from distribution agreements). See BCG 2.5.13 for information on initial and subsequent recognition and measurement of noninsurance contingencies.

12.6 Seller’s claim liability indemnifications

Indemnification agreements relating to the adequacy of acquired claim liabilities obtained concurrent with a business combination, including those in the form of reinsurance contracts, are accounted for on the acquisition date consistent with other indemnification assets in accordance with ASC 805-20-25-27 through ASC 805-20-25-28 (per ASC 944-805-25-5) and not treated as retroactive reinsurance. In contrast, reinsurance agreements entered into subsequent to the acquisition date are accounted for as ceded reinsurance transactions, including application of retroactive reinsurance guidance. The guidance in ASC 944-805 on indemnification agreements obtained concurrent with a business

combination is a more concise version of the guidance originally issued by the EITF in 1996 and 1997. The original guidance provided examples of both a direct seller indemnification and a seller indemnification achieved through negotiation of a reinsurance contract with a third-party reinsurer contemporaneous with, and in contemplation of, the business combination. Despite the fact that the specific examples have not been carried forward to ASC 805, we believe both of those indemnifications would continue to be accounted for under ASC 805-20-25-27 through ASC 805-20-25-28.

In subsequent accounting periods, any asset relating to an indemnification agreement existing at the acquisition date would be measured on the same basis as the indemnified item to which it relates, subject to any contractual limitations on its amount and an assessment of collectibility under ASC 805-20-35-4. For example, for an indemnification of acquired claim liabilities that are classified as insurance contracts, the measurement of the indemnification asset would be consistent with that of the claim liability.

ASC 944-805-S99 notes that any receivable from the seller relating to an indemnification agreement should not be netted against the related liability in the balance sheet or in supporting information such as footnotes or the disclosures required by SEC Industry Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property Casualty Insurance Underwriters*. The SEC staff indicated that although it is preferable to present the effects of the loss guarantee on a gross rather than net basis, it would not object to claim losses and loss adjustment expenses being reported net of the effect of the reserve guarantee in the income statement. A net presentation is appropriate only if the effects of the reserve guarantee are disclosed separately in the notes to the financial statements, in the SEC Industry Guide 6 disclosures including the reconciliation of claims reserves, and in the loss ratio information.

From the perspective of the seller, an indemnification agreement relating to the adequacy of acquired claim liabilities falls within the scope of ASC 460. Therefore, the seller would recognize and measure the fair value of the guarantee and recognize a liability for the obligation. The offsetting entry would likely affect the gain or loss on the transaction as a whole. In addition, the seller would be required to comply with the disclosure requirements of ASC 460-10-50-4 through ASC 460-10-50-6.

***Chapter 13:
Statutory accounting by
insurance entities—added
January 2021***

13.1 *Statutory accounting and reporting overview*

Insurance companies and health maintenance organizations (collectively referred to as reporting entities) file quarterly and annual financial statements in each state in which a reporting entity is domiciled or licensed. The financial statements are prepared on forms promulgated by the National Association of Insurance Commissioners (NAIC), also referred to as the "convention blank," "statutory blank," or simply the "blank."

The Annual Statement is used by state regulators to monitor the financial condition of the reporting entity between regulatory examinations (generally every 3 to 5 years) and to obtain financial data used to regulate the industry. To accomplish these objectives, states require the Annual Statement to be prepared using practices or procedures prescribed or permitted by the laws and regulations of a reporting entity's state of domicile. These practices may, however, differ from state to state, and each state's insurance laws and regulations should be consulted. However, all states have adopted the NAIC's Accounting Practices and Procedures Manual as the basis for its state-based accounting framework. The Annual Statement is due by March 1 and the statutory basis audited financial statements are generally due June 1.

Statutory accounting and reporting applies to all insurers authorized to do business in the United States and its territories.

This chapter provides:

- an overview of the conceptual differences between statutory accounting principles (SAP) and GAAP,
- an overview of the statutory accounting setting through the NAIC and its working groups,
- an overview of statutory reporting requirements, and
- an overview of permitted or prescribed practices.

13.2 *Conceptual differences between SAP and GAAP*

The objectives of SAP reporting differ from the objectives of GAAP reporting in that SAP is designed to address the concerns of insurance state regulators who are the primary users of statutory financial statements, while GAAP is designed to meet the varying needs of different users of the financial statements. SAP is focused on measuring a reporting entity's ability to pay future claims, while GAAP is more focused on measuring earnings. Statutory Accounting Principles (SAP) concepts

According to NAIC's Statutory Accounting Principles Preamble, SAP applies an accounting model based on the concepts of conservatism, consistency, and recognition.

- *Conservatism*

Financial reporting by insurance companies requires judgment in developing estimates. Actual results may vary from such estimates for a variety of reasons. To the extent that actual expenses significantly exceed management's estimates, the reporting entity's ability to meet policyholder obligations may also be at risk. As such, in order to provide a margin of protection for

policyholders, the SAP requires the concept of conservatism when developing estimates. Per the Preamble, “statutory accounting should be reasonably conservative over the span of economic cycles” and valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

□ *Consistency*

Consistency in the application of statutory accounting principles results in financial information that is comparable and meaningful and allows stakeholders to assess a reporting entity’s financial condition. An effective statutory accounting model should be responsive to changes in the marketplace and the economic and business environment and address emerging accounting issues. In order to comply with the objectives of the insurance regulators, reporting entities need to be able to sufficiently justify continuing to follow a particular accounting principle or practice beyond precedent or historically accepted practices.

□ *Recognition*

The determination of financial condition through an analysis of the reporting entity’s balance sheet is the primary focus of solvency measurement. The secondary focus is the income statement. Operating performance is another indicator of a reporting entity’s ability to maintain itself as a going concern.

Per the Preamble, “[t]he ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.” Accordingly, assets are valued conservatively and liabilities are recognized when incurred.

13.3 Statutory accounting setting through NAIC

The National Association of Insurance Commissioners (NAIC) is the US standard-setting and regulatory support organization created and governed by the insurance commissioners from the 50 states, the District of Columbia, and five US territories. The NAIC commissioners establish standards that are adopted by the states, conduct peer review, and coordinate regulatory oversight of the states. The commissioners, assisted by NAIC staff and the state insurance departments, form the national system of state-based insurance accounting and regulation in the US.

The NAIC operates using a hierarchy of committees, task forces, working groups, and subgroups, which meet in person and via conference call throughout the year. The groups discussed below develop and maintain statutory accounting and reporting and investment valuation.

□ *Financial Condition Committee*

The Financial Condition Committee acts as a central forum and coordinates solvency-related considerations relating to accounting practices and procedures, blanks, valuation of securities, financial analysis, multi-state examinations, and examiner training, and issues concerning insurer insolvencies and insolvency guarantees.

□ *Accounting Practices and Procedures Task Force*

The objective of the Accounting Practices and Procedures Task Force is to identify, investigate, and develop solutions to accounting problems. The taskforce approves updates to the NAIC

Accounting Practices and Procedures Manual (AP&P Manual) proposed by the Statutory Accounting Principles Working Group (SAPWG). The AP&P Manual provides insurers the basis for preparing financial statements for financial regulation purposes. The task force also studies “innovative insurer accounting practices,” which affect the ability of state regulators to determine the true financial condition of insurers.

□ *Statutory Accounting Principles Working Group*

The SAPWG is responsible for developing and adopting interpretation revisions to the AP&P Manual. It issues or amends Statements of Statutory Accounting Principles (SSAPs). An interpretation to an existing SSAP may be developed to provide timely application, interpretation, or clarification guidance.

When new GAAP is issued, the SAPWG considers whether to accept, reject, or accept with modification the new guidance. The SAPWG’s analysis of GAAP guidance can sometimes lag significantly after finalization of the GAAP guidance.

□ *Valuation of Securities Task Force*

The objective of the Valuation of Securities Task Force (VOS) is to provide regulatory leadership and insight with respect to NAIC’s credit assessment process for securities owned by insurance companies. The VOS has oversight of the Securities Valuation Office (SVO) and the Structured Securities Group and updates the Purposes and Procedures Manual of the NAIC Investment Analysis Office for changes in investment accounting and reporting requirements.

The SVO is responsible for the day-to-day credit quality assessment and valuation of securities owned by insurance companies, while the SSG is responsible for the analysis of residential mortgage-backed securities and commercial mortgage-backed securities owned by insurance companies and subject to SSAP 43 Revised, *Loan-Backed and Structured Securities*.

13.3.1 NAIC statutory hierarchy

The NAIC has adopted a statutory hierarchy that displays the order of priority for the different types of guidance available. Level 1 is the most authoritative and should be considered first. If guidance in level 1 does not specify the accounting for a particular transaction or event, the next level down should be considered until the most relevant accounting guidance is identified. The hierarchy is not intended to preempt state legislative and regulatory authority.

- Level 1 – SSAPs, including US GAAP reference material adopted by the NAIC
- Level 2 – Consensus positions of the Emerging Accounting Issues Working Group as adopted by the NAIC (INTs adopted prior to 2016), interpretations of existing SSAPs as adopted by the SAPWG (INTs adopted in 2016 and beyond)
- Level 3 – NAIC Annual Statement Instructions, Purposes and Procedures Manual of the NAIC Investment Analysis Office
- Level 4 – Statutory Accounting Principles Preamble and Statement of Concepts

- Level 5 – Sources of nonauthoritative GAAP accounting guidance and literature, including:
 - Practices that are widely recognized as prevalent either generally or in the industry
 - FASB Concepts Statements
 - AICPA guidance
 - International Financial Reporting Standards
 - Pronouncements of professional associations or regulatory agencies
 - Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids
 - Accounting textbooks, handbooks, and articles.

Note that use of Level 5 guidance for statutory accounting would likely represent a state prescribed or permitted practice because Level 5 literature has not been explicitly adopted by the NAIC.

13.4 Statutory reporting requirements

Each state requires reporting entities conducting business in its state to file annual financial statements (Annual Statement). All states begin with the blank promulgated by the NAIC; however, each state has the authority to make changes to the blank. Changes made by the states generally do not change the basic financial information and are typically supplemental information. Disclosures required by SSAPs can be made in specific notes, schedules, or exhibits to the Annual Statements.

The quarterly statements should include disclosures sufficient to make the information presented not misleading. It is presumed that the users of the quarterly statements have read or have access to the Annual Statements of the preceding year. Accordingly, disclosures that would be substantially duplicative to those included in the Annual Statements may be omitted. Disclosures in the quarterly statements generally include significant changes since year-end, with the exception of material contingencies, which are required to be disclosed even though a significant change may not have occurred since year-end. The first, second, and third quarter statements are generally due May 15, August 15, and November 15, respectively. The NAIC does not require interim financial statements to be audited or reviewed.

Interim financial statements, also known as quarterly statements, generally follow the form and content of presentation promulgated by the NAIC; however, reporting entities need to consult their domiciliary state requirements as states may have adopted minor variations to the NAIC forms.

13.4.1 Risk-based capital filings

In accordance with the Risk-Based Capital (RBC) for Insurers Model Act, a reporting entity is required to submit a report of its RBC levels as of year-end, in a form promulgated by the NAIC and as required by the RBC instructions. The RBC report, which is due March 1, should be submitted to the domiciliary insurance department and may be provided to states in which the reporting entity is authorized to do business, if requested by the respective states.

RBC is the amount of required capital that a reporting entity must maintain based on the inherent risks in the reporting entity's operations. RBC limits the amount of risk a reporting entity can assume and is intended to be a minimum regulatory capital standard and not necessarily the full amount of capital that a reporting entity would want to hold to meet its safety and competitive objectives. RBC is not designed to be used as a stand-alone tool in determining financial solvency of an insurance company. Rather, it is one of the tools that provide regulators legal authority to take control of a reporting entity that may be in jeopardy. Risk-based capital reports are not required to be audited.

13.4.2 *SAP audited financial statements*

In accordance with the NAIC Model Audit Rule, a reporting entity is required to engage an independent certified public accountant to conduct an annual audit. The audited financial statements are due to the state regulators generally on or before June 1 for the immediately preceding year ended December 31.

The annual audited financial statements should include the following for the two most recent years:

- Report of independent certified public accountant
- Balance sheet reporting admitted assets, liabilities, capital, and surplus
- Statement of operations
- Statement of cash flow
- Statement of changes in capital and surplus
- Notes to financial statements

The form, language, and groupings of the audited financial statements should be substantially the same as the relevant sections of the NAIC Annual Statement.

Each state also requires reporting entities conducting business in its state to file annual financial statements (Annual Statement) (see IG 13.4). Notes to the audited financial statements should include the disclosures required by the NAIC Annual Statement Instructions and the AP&P Manual, after consideration of applicability, materiality, and significance. There may be certain disclosures that are not required for the Annual Statement, which are required in the audited financial statements. A reconciliation of differences, if any, between the audited financial statements and the Annual Statement should be disclosed.

13.4.3 *Permitted or prescribed statutory accounting practices*

The primary responsibility of each state insurance department is to regulate reporting entities in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that obligations to policyholders, contract holders, and other legal obligations are met as they become due. Additionally, reporting entities must maintain a certain level of capital and surplus, as required by statute, to provide an adequate margin of safety.

Prescribed accounting practices are accounting practices incorporated directly or by reference by state laws, regulations, and general administrative rules applicable to all reporting entities domiciled in the respective state.

Some domiciliary reporting entities may request a state insurance department to provide approval to depart from certain SSAPs and state prescribed accounting practices (for example, when the reporting entity does not believe that applying the prescribed rules reflect the economics of the transaction they have entered into); this is known as a permitted practice. The process for a permitted practice begins with a reporting entity submitting a written request to its domiciliary insurance department. If the domiciliary insurance department has determined that a permitted practice is to be approved, it must first provide notice, at least five business days in advance of such approval, to all insurance departments in the states the reporting entity is licensed in. The notice must disclose the following information:

- The nature and description of the permitted accounting practice request
- The quantitative impact of the permitted accounting practice request along with all other approved permitted accounting practices currently in effect for the reporting entity
- The impact of the requested permitted accounting practice on a legal entity basis and on all parent and affiliated US insurance companies, if applicable
- The potential impact to each financial statement line item affected by the request. The potential impact may be determined by comparing the financial statements prepared in accordance with SSAPs and the financial statements incorporating the requested permitted accounting practice.

13.5 Key differences between SAP and US GAAP

The principal differences between NAIC statutory accounting principles (SAP) and GAAP include:

- Statutory financial statements are presented for each legal entity insurer and subsidiaries of each entity are not consolidated with the parent company. Under GAAP, entities under common control are presented on a consolidated basis.
- SAP rules follow the type of business (e.g., life, property and casualty) but make no distinction between long-duration and short-duration contracts. GAAP accounting is not based on the type of business but has separate accounting models for short duration and long-duration contracts.
- Long duration insurance policies without significant mortality or morbidity risk are classified as investment contracts and are accounted for using a deposit method under GAAP. SSAP 51 classifies contracts that have any mortality or morbidity risk, regardless of significance, and contracts with a life contingent annuity purchase rate guarantee option as insurance contracts.
- Qualifying policy acquisition costs are capitalized and amortized over the policy term under GAAP, while under SAP these costs are expensed as incurred.
- SAP generally allows companies to recognize commission income received under property and casualty reinsurance contracts immediately when it does not exceed the acquisition costs incurred. For prospective life insurance contracts, amounts are recognized as commission income without limitation. For reinsurance of in-force life insurance contracts, SAP requires commissions to be

included in surplus and amortized to income over the life of policies. GAAP requires the recognition of income to be delayed into future periods.

- Statutory reserves are established for life and health companies using specified mortality and morbidity tables and estimates of future investment earnings, lapses, and expenses, based on state law or regulation, while GAAP reserves are established based on company or industry experience. Statutory reserves do not consider withdrawal assumptions. This generally results in SAP reserves being higher than GAAP reserves because the SAP assumptions are generally more conservative than GAAP.
- Beginning January 1, 2020, insurers will be required to calculate statutory reserves for certain life insurance products using “principle-based reserving” (PBR) requirements, which will replace reserving formulas with a set of principles that allows an insurer to reflect its own credible experience and risks in calculating reserves. The guidance is effective for new business only. Because PBR requirements impose a minimum reserve, it is expected that statutory life reserves may still exceed GAAP reserves.
- Certain assets and investments recognized under GAAP are non-admitted under SAP. These include certain receivables in excess of 90 days past due (whether or not collectible), prepaid expenses, furniture and equipment, investments not authorized by statute or in excess of statutory limitations, goodwill in excess of 10% of capital and surplus (for purposes of the calculation of this limitation, capital and surplus is reduced by admitted goodwill, net deferred tax assets, and electronic data processing (EDP) equipment), certain portions of deferred tax assets, and EDP equipment in excess of 3% of capital and surplus (net of goodwill, deferred tax assets and EDP equipment). Life insurance companies are required to treat policy loan balances that exceed the underlying cash surrender values credited to policyholders under their policies as non-admitted assets. For property and casualty direct and group billed uncollected premiums, bills receivable for premiums, and amounts due from agents and brokers, the date for purposes of aging premiums is the policy effective date, not the contractual due date to the insurer.
- Income tax effects of differences between tax and book accounting are recognized under SAP and GAAP. However, changes in the deferred tax balance for SAP are an adjustment to surplus, not income tax expense. Deferred tax assets net of any valuation allowance under SAP are subject to recoverability and calculated admissibility tests, while GAAP deferred tax asset balances are evaluated for realizability.
- For SAP purposes, investments in subsidiaries and controlled and affiliated entities (SCAs) are reported using an equity method based on the reporting entity’s shares of the audited statutory equity of the SCAs financial statements (for insurance SCA entities), audited GAAP equity, or audited GAAP equity with specified adjustments depending on the type of SCA entity. The change in the carrying value between reporting periods must be recorded as an unrealized gain/loss through surplus (rather than in income or equity as required under GAAP). Dividends received are recorded in net investment income. For SAP, the definition of an SCA entity is ownership of more than 10% of the voting shares of the entity. For GAAP, SCAs should be evaluated to determine if they are required to be consolidated because the insurer is considered to be the primary beneficiary of a variable interest entity or the insurer is deemed to have control under the GAAP voting interest model (refer to CG 2 (VIE) and CG 3 (VOE)). If equity method accounting is deemed appropriate, entities following GAAP should look to the guidance in ASC 323, *Investments - Equity Method and Joint Ventures*. The SAP guidance on accounting for investments is SSAP 97.

- For SAP, investments in joint ventures (JVs), limited liability companies (LLCs), and limited partnerships (LPs) in which more than 10% of the entity is owned by the insurer, control is a rebuttable presumption, and SSAP 97 is required to be followed as described above. JVs, LLCs, and LPs that are less than 10% owned by the insurer, or for which presumptive control has been rebutted, are subject to SSAP 48, and valued using an equity method at audited GAAP equity or audited tax equity or audited IFRS (SSAP 48, paragraph 9) if audited US GAAP financial statements are not available. For GAAP, if an investor has determined it does not have a controlling financial interest in an investee, it should then determine if the equity method of accounting prescribed by ASC 323, *Investments – Equity Method and Joint Ventures* applies (refer to EM 2).
- Statutory accounting has not adopted GAAP guidance for business combinations; under SAP, the difference between the purchase price of an acquired entity and its book value (based on GAAP or SAP equity as applicable) is considered goodwill and is amortized to unrealized capital gain or loss over the period in which the acquiring entity benefits economically, not to exceed 10 years.
- The risk transfer provisions are the same under GAAP and SAP for property/casualty reinsurance contracts. However, certain differences in reinsurance accounting exist for GAAP and SAP, as follows:
 - The practice of reporting assets and liabilities relating to reinsured contracts net of the effects of reinsurance is still applied for SAP but prohibited under GAAP when the ceding entity is not relieved of its legal liability to its policyholder for reinsurance accounting (because there is no right of offset between the two parties) (refer to ASC 944-310-25-2).
 - SAP and GAAP differ on the accounting for retroactive reinsurance; GAAP for retroactive reinsurance precludes immediate gain recognition unless the ceding enterprise's liability to its policyholders is extinguished (refer to ASC 944-605-35-9). Under SAP, retroactive reinsurance does not require discounting of recoverables, so an immediate increase to surplus is recognized.
- When assessing risk transfer in a life reinsurance contract, SAP makes a distinction between proportional and non-proportional risk transfer. Proportional risk is deemed to be transferred when the underlying risks (per a chart of components in the statutory APP Manual Appendix A-791) are transferred. Under GAAP, a test is performed to determine whether significant insurance risk is transferred. SAP non-proportional risk transfer is tested in a similar manner as GAAP.
- ASC 944-805-25-5, which contains guidance on accounting by the purchaser for a seller's guarantee of the adequacy of liabilities for losses and loss adjustment expenses of an insurance enterprise acquired in a business combination, is rejected by SAP (see IG 12).
- Statutory accounting rules require a liability to be recorded for net reinsurance balances due from unauthorized reinsurers that exceed collateral held. In addition, property and casualty insurers must establish a special formula-based liability for overdue reinsurance balances due from authorized reinsurers and certified reinsurers. Such liabilities are not required for GAAP; however, insurers assess collectability of reinsurance recoverables and may record an allowance.
- Under SAP, investments in bonds are generally carried at amounts that differ from the carrying value under GAAP. For life and health insurers, bonds rated "1" through "5" by the NAIC's Securities Valuation Office are carried at amortized cost. Bonds rated "6" are carried at the lower

of cost or fair value. For property/casualty companies and HMOs, bonds rated "1" and "2" are carried at amortized cost. All other bonds are valued at the lower of cost or fair value. Under both GAAP and SAP, all investments in debt and equity securities must be evaluated for impairment; however, SAP has a different impairment model for bonds than GAAP. Under GAAP, both pre and post adoption of ASU 2016-13, the non-credit portion of impairments relating to debt securities that the entity does not intend to sell and for which it is not more likely than not that the entity will be required to sell before anticipated recovery is recorded in other comprehensive income. Also, under SAP, non-loan backed bonds, which are considered to be other-than-temporarily impaired and under which the insurer does not have the ability and intent to hold the securities to maturity, are written down to fair value with a realized loss recognized in the income statement.

- Under SAP, life insurance companies are required to establish a formula-driven Asset Valuation Reserve for unrealized gains and losses by a direct charge to surplus to offset potential future credit-related investment losses. Under GAAP, no similar reserve is required.
- Under SAP, life insurance companies are required to establish an Interest Maintenance Reserve for realized gains and losses on sales of debt securities, mortgage loans, preferred stocks, and certain derivatives that arise as a result of changes in the level of interest rates. This reserve is amortized into income over the original life of the investment. Under GAAP, capital gains and losses are recognized in the income statement in the period in which the asset is sold.
- Under SAP, accounting changes (i.e., corrections of errors, changes in principles, and changes in estimates) are, in certain circumstances, recognized differently than they would be under GAAP. Under SAP, restatements of prior periods in an Annual Statement are generally not required unless mandated by a state insurance regulator. Capital and surplus, or policyholders' surplus in the case of mutual companies, is the statutory equivalent of stockholders' equity under GAAP. Under SAP, it represents the net admitted assets of an insurance company.
- Under SAP, surplus notes approved by the state insurance commissioner are classified as surplus on the balance sheet, and interest is reported as an expense and a liability only after payment has been approved by the commissioner, while GAAP requires accounting for surplus notes as a debt instrument.
- Under SAP, pension and other postretirement benefit calculations are required, and SSAP 92 and SSAP 102 require companies to recognize a net liability or asset to report the funded status of defined benefit pension and other postretirement benefit plans on the balance sheet. SSAP 92 and SSAP 102 were effective for January 1, 2013, and companies could elect a ten-year phase-in period. Unlike GAAP, any prepaid asset resulting from the excess of the fair value of plan assets over the benefit obligation is non-admitted under SAP.
- SAP requires additional reporting of summarized investment information in a supplemental schedule, in greater detail than the disclosures required in audited GAAP financial statements, e.g., foreign currency exposures to a single country for each NAIC sovereign rating category).
- SSAP 11 requires an accrual for postemployment vested benefits for both employees and agents while GAAP guidance regarding postemployment benefits (refer to ASC 712-10-15-3 and ASC 712-10-15-4) is only applicable to employees. Under GAAP, contractual obligations to agents should be evaluated under ASC 450-20-60, *Contingencies*, for liability recognition.

- Economic transactions between sister companies, as defined by SSAP 25, result in immediate gain/loss recognition. For US GAAP, guidance regarding transactions between parties under common control should be followed (see BCG 7).
- SSAP 5R requires liability recognition of related party guaranties in some circumstances. GAAP eliminates all intercompany guaranties in consolidation.
- Under SSAP 101, if the estimated tax loss contingency is greater than 50% of the tax benefit originally recognized, the tax loss contingency recorded is calculated as 100% of the original tax benefit recognized. Under GAAP, a tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that is greater than 50% likely of being realized upon settlement with a taxing authority that has full knowledge of all relevant information.
- SSAP 35R requires liabilities and assets related to assessments from insolvencies of entities that wrote long-term care contracts to be discounted. GAAP provides an option to discount accrued guaranty fund liabilities if the amount and timing of the cash payments are fixed or reliably determinable.
- In accordance with SSAP 106, the ACA Section 9010 assessment that is accrued and due in the subsequent year is required to be classified in a segregated surplus account on the face of the balance sheet in the current year. This segregation is not required under GAAP.

13.6 Statutory investment accounting

Insurance statutes of each state regulate the types of investments insurance companies are permitted to make, but generally defer to the NAIC APP Manual and respective investment SSAPs for recognition and valuation. Invested assets that do not qualify under any of the SSAPs are non-admitted in accordance with SSAP 4. Audited statutory financial statements must include Supplemental Investment Schedules detailing the company's investments.

13.6.1 Investment in subsidiaries and controlled and affiliated entities

Under SAP, investments in subsidiaries and controlled and affiliated entities (SCAs) are accounted for as a single line item investment.

SSAP 1 states that majority-owned subsidiaries should not be consolidated because such consolidation would be inconsistent with the recognition concept in the Statement of Concepts, which states that one objective of statutory accounting is to reflect a company's ability to meet its policyholder obligations with the existence of readily marketable assets available when both current and future obligations are due. With an investment in a subsidiary, the cash flow generated by the investee may not be available to satisfy policyholder obligations. Therefore, the insurance company asset that is readily marketable is the shares of ownership (e.g., common or preferred stock). Consolidated financial statements are only prepared when permitted by the domiciliary department of insurance. For similar reasons, the NAIC has also explicitly rejected GAAP guidance related to consolidation when an entity is determined to be the primary beneficiary of a variable interest entity.

SSAP 97, *Investments in Subsidiary, Controlled, and Affiliated Entities*, addresses the accounting for SCAs. In order to be an admitted asset, the investment must be audited. For SSAP 48 entities for which more than 10% is owned by the insurer, SSAP 97 is also required to be followed.

13.6.1.1 Audit requirements of investments in SCAs

SSAP 97, *Investments in Subsidiary, Controlled, and Affiliated Entities*, and its Implementation Questions and Answers provide the following guidance on the audit requirements necessary to admit the SCA asset:

- A full scope audit of the financial statements, including a balance sheet, income statement, cash flows, and footnotes is required for each individual and/or consolidated SCA Balance sheet only audits are not acceptable.
- There is a limited exception to the audit requirement for downstream non-insurance holding companies (DNHC) when the three conditions of paragraph 26 of SSAP 97 are met, including that the downstream noninsurance holding company does not own any assets that are material to the DNHC other than SCAs and SSAP 48 entities and the holding company is not subject to any material (to the DNHC) liabilities, commitments, contingencies, guarantees, or obligations.
- Audits of consolidated or combined downstream SCAs are permitted. For example, it is acceptable for three directly-owned SCAs of an insurance company to obtain a combined audit instead of three standalone audits. A consolidated audit at the insurance company parent level does not meet the requirements for audits of investees of the parent insurance company (unless it is a consolidated audit of insurance companies participating in a reinsurance pool in accordance with the Model Audit Rule). Note that SSAP 97, paragraph 22 requires a "consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities and non-SCA SSAP 48 entities, and any required intercompany eliminations" to be included as other financial information in the audited consolidated or combined financial statements.
- For non-US SCAs, as an alternative to obtaining a US GAAP audit, compliance with SSAP 97 can be achieved by obtaining an audit of the foreign GAAP financial statements, including an audited footnote reconciliation from the foreign GAAP net income and equity to US GAAP net income and equity.
- An adverse or qualified GAAP audit opinion that does not contain a quantification of the GAAP departures does not automatically require the investment in a downstream noninsurance holding company to be nonadmitted. When the departure relates to the DNHC valuing its investments in insurance companies in accordance with statutory accounting principles, the GAAP departure does not need to be quantified per paragraph 20.d. of SSAP 97. (SSAP 97, Question 5 of the Implementation Q&A)
- GAAP audits of SCAs do not need to be completed and issued before the audited statutory financial statements are filed. Engagement teams should perform enough audit work on the investees to opine on the parent insurance company financial statements, but SSAP 97 does not require the GAAP audits to be completed prior to the release of the insurance company parent statutory financial statements. This guidance is consistent with Question 6 of the SSAP 97 Implementation Q&A.

13.6.1.2 Accounting for investments in SCAs

SSAP 97, *Investments in Subsidiary, Controlled, and Affiliated Entities*, addresses the accounting for SCAs. SCAs are reported using an equity method based on the reporting entity's shares of the audited statutory equity of the SCAs financial statements (for insurance SCA entities), audited GAAP equity, or audited GAAP equity with specified adjustments depending on the type of SCA entity. The change in the carrying value between reporting periods must be recorded as an unrealized gain/loss through surplus.

The "equity pick up" of surplus of an insurance company investee is not necessarily the entire "capital and surplus" balance. Per SSAP 97, the carrying value of an insurance company after initial acquisition is the original acquisition cost adjusted for the insurer's share of changes in unassigned funds, "special surplus funds," and "other than special surplus funds." Surplus notes are excluded from the carrying value of the subsidiary in the parent company financial statements. When surplus notes are issued by a subsidiary and held by the parent insurer, these investments are accounted for by the parent as Schedule BA assets. When the surplus notes are issued to an entity other than the parent, the parent insurer cannot record any value for the surplus notes because it is not capital from the parent company's perspective (i.e., it is akin to a minority interest). In 2018, the NAIC issued guidance relating to the reverse situation (i.e., SCA entities owning surplus notes issued by the parent). SSAP 97 and SSAP 41 were amended to clarify that surplus notes should be eliminated in the parent insurer's surplus if the SCA acquires any portion of outstanding surplus notes issued by the parent.

Another adjustment to the equity pickup is for non-controlling interests for entities valued using US GAAP equity. The component of GAAP equity that represents non-controlling interests should be excluded from the insurer's investment as it is not part of the insurer's "share of the audited GAAP basis" (paragraph 11 of SSAP 97).

The carrying value of certain SCAs (SSAP 97 paragraphs 8.b.ii and 8.b.iv entities) is adjusted audited GAAP equity. The required adjustments are listed in SSAP 97 paragraphs 9.a through SSAP 97 paragraph 9.g. Note that the adjustments for goodwill and deferred tax assets (SSAP 97 paragraphs 9.d and 9.e) are based on 10% of equity of the investee, not the parent insurance company investor. The schedule to adjust from audited US GAAP to adjusted audited GAAP is not included in the audited financial statements. The insurer prepares the schedule in connection with the preparation of the parent entity financial statements, as the adjusted equity represents the parent insurance company's carrying value in its SCA investment.

When an insurance company directly acquires another insurance company in a transaction that results in statutory goodwill (the difference between the historical statutory book value of the acquired entity and the purchase price), the goodwill is part of the carrying value of the acquired entity on the insurance company's balance sheet as an investment in common stock. Therefore, for investments in acquired insurance companies, there will be a difference between total capital and surplus per the investee's annual statement and audited statutory financial statements and the carrying value in the insurance company parent's financial statements, unless the purchase price for the acquired entity equaled its statutory book value at the acquisition date. The goodwill is limited to 10% of capital and surplus (adjusted to exclude admitted net positive goodwill, EDP equipment, and operating system software), and is amortized by the insurance company parent to unrealized gain/loss on investments. Also, note that goodwill cannot be pushed down to the books of the acquired insurance entity. In addition, when an acquired entity is subsequently merged into another entity, the goodwill is required to be written off immediately to surplus per SSAP 68, paragraph 13.

In 2018, the NAIC adopted a revision to SSAP 68 to clarify that “cancelling equity of an owned entity, without issuance of new equity, and incorporating the assets and liabilities of the owned entity directly within the reporting entity’s financial statements (e.g., dissolving the SCA entity and absorbing their assets and liabilities)” also qualifies as a statutory merger.

The carrying value of an investee can be less than \$0 in two circumstances. Per SSAP 97 paragraph 13.e, the insurance company should provide for its share of losses after reducing its investment balance to \$0 when the insurer has guaranteed obligations of the investee or is otherwise committed to provide further financial support. In addition, noninsurance entities valued in accordance with SSAP 97 paragraph 8.b.ii that hold only nonadmitted assets would also be valued at negative equity by the parent insurer if the value of the nonadmitted assets exceeds total equity. The other adjustments required to US GAAP for SSAP 97 paragraph 8.b.ii entities that are listed in SSAP paragraph 9 could also result in negative equity. This guidance is consistent with Question 7 in the SSAP 97 Implementation Q&A. An insurer is not permitted to forgo an audit and record a nonadmitted asset (i.e., with zero value) to avoid this treatment.

All basis differences between cost/purchase price and the underlying GAAP equity should be amortized, similar to goodwill. This includes minority owned (less than 10%) SSAP 48 entities that are not scoped into SSAP 97. SAP also requires the basis differences to be included with goodwill for purposes of determining the 10% goodwill limitation.

Insurance companies that purchase other insurance entities, either directly or through a non-insurance downstream holding company, are required to include any goodwill related to the purchase in their goodwill limitation calculation. In 2019, the NAIC clarified that goodwill resulting from the application of pushdown accounting by an insurer to a non-insurance SCA is required to be included in the 10% goodwill limitation calculation. However, when insurance companies own non-insurance entities valued using US GAAP equity and those non-insurance entities acquire other non-insurance companies, the insurance entity parent companies are not required to include the goodwill in their goodwill limitation calculation if the goodwill is pushed down to the acquired downstream GAAP entity. However, pushdown is not required if a downstream non-insurance holding company owned by the insurer purchases the non-insurance GAAP entity. The NAIC continues to review the accounting for goodwill held in various holding company structures, and additional discussion and guidance is expected in 2021, which could change this guidance.

Insurance entities are required to disclose a detail listing of directly owned SSAP 97 SCA entities. However, this excludes insurance SCA’s and all SSAP 48 entities, including those that are affiliates of the insurer (which is generally ownership of 10% or more of the SSAP 48 entity).

In practice, questions have arisen in terms of how a company or filer treats the goodwill from the acquisition of a holding company that owns insurance and non-insurance companies that were purchased by a downstream holding company subsidiary of an insurance company. There are two acceptable approaches for viewing this transaction under SSAP 97, both of which result in the same answer. One approach would be for the filer to account for the investment in an SCA, and that investment must include goodwill, whether it has been pushed down or not. Therefore, when the filer applies the provisions of SSAP 97, the downstream insurance company acquired will be valued at its statutory carrying amount, which would include goodwill (including applying the goodwill limitations).

The alternative approach is that the goodwill is pushed down to the SCA and, therefore, the filer must value the insurance company acquired, including goodwill at its statutory carrying amount, or the

goodwill is at the holding company. If the filer believes that the goodwill is at the holding company, the filer must apply the provisions of SSAP 97 paragraph 21.e, which would require the other assets of the holding company to be accounted for in accordance with statutory accounting principles and, again, the goodwill limitations must be applied. The NAIC is discussing and expected to issue guidance in 2021 on goodwill in holding company structures, which could result in revisions to this guidance.

Example IG 13-1 and Example IG 13-2 illustrate the goodwill admissibility guidance under SSAP 97.

EXAMPLE IG 13-1

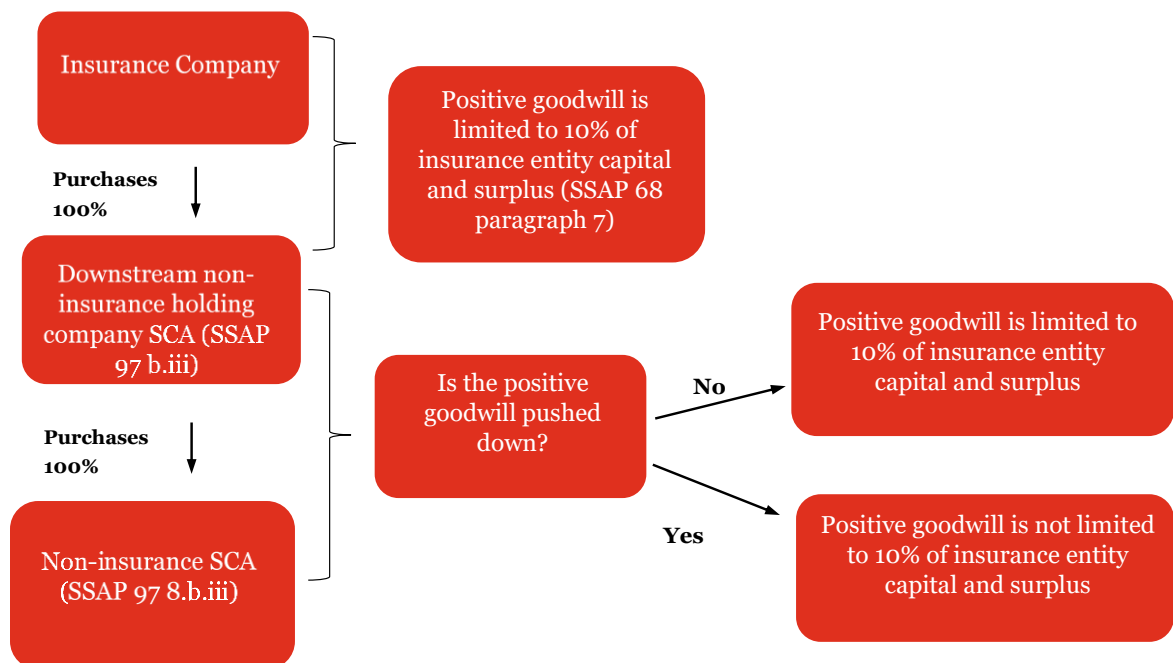
SSAP 97 goodwill admissibility – purchase of an SCA accounted for under SSAP 97 paragraph 8.b.iii

Insurance Company purchases a downstream non-insurance holding company SCA accounted for under SSAP 97 paragraph 8.b.iii. Subsequently the non-insurance holding company purchases a non-insurance SCA accounted for under SSAP 97 paragraph 8.b.iii.

How would goodwill be accounted for in both acquisitions?

Analysis

As depicted below, the goodwill from the acquisition of the non-insurance downstream holding company SCA accounted for under SSAP 97 paragraph 8.b.iii is limited to 10% of the insurance reporting entity’s capital and surplus whether the goodwill is pushed down or not. However, when the non-insurance downstream holding company purchases a non-insurance SCA accounted for under SSAP 97 paragraph 8.b.iii, the goodwill is limited to 10% of Insurance Company’s capital and surplus only when it is not pushed down to the lower-tier non-insurance SCA. This is because SCAs accounted for under paragraph 8.b.iii are valued at audited GAAP equity without adjustment.



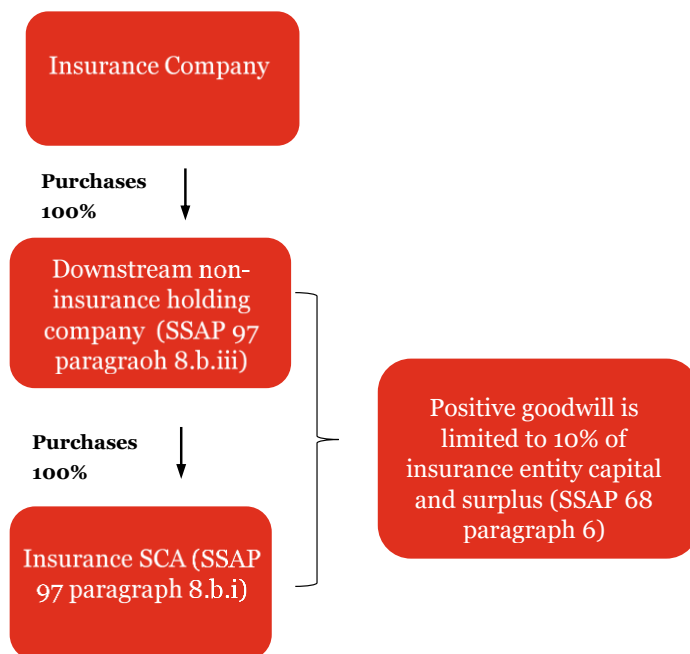
EXAMPLE IG 13-2**SSAP goodwill admissibility guidance - purchase of an SCA accounted for under SSAP 97 paragraph 8.b.i**

Insurance Company purchases a downstream non-insurance holding company SCA accounted for under SSAP 97 paragraph 8.b.iii that subsequently purchases a US insurance SCA accounted for under paragraph 8.b.i.

How would goodwill be accounted for in the purchase of the US insurance SCA?

Analysis

As depicted below, since Insurance Company purchased a US insurance SCA under paragraph 8.b.i (either directly or indirectly through a downstream holding company), goodwill is limited to 10% of the insurance reporting entity's capital and surplus. Pushdown of goodwill is not permitted for US insurance SCAs.

**13.6.2 SAP for Investments in equity and debt securities - overview**

SSAP 26R, SSAP 30, SSAP 32, SSAP 37, SSAP 39, and SSAP 43R describe the statutory accounting for debt and equity securities. Unrealized gains and losses on equity securities and bonds valued at the lower of cost or fair value are recorded in surplus. Prior to the adoption of ASU 2016-13, which modifies the existing GAAP impairment model for available for sale (AFS) debt securities, there is generally no difference between SAP and GAAP with respect to whether an investment is other-than-temporarily impaired for (1) stocks and (2) SSAP 26R bonds for which the impairment is credit-related, not interest related. There may be some circumstances when a GAAP credit-related impairment may not be recorded for SAP on SSAP 26R bonds. Interest-related losses on non-loan

backed bonds are only recognized when the insurer has the intent to sell an investment, at the reporting date, before recovery of the cost of the investment. Note that for SSAP 26R bonds that have been determined to be other-than-temporarily impaired, the entire difference between fair value and carrying value is recorded as a realized loss, which differs from the guidance in GAAP.

After the adoption of ASU 2016-13, the AFS debt security model under GAAP differs from the statutory impairment model in that it no longer allows consideration of the length of time during which fair value has been less than its amortized cost basis when determining whether a credit loss exists. Under SAP, for SSAP 26R bonds that have been determined to be other-than-temporarily impaired, the entire difference between fair value and carrying value is recorded as a realized loss. That differs from GAAP, in which only the portion of the impairment related to credit losses is recorded in an allowance for credit losses account with an offsetting entry to realized loss and any portion not related to credit losses is recorded through other comprehensive income. GAAP also differs from SAP as the GAAP allowance for credit losses can be reversed for subsequent increases in expected cash flows (see LI 8 for more information on the GAAP AFS impairment model). ASU 2016-13 also changes the impairment model for held-to-maturity debt securities and requires entities to record lifetime expected credit losses for these securities, which are also recorded through an allowance account (see LI 7.3). ASU 2016-13 is effective in 2020 for SEC filers other than small reporting companies (SRCs) and effective in 2023 for all other companies, including SRCs.

SSAP 56 prescribes the statutory accounting for investments held through separate accounts in both the general account and separate account statements. SAP differs from GAAP in that seed money is always included with separate account assets in the single line treatment on the insurer's balance sheet. SAP has also not adopted ASC 944-80, including the required criteria to allow separate account assets as a single line item in the balance sheet. As a result, more separate accounts receive the single line item presentation in the balance sheet for SAP than for GAAP. In addition, under SAP, separate account assets always equal separate account liabilities.

SSAP 100R, provides statutory guidance for fair value measurements and disclosure requirements. It adopts the majority of the ASC 825-10 guidance, with one significant exception: SAP did not adopt the guidance regarding the consideration of non-performance risk (own credit risk) in determining the fair value measurement of liabilities after initial recognition because it is not consistent with the statutory concepts of conservatism.

13.6.2.1 SAP for equity securities

The statutory accounting for equity securities is included in SSAP 30 and SSAP 32. For statutory purposes, redeemable preferred stocks are reported similar to a debt security. Highly rated non-redeemable preferred stocks (NAIC 1-3 designated securities held by life companies and NAIC 1-2 designated securities held by non-life companies) are valued at amortized cost; all other non-redeemable preferred stock is valued at the lower of cost or fair value.

Temporary changes in the value of common stocks and certain non-redeemable preferred stocks are recognized as unrealized gains or losses and shown net of income tax as a separate component of policyholders' (stockholders') equity under SAP. On an SAP basis for life companies, these changes are also recognized as part of the Asset Valuation Reserve calculation.

Temporary changes in the fair value of equity securities valued at amortized cost do not require a write down of amortized cost; other-than-temporary impairments of equity securities are recognized in income.

13.6.2.2 *SAP for debt securities*

Under SAP, for reporting entities that maintain an asset valuation reserve (AVR), bonds are reported at amortized cost, except for those with an NAIC designation of 6, which are reported at the lower of amortized cost or fair market value. For reporting entities not required to maintain an AVR, bonds that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) are reported at amortized cost; with all other bonds (NAIC designations 3 to 6) reported at the lower of amortized cost or fair market value. Changes in the fair value of non-impaired bonds valued at fair value are recorded in net unrealized capital gain/loss reported in surplus. If impairment of a non-loan backed bond (SSAP 26R bond) is deemed to be other than temporary, the bond is written down to fair value with the impairment loss recorded in income.

The NAIC has adopted impairment guidance which provides that, in periods subsequent to the recognition of an other-than-temporary-impairment loss for a debt security, the insurer should account for the security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the security on the measurement date becomes the new cost basis, and the discount or reduced premium, based on the new cost basis, is amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. This impairment guidance applies to non-loan backed (SSAP 26R) bonds and preferred stock.

13.6.2.3 *SAP for loan-backed and structured securities*

In accordance with SSAP 43R, *Loan-Backed and Structured Securities*, for securities for which the fair value is less than amortized cost, and either (1) the insurer has the intent to sell the security or (2) the insurer does not have the intent and ability to retain the security until recovery of its carrying value, insurance entities are required to recognize an impairment in earnings equal to the difference between the security's fair value and its carrying value. The fair value at the time of the impairment becomes the security's new cost basis. For securities for which the insurer does not expect to recover its amortized cost basis, but has the intent and ability to hold the security until maturity, the insurer will recognize in earnings a realized loss of only the "non-interest" related decline (as defined by footnote 8 to SSAP 43R). SSAP 43R does not permit a reporting entity to change its assertion regarding its intent to sell or lack of ability and intent to hold a security until recovery of its amortized cost basis. The new carrying value will be calculated as the present value of cash flows expected to be collected based on an estimate of the expected future cash flows of the impaired loan-backed bond, discounted using an effective interest rate which varies depending on the type of security, as specified by SSAP 43R. The interest-related impairment is not recognized in earnings or surplus.

For entities subject to an asset valuation reserve and interest maintenance reserve, paragraph 37 of SSAP 43R requires that the non-interest related portion of the other-than-temporary impairment loss be recorded in AVR and the interest-related other-than-temporary impairment loss be recorded in IMR, even if the security was written down to fair value because the insurer has the intent to sell the security or because the insurer does not have the intent and ability to hold the security until recovery of its cost basis. This guidance is different from the AVR/IMR treatment for non-loan backed bonds, which prohibits bifurcation of the OTTI loss into AVR and IMR components. SSAP 43R also requires that the gain or loss on the sale of all SSAP 43R bonds be bifurcated into its interest (IMR) and other than interest (AVR) components. For SSAP 43R securities, this may result in the previously reported AVR or IMR being recaptured on subsequent sales of impaired securities. However, this is not applicable for SSAP 26R securities, which record realized gains and losses to IMR unless the rating is different by more than 1 rating class between the beginning and ending of the holding period.

SSAP 43R (paragraph 32) requires the entity to assess whether it has the intent and ability to hold the security for enough time to recover the amortized cost basis. Impairment should be recognized if the entity does not have the intent and ability to hold the investment for the time necessary to recover the amortized cost basis. A footnote to paragraph 32 (FN 7) states the following: "this assessment of intent and ability shall be considered a high standard due to the accounting measurement method established for the securities within the scope of this Statement (amortized cost)." SSAP 43R, Appendix A, Question 5 recognizes that a change in management's assertion may occur based on new information becoming known in subsequent periods or changes in facts and circumstances relating to a particular security. However, if a reporting entity previously asserted the intent and ability to hold a security until recovery but subsequently sells or otherwise disposes of that security at a loss, the entity must be prepared to justify why the subsequent sale does not call into question similar assertions for securities that are still held by the entity. Given the similarity of the "intent and ability" language in SSAP 43R with prior GAAP (pre FSP 115-2) other-than-temporary impairment guidance, we believe consideration should be given to prior GAAP guidance when assessing whether subsequent sales may call into question (taint) management's assertion regarding remaining securities. With respect to impairment and subsequent investment income recognition, SSAP 43R adopts only three paragraphs of SOP 03-03 (5, 7, and 9) which have been codified in ASC 310-30; the remainder of that guidance and ASU 2016-13 are still under consideration by the NAIC.

13.6.3 SAP for securities lending

SSAP 103R, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires that most securities lending arrangements be recorded on the balance sheet. Only those arrangements in which the collateral received may not be sold or replugged by the transferor or its agent may be off balance sheet.

Security lending arrangements in which the collateral may be sold or replugged are presented in financial statements in one of two ways.

- Reinvested collateral assets from securities lending arrangements when the program is administered by the reporting entity's unaffiliated agent are reported as a single amount as "securities lending reinvested collateral assets," and the liability to return the collateral is reported as part of miscellaneous liabilities as "payable for securities lending."
- Reinvested collateral from securities lending arrangements when the program is administered by the insurer are shown in the appropriate asset categories of the underlying collateral (e.g., bonds, common stock, preferred stock).

For securities lending programs administered by insurer's affiliated agent, the insurer has the option to use the "one-line" presentation or report the collateral as part of other investment categories. Schedule DL is used to provide additional detail of an insurer's securities lending program including fair value, book value, and maturity date of all collateral assets.

13.6.4 Interest maintenance reserve

All life and health insurance companies and fraternal benefit societies are required to include an interest maintenance reserve (IMR) in their statutory Annual Statement in accordance with SSAP 7. The NAIC also codified a "Blue Book," which is comprised of Q&As and other guidance to assist companies on the accounting and reporting of AVR and IMR.

The IMR captures realized capital gains and losses from the sale of fixed income investments resulting from changes in the overall level of interest rates. Realized gains and losses that are considered "credit related" (as defined) are excluded from the IMR and are included in the AVR calculation. The purpose of the IMR is to minimize the effect that realized gains and losses arising from interest rate movements have on surplus, as well as to stabilize statutory surplus against fluctuations in the market value of securities as cash flows of assets and liabilities are matched. IMR is calculated in accordance with the NAIC, *Annual Statement Instructions for Life and Accident and Health Insurance Companies*. All realized gains and losses (net of tax) classified as interest-related are accumulated and are amortized into net income on a basis reflecting the remaining period to maturity of the assets sold. Companies generally use one of two methods to allocate tax to realized gains: the statutory tax rate or the company's effective tax rate. Whichever method is used should be used consistently. A net deferred loss that otherwise would have been classified as an asset is treated as non-admitted and carried over to the following year. There are two prescribed methods for calculating IMR amortization, the seriatim method, and the grouped method. The latter method accumulates the realized gains and losses according to the number of years to expected maturity and is less complicated to calculate than the seriatim method.

There are very specific and complex rules for the treatment of IMR when a large block of business is reinsured. In general, the ceding company releases the IMR associated with the block of business reinsured, and the assuming company records a liability for IMR in the amount of IMR released by the ceding company. See the life and health Annual Statement instructions for more detail.

13.6.5 SAP for property used in the business

In accordance with SSAP 40R, property occupied by the reporting entity (e.g., home office property) is classified as an investment and carried at depreciated cost less encumbrances, unless events or circumstances indicate that the carrying amount of the asset may not be recoverable. SSAP 90, *Accounting for the Impairment or Disposal of Real Estate Investments, Discontinued Operations*, is consistent with GAAP guidance, with certain modifications, including guidance on assessing impairment on property occupied by the reporting entity. Reporting entities should look to the guidance in SSAP 90 for events or changes in circumstances that indicate that the recoverability of real estate should be assessed. In cases when recoverability is assessed and the asset is impaired, the reporting entity should write the asset down to its fair value, determined in accordance with SSAP 90, thereby establishing a new cost basis. The impairment loss is recorded in the summary of operations as a realized loss. SSAP 40R continues to require that insurance companies occupying home office properties record equal amounts of rental income (investment income) and expense (operating expense) related to such occupancy. The amount recorded should be at a rate comparable to rent received from others and/or rental rates of like property in the same area. Although appraisals are required every five years for real estate held for sale and held for the production of income, this requirement does not extend to real estate occupied by the reporting entity.

Certain assets designated as non-admitted assets (e.g., furniture and non-EDP equipment), as discussed in SSAP 20, are not recognized as an asset for SAP because they are not available to meet current and future obligations and cannot be used to fulfill policyholder obligations. The change in non-admitted assets between years is charged or credited directly to surplus.

13.6.6 Regulatory limitations on investments

Insurance companies are subject to statutory limitations regarding the amount of a particular investment that may be held. Such limitations may include restrictions as to what percentage of the

total portfolio a given investment type may represent (e.g., real estate investments) or may be related to the financial condition of the investee (e.g., non-investment grade securities). Such regulations vary from state to state and, accordingly, statutes of the state of domicile should be referred to for appropriate guidance and should be reviewed periodically. Many states' investments requirements include a "basket provision" that allows the excess of permitted investments to be admitted as part of the "basket." The New York State statutes (Sections 1401 through 1410) are generally considered to be the most stringent; therefore, many companies use them as a standard for investment limitations.

Some insurers may invest in an investment pool with other entities in their holding company group in which the affiliated companies transfer cash to the pool which is then used to purchase investments. The insurer may consider the arrangement to be similar to an investment in a mutual fund and, accordingly, may believe that recognition on Schedule D is appropriate. However, the pool may not legally be structured as an investment company (i.e., it may not issue "shares," etc.) and may not have been filed with the NAIC's securities valuation office (SVO). When the investment is not filed with the SVO, the company should consult with the domiciliary regulator to determine the appropriate accounting treatment, including consideration as a permitted practice.

13.6.7 *SAP for mortgage loans and real estate investments*

Under statutory accounting, a mortgage loan is considered impaired when it is probable the reporting entity will be unable to collect all amounts due in accordance with the contractual terms of the mortgage agreement. The fair value of a mortgage loan is the fair value of the collateral less costs to sell. For loans that are in default, being voluntarily conveyed, or being foreclosed, the carrying value is adjusted for additional expenses, such as insurance, taxes, and legal fees that have been incurred to protect the investment or to obtain clear title to the property to the extent that these amounts are deemed to be recoverable from the ultimate disposition of the property. However, if these costs cannot reasonably be expected to be recovered, they should not be added to the carrying value, and should instead be expensed.

Under statutory accounting, property held for the production of income is reported at depreciated cost less encumbrances unless events or circumstances indicate that the carrying amount may not be recoverable. Impairment should be measured and assessed in accordance with SSAP 90. Property that the entity has the intent to sell or is required to sell is classified as held for sale and carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell (consistent with GAAP guidance). In either case, fair value is determined by an appraisal that considers the present value of future cash flows generated by the property, a physical inspection of the property, current sales prices of similar properties, and costs to sell the property in accordance with SSAP 40R. Appraisals of properties held for sale and for the production of income must be obtained at least every five years.

13.6.8 *SAP for derivative financial instruments*

SSAP 86, *Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions*, uses selected concepts from GAAP and addresses the recognition and measurement of derivatives used in hedging transactions, income generation transactions, and replication (synthetic asset) transactions. While not often resulting in different classification between GAAP and SAP, the SSAP 86 definition of derivatives differs from the GAAP definition, as SAP does not require net settlement. SSAP 86 adopts the hedge effectiveness standards and documentation standards of GAAP but differs from GAAP in that it rejects the concept of embedded derivatives and the requirement to mark all derivatives to market. Under SSAP 86, effective hedges are accounted for "consistent with the item being hedged." Therefore, derivatives that hedge investments in bonds are

carried at amortized cost with no recognition of changes in fair value of the derivative. Derivatives that hedge investments in common stock are marked to market through surplus. Ineffective hedges that do not meet hedge criteria standards at inception or no longer meet hedge effectiveness criteria are recorded at fair value with changes in fair value recorded directly to surplus, not through investment income. SSAP 86 adopts other GAAP guidance related to the accounting for derivatives and hedging activities and related implementation technical guidance "to the extent that such guidance is consistent with the statutory accounting approach to derivatives utilized in [SSAP 86]."

13.6.9 Asset valuation reserve

All life and health insurance companies and fraternal benefit societies are required to include a reserve in their statutory Annual Statement, described as an Asset Valuation Reserve (AVR) for their stock, bond, mortgage, real estate, and other invested assets. The purpose of the AVR is to decrease the volatility of the incidence of asset losses and to recognize the long-term return expectations for investments. The AVR contains a default component (which comprises bond, preferred stocks, short-term investments, and mortgage sub-components) and an equity component (which comprises common stock, real estate, and other invested asset sub-components). The AVR is limited to maximums by sub-components but cannot be less than zero for any sub-component. The increase or decrease to this reserve is charged or credited directly to surplus. Unrealized gains included in the AVR calculation should be presented net of deferred taxes, similar to the way in which realized gains are shown net of capital gains taxes.

Companies issuing variable annuity products with certain guarantees may seek to hedge those guarantees by purchasing freestanding derivative instruments. The AVR instructions state that realized and unrealized gains and losses on derivatives hedging assets are to be included in AVR and also require an AVR charge for the counterparty credit risk associated with derivatives in an asset position (regardless of whether they hedge assets or liabilities or do not function as a hedge). Most interpret the AVR instructions to require that realized and unrealized gains and losses on derivatives hedging liabilities (i.e., equity, not credit-related, gains and losses) should not be included in AVR.

The AVR is calculated in accordance with the annual instructions contained in the NAIC, *Annual Statement Instructions for Life and Accident and Health Insurance Companies* and include a full listing of AVR-exempt securities.

13.7 Affiliated and related party considerations

SSAP 25 provides guidance related to affiliated and related party transactions.

The key concepts to consider when assessing related party transactions include the following:

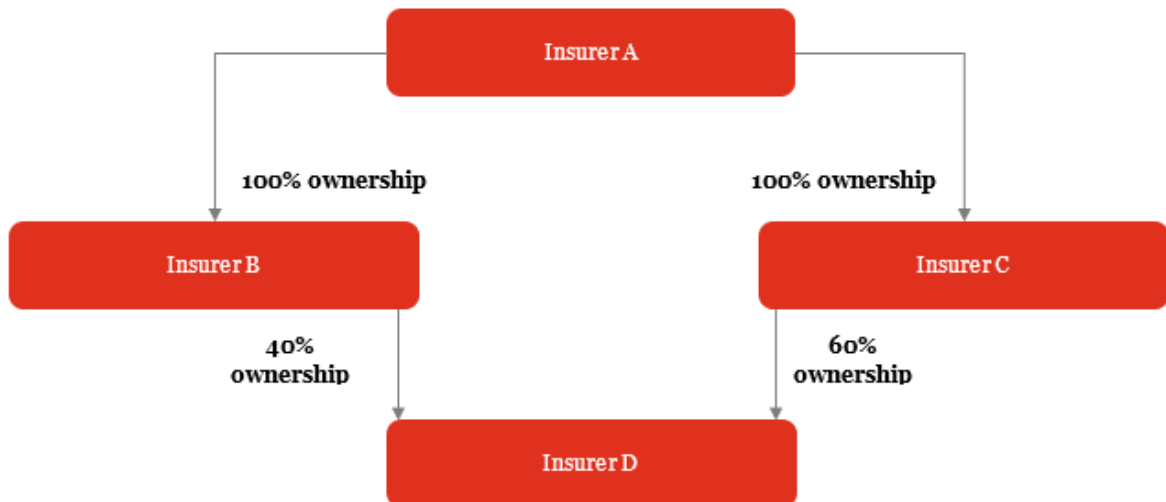
- Determining whether the transaction is economic or non-economic. An economic transaction is defined as an arms-length transaction that results in the transfer of risks and rewards of ownership. In some cases, a transaction may be economic to one party and non-economic to the other.
- When related-party transactions result in a "mere inflation of surplus" at a parent insurance company level, any gain or loss resulting from the transaction must be deferred by recording a deferred gain and an unrealized loss.

Example IG 13-3 and Example IG 13-4 illustrate common related-party transactions.

EXAMPLE IG 13-3

Intercompany sale of assets

Insurer A owns 100% each of Insurer B and Insurer C. Insurer C owns 60% of Insurer D, while Insurer B owns the remaining 40%.



Insurer D sells Insurer B a bond in a \$100 million unrealized gain position. Is the transaction economic to Insurer B and Insurer D?

Analysis

The transaction is economic to Insurer D, but not to Insurer B.

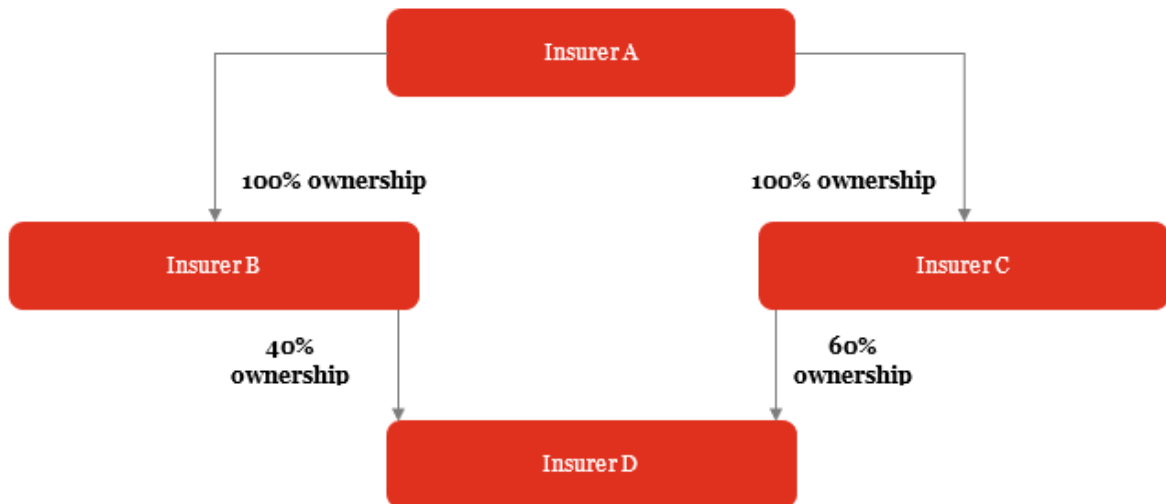
Insurer D has transferred the risks and rewards to Insurer B and may therefore record the realized gain on sale; however, Insurer B now owns directly what it previously owned indirectly through its SSAP 97 investment in Insurer D (40% of the bond in addition to purchasing the other 60% it had not previously indirectly owned). If Insurer D is a life, health, or fraternal insurer, it will need to record IMR or AVR on the realized gain on a bond (depending on whether the gain is interest or credit related).

Insurer B should defer \$40 million of the gain recognized on the sale by Insurer D as it is related to the portion previously indirectly owned by Insurer B, and therefore would lead to a mere inflation of surplus in Insurer B. Although Insurer A is the ultimate parent company, no separate deferral of this portion of the gain would be required by Insurer A, as the deferral would be recognized through its recognition of the equity earnings of Insurer B.

Insurer A should, however, separately defer the remaining \$60 million gain. While Insurer C owns 60% of Insurer D, it was not a party to the transaction, and the affiliate that Insurer D transacted with (Insurer B) is not owned by C. The obligation to defer the remaining \$60 million occurs at the common parent level, which is Insurer A.

EXAMPLE IG 13-4**Capital contribution from parent to subsidiary**

Insurer A owns 100% each of Insurer B and Insurer C. Insurer C owns 60% of Insurer D, while Insurer B owns the remaining 40%.



Insurer A contributes capital in the form of appreciated bonds to Insurer C, with an amortized cost of \$70 million and a fair value of \$100 million. Is the transaction economic to Insurer A and Insurer C?

Analysis

This transaction is economic to Insurer C, and therefore, Insurer C would recognize the capital contribution at the fair value of \$100 million. However, the transaction is non-economic to Insurer A because it still owns the bonds indirectly through its investment in Insurer C.

Therefore, the sale of bonds would be recorded at \$70 million in Insurer A's financial statements, representing the lower of cost or fair value.

When recording its equity earnings in Insurer C, Insurer A would reduce the carrying value of its investment in Insurer C by \$30 million, representing the amount that the fair value exceeded the cost of the transferred assets. This results in a transaction that is surplus neutral in Insurer A's financial statements.

13.8 SAP for deferred acquisition costs

Under SSAP 71, deferred acquisition costs (DAC) are expensed as incurred as period costs.

SAP generally allows companies to recognize commission income received under reinsurance contracts immediately to the extent it does not exceed the acquisition costs incurred. The excess ceded commission income for both proportional and nonproportional contracts is required to be deferred

and a liability equal to the difference between the anticipated acquisition costs and the reinsurance commissions received recognized in the statutory-basis financial statements.

As a result, several questions have arisen with regard to:

- what constitutes the "anticipated acquisition cost" of the business ceded (acquisition costs are defined in SSAP 71)?
- what ceding commission rate (or amount) should be used to determine the liability established when the ceding commission is determined via a function of the experience under the reinsurance contract (such as a sliding scale commission rate or contingent profit provision)?
- whether the wording "to be amortized pro rata over the life of the reinsurance agreement" means to be amortized over the period during which the reinsurance premium is earned, or whether it means something else (such as when losses are ultimately paid), and whether there should be a difference if contingent ceding commissions are involved.

Acquisition costs to be included in the calculation should meet the definition of acquisition costs per SSAP 71. This definition differs from the GAAP definition of deferred acquisition costs under ASC 944-30. Under SAP, costs incurred to acquire new or to renew insurance contracts and costs that vary with and are related to the insurance contracts qualify to be included. Common examples of qualifying acquisition costs include agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees.

With respect to the commission rate to be used in the calculation for the "excess ceding commission," the company should use its best estimate of the ceding commission at inception of the reinsurance contract.

SSAP 62R, *Property and Casualty Reinsurance*, paragraph 55, clarifies that the amortization period for excess ceding commissions is "over the effective period of the reinsurance contract in proportion to the amount of coverage provided under the reinsurance agreement."

13.9 *SAP for contract liabilities*

Accounting for loss and loss adjustment expense liabilities for statutory financial statements is discussed in SSAP 55.

Claims, losses, and loss/claim adjustment expenses are recognized when the covered or insured event occurs. In most circumstances, payments are made after the event's occurrence and, therefore, a liability is recorded. Generally, the liability is based on the ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends and any other factors that would modify past experience. See further details regarding recording claim liabilities at present value (i.e., discounting) in IG 4.3.3 as this guidance is specific to the type of contract.

When determining the amount of the liability for claims, management must accrue their best estimate. In very rare circumstances, if management cannot identify a best estimate and they have identified a range, and no point within that range is a better estimate than any other point, then the midpoint of the range should be recorded. Multiple equally likely outcomes do not constitute a reasonable range; in this scenario, management must determine that one of these is its best estimate.

If management chooses to anticipate salvage and subrogation recoveries in estimating its total claims liabilities, then they should be estimated in a fashion similar to the estimation for future claims costs. The expected future receipts are deducted from the liability for unpaid claims. The total amount of anticipated salvage and subrogation recoveries should be disclosed in the footnotes.

13.9.1 SAP for property and casualty contracts

SAP accounting for property and casualty contract liabilities (other than financial guaranty and mortgage guaranty insurance contracts and title insurance) is similar to that of GAAP accounting for claim liabilities related to short-duration contracts. See SSAP 60, SSAP 58, and SSAP 57, respectively, for guidance on financial guaranty, mortgage guaranty, and title insurance.

SSAP 55 provides a list of costs that should be included in the claims reserve liability. Such costs include reported losses, incurred but not reported losses, and loss adjustment expenses. Loss adjustment expenses (LAE) are divided into two broad categories: defense and containment costs (DCC) and adjusting and other (AO). SSAP 55, paragraph 6, provides a list of expenses that are included in each category.

Many insurance entities that use third party administrators (TPAs) or similar companies to process claims pay the TPA a set percentage of written premiums to cover the cost of settling claims (e.g., 8% of written premiums). Paragraph 5 of SSAP 55 prescribes that the insurer cannot offset its LAE reserves with the amounts paid to the TPAs (to cover the cost of settling claims that will be disbursed by the TPA in the future). Instead, the insurer must treat the payments as a prepaid asset. Amounts paid to the TPAs are nonadmitted as they represent "prepaid expenses" under SSAP 29. Although SSAP 55 does not provide any guidance on when to reduce the LAE reserve, we believe the guidance implies this would happen when the direct adjusting service on the obligation to the claimant has been paid.

SSAP 9, *Subsequent Events*, specifies that the period for assessing subsequent events and related disclosures extends to the issuance of the audit opinion. Paragraph 15 of SSAP 55, *Unpaid Losses*, states that additional information regarding year-end loss reserve development obtained subsequent to the filing of the Annual Statement, which is not the result of an error in the estimation process, should not result in adjustment to the audited financial statements. Therefore, loss reserve development is exempt from being considered a recognized subsequent event. NAIC staff has informed us that by analogy, other policyholder liabilities, including additional reserves resulting from asset adequacy tests, are also exempt. If material, the loss reserve development would be disclosed in a note to the audited financial statements. However, this guidance is limited to loss reserve development; consequently, other events that occur after the filing of the Annual Statement may still require adjustment to the audited statutory financial statements (and could trigger an Adverse Financial Condition letter if the requirements are met). For unpaid claims, losses, and LAE, insurers must still consider information obtained through the Annual Statement filing date.

13.9.1.1 SAP for discounting property and casualty loss reserves

SSAP 65, paragraph 10, does not allow discounted loss reserves except in cases when the payments are fixed and reasonably determinable, such as those emanating from workers' compensation tabular indemnity reserves and long-term disability claims. However, individual states have prescribed or permitted discounted reserves. When calculating the discounted reserves, some states require the reporting entity to use a discount rate that is the lower of:

- The reporting entity's return on invested assets less 1.5% if the entity's statutory invested assets are at least equal to policyholder reserves; otherwise, the reporting entity's average net portfolio rate less 1.5%. Net portfolio rate is calculated by dividing the net investment income earned by the average of the current and prior year total assets.
- The current yield to maturity on a US Treasury debt instrument with maturities consistent with the expected payout of the liabilities.

In addition, companies who obtain a permitted practice to discount loss reserves are subject to the disclosure requirements of SSAP 1, paragraph 7, including the requirement of the entity to disclose the monetary effect on statutory surplus and net income of using an accounting practice that differs from NAIC statutory accounting practices and procedures. Companies should also disclose the rate and basis for rate used, amount of non-tabular discount by line of business and reserve category, and the amount of non-tabular reserve reported in the statement. In addition, companies should disclose whether the practice of discounting is prescribed or permitted by the domiciliary regulator. If it is a permitted practice, companies are required to disclose the date that the domiciliary state issued the permitted practice and the expiration date of such practice (if any). A change in the discount rate should be accounted for as a change in estimate and recorded in income in the period of change in accordance with SSAP 3. The change should be disclosed in accordance with SSAP 65, paragraph 15.

13.9.1.2 *SAP for claims-made contracts*

SSAP 55, paragraph 4, states that for claims-made coverage, the covered or insured event is the reporting to the reporting entity of the incident that gives rise to a claim.

When a reporting entity issues an extended reporting endorsement or contract and the preceding claims-made policy terminates, the reporting entity assumes the liability for the unreported claims and expense. For statutory purposes, the accounting for premium and losses when contracts have extended periods is determined based on whether the extended reporting period is for a specified period of time or indefinite. For an indefinite reporting period, the insurer fully earns the premium and a liability for unpaid loss and loss adjustment expenses is recorded immediately. For coverage of a fixed period, the premium is earned over the fixed period (resulting in an unearned premium reserve) and losses are recorded as reported.

13.9.1.3 *Unearned premium reserve for policies greater than 13 months*

For contracts that are written for coverage periods that equal or exceed 13 months (most commonly home warranty and mechanical breakdown policies), revenues are generally not received in proportion to the level or period of exposure. To account for this, SSAP 65 describes the methods entities with these contracts should use to establish their unearned premium reserves.

For each of the three most recent policy years, the unearned premium must be the largest amount as calculated by three tests described in SSAP 65:

- Best estimate of refundable amounts to the policyholder at the reporting date,
- Gross premium multiplied by the ratio of projected future gross losses and expenses to be incurred during the unexpired term of the contracts to projected total gross losses and expenses, and

- Projected future gross losses and expenses to be incurred during the unexpired term reduced by present value of future guaranteed gross premium.

There is a separate calculation for years prior to the three most recent years.

13.9.1.4 SAP for structured settlements

In accordance with SSAP 65, paragraphs 17-20, when annuities are purchased to fund structured settlement periodic fixed payments and the insurance company is the payee, no decrease in the liability to the policyholder is recorded. The annuity is recorded at its present value and reported as an other-than-invested asset. However, when the claimant is the payee, loss reserves are reduced to the extent that the annuity provides funding for future payments and a gain or loss is recognized. US GAAP requires gain deferral in instances when the insurance company purchases a structured settlement annuity for the claimant, but the insurer has not been legally released from its obligation.

13.9.1.5 SAP for high deductible policies

The accounting for high deductible policies is discussed in SSAP 65, paragraphs 34-39. Specific guidance was provided for these types of policies because state laws generally require the insurer to fund the deductible and periodically review the financial viability of the insured to make an assessment of the suitability of the deductible plan to the insured. Highlights of the statutory accounting for these policies include the following:

- Reserve for losses should be established throughout the policy period, not over the period after the deductible has been reached. The reserve should be net of the deductible unless the deductible is determined to be uncollectible.
- If the policy requires the insurer to fund all losses, including those under the deductible limit, reimbursement of the deductible is accrued and recorded as a reduction of paid losses simultaneously with the recording of the paid loss by the reporting entity.
- The amount accrued for reimbursement of the deductible is aged from the contractual due date.
- 10% of the deductible recoverable in excess of collateral held is reported as a nonadmitted asset. If more than 10% is deemed unrecoverable, the total unrecoverable amount is considered non-admitted.
- SSAP 65 allows a single collateral deposit to satisfy collateral requirements for multiple high-deductible policies, subject to a "fair and equitable" allocation agreement.
- SSAP 65 requires detailed disclosures of loss reserves related to high deductible policies and the related credit risk of such policies.

13.9.2 SAP for life contracts

SSAP 51 discusses the statutory accounting for life reserves. SSAP 51 rejects GAAP guidance for universal life-type contracts and, instead, requires contracts to be classified as either life insurance or a deposit. SSAP 50 provides definitions for each. Generally, contracts that include any mortality or morbidity risk are considered life insurance. Contracts with no mortality or morbidity risk are deemed

to be deposit contracts. Reserves for life contracts should be determined based on the statutory tables included in Appendices A-820 and A-822 of SSAP 51.

SSAP 55, paragraph 7, provides a list of costs that should be included in the claims reserve liability.

SSAP 51, paragraph 49, requires that when an insurer's state of domicile requires reserves to be held in excess of the minimum standards of the NAIC, or when the insurer chooses to hold in excess of minimum reserves, the excess be disclosed in the reconciliation of state prescribed or permitted practices to NAIC prescribed practices, as required by SSAP 1. This disclosure requirement is specific to life insurance contracts and would only be required, when material, based on contracts issued on or after January 1, 2001.

In addition, if an insurer holds reserves in excess of its state of domicile's required reserve, e.g., funds are held in a "claim fluctuation reserve" that is not calculated in accordance with established actuarial standards, this fact would also be discussed in the reconciliation between NAIC-prescribed to state-prescribed and permitted statutory accounting practices.

For SAP, no premium deficiency is calculated for life contracts. However, asset adequacy analysis, including cash flow testing, must be performed by life insurers that meet certain requirements, as specified in Appendix A-822 of the NAIC's Accounting Practice and Procedures Manual.

13.9.3 SAP for health contracts

The accounting for the liabilities related to health contracts is described in SSAP 54R and SSAP 55, *Unpaid Claims, Losses and Loss Adjustment Expenses, and Claim Adjustment Expenses*.

SSAP 55, paragraph 9, provides a list of costs that should be included in the claims reserve liability. Paragraph 12 of SSAP 55 discusses the concept of conservatism in determining claim reserves but notes that there is not a specific requirement to include a provision for adverse deviation in claim reserves (nor is it prohibited).

13.9.4 SAP for loss recognition (premium deficiency)

Statutory accounting for premium deficiencies is described in SSAP 53 (*P&C*), SSAP 54R (*Accident & Health*), SSAP 58 (*Mortgage*), SSAP 59 (*Credit Life and Health*), and SSAP 60 (*Financial Guaranty*). Generally, the calculation of a premium deficiency for SAP is the same as that performed for short-duration GAAP contracts. However, for SAP, the determination is made on a legal entity basis instead of a consolidated entity basis. Therefore, a separate analysis is required. As it is not part of loss reserves, the liability is not allocated to each line of business. In addition, it cannot be recorded as a direct adjustment to surplus. The premium deficiency reserve is presented on the Annual Statement as an *aggregate write-in for liabilities*.

13.10 SAP for reinsurance and business combinations

Statutory accounting guidance for reinsurance is included in SSAP 61 R for life, deposit-type, and accident and health contracts and SSAP 62R for property and casualty contracts. See IG 8 for SAP and GAAP differences related to risk transfer. Reinsurance accounting for property and casualty contracts under SAP is similar to US GAAP; therefore, the focus of this section will be on life reinsurance contracts. In order to recognize the benefit of a reinsurance contract, the agreement must not be entered into for the principal purpose of providing significant immediate surplus aid while not

transferring all the significant risks of the business reinsured and leaving the expected potential liability of the ceding reinsurer unchanged. Appendix 791 of the NAIC's Accounting Practice and Procedures Manual gives more prescriptive guidance on this objective for life and health insurers. SSAP 61R and Appendix 791 are rule-based guidance that is different from the more principle-based US GAAP requirements. As a result, there are a number of reinsurance contracts that are written with the intent of meeting the statutory risk transfer rules but are not considered to have transferred a significant risk of a significant loss to the reinsurer, as required under US GAAP. While there may be reinsurance contracts that achieve risk transfer for US GAAP and not SAP, this situation is less common. Reinsurance agreements must be evidenced by a written agreement or binding letter of intent no later than the "as of date" of the financial statement (December 31 for year-end financial statements). Binding letters of intent must be executed by a full written agreement within 90 days. See Figure IG 13-1 for a summary and observations related to Appendix A-791.

Figure IG 13-1

Summary of risk transfer requirements for life and health reinsurance in Appendix A-791

Accounting requirements	Observations
<p>Paragraph 1 - Appendix does not apply to:</p> <ul style="list-style-type: none"> i. assumption reinsurance ii. yearly renewable term iii. certain non-proportional reinsurance such as stoploss and catastrophe reinsurance 	<p>Exempted reinsurance types do not normally provide significant surplus relief at inception and are less of a regulatory concern.</p> <p>Yearly renewable term (YRT) contracts exempted from Appendix A-791 are accounted for as reinsurance only when the treaty contains none of the conditions described in paragraphs 2.b., 2.c., 2.d., 2.h., 2.i., 2.j. or 2.k. of Appendix A-791. In addition, YRT with surplus relief in the first year greater than a treaty with zero premium and allowances is not exempt.</p>
<p>Paragraph 2.a - Renewal expense allowances must be sufficient to cover anticipated allocable renewal expenses on the portion of business reinsured or a liability for the short fall accrued.</p>	<p>Such expenses include commissions, premium taxes, billing, valuation, and maintenance, including salaries, computer usage, postage, etc.</p> <p>The purpose is for the reinsurer to bear all of the risks of the business ceded, including allocable expenses.</p>
<p>Paragraph 2.b - Reinsurer cannot have the right to additional surplus or assets either as an option or automatically at a future contingent or certain date.</p>	<p>A provision that automatically converts a funds withheld or modified coinsurance treaty to coinsurance would normally fail unless certain restrictions are in place.</p>
<p>Paragraph 2.c - Ceding company cannot be required to pay reinsurer for any negative experience unless the ceding company voluntarily terminates the contract.</p>	<p>Payment of a loss carryforward in the event that the ceding company chose to voluntarily recapture the treaty when a loss carryforward existed would not preclude risk transfer.</p> <p>Experience refund accounts that allow the cedant to retain profitability does not violate this provision.</p> <p>Effective January 1, 2021, the NAIC added guidance to paragraph 2c related to YRT reinsurance of group term life. This new guidance is as follows:</p> <p>Q – If group term life business is reinsured under a YRT reinsurance agreement (which includes risk-limiting</p>

Accounting requirements	Observations
	<p>features such as with an experience refund provision which offsets refunds against current and/or prior years' losses (i.e., a "loss carry forward" provision), under what circumstances would any provisions of the reinsurance agreement be considered "unreasonable provisions which allow the reinsurer to reduce its risk under the agreement" thereby violating subsection 2.c.?</p> <p>A – Unlike individual life insurance where reserves held by the ceding insurer reflect a statutorily prescribed valuation premium above which reinsurance premium rates would be considered unreasonable, group term life has no such guide. As long as the reinsurer cannot charge premiums in excess of the premium received by the ceding insurer under the provisions of the YRT reinsurance agreement, such provisions would not be considered unreasonable. Any provision in the YRT reinsurance agreement that allows the reinsurer to charge reinsurance premiums in excess of the proportionate premium received by the ceding insurer would be considered unreasonable. The revisions to this Q&A regarding group term life yearly renewable term agreements is effective for contracts in effect as of January 1, 2021.</p>
<p>Paragraph 2.d - Reinsurance agreements cannot have a scheduled or automatic termination or recapture date.</p>	<p>There can be no provisions in the agreement that would require the ceding company to terminate or recapture all or part of the treaty but there can be voluntary provisions.</p>
<p>Paragraph 2.e - Payments to the reinsurer cannot exceed the income realized from the reinsured portion of the underlying policies.</p>	<p>Reinsurance premiums cannot exceed the direct premiums the ceding company receives on the portion of policies reinsured. In circumstances when the ceding company is reinsuring a rider (such as a GLWB rider) and not the base policy, the ceding company sometimes asserts that the pricing of the rider is partially supported by spread margins or fees related to the base product, and as a result, in their analysis, adjust the explicit "premium charged to the policyholder" for purposes of the paragraph 2.e analysis to include fees or investment margin from the base contract. They may also state that the analysis should be done over the expected life of the contract and not look at individual settlement periods. Our view is that the ceding insurer should obtain confirmation from its domiciliary regulator that they do not object to the analysis being done in this way and do not object to the reinsurance credit taken by the ceding insurer.</p> <p>Reinsurers cannot have the right to set direct policyholder rates. Reinsurers can increase the cost of insurance charges provided they do not exceed the rates the ceding company is receiving from policyholders.</p>

Accounting requirements	Observations
	Interest crediting is included in the calculation of income realized from direct policies.
<p>Paragraph 2.f- Treaty must transfer all of the following significant risks if the business is reinsured:</p> <ul style="list-style-type: none"> i. Morbidity ii. Mortality iii. Lapse iv. Credit quality of invested assets v. Reinvestment vi. Disintermediation 	<p>The word “significant” in this provision applies to the risk itself and not the amount of the risk transferred. The guidance defines which risks are deemed significant for most types of insurance.</p> <p>Any limitations on coverage violate this provision unless the domiciliary regulator agrees that risks not transferred are immaterial and do not preclude reinsurance accounting. Clauses that would prevent passing the Appendix A-791 test include: caps and limits on coverage no matter how high or remotely possible (including exclusion for death or injury due to terrorist attacks, pandemics, or natural catastrophes), funds withheld or modified coinsurance for products when investment risk is significant for the product but do not pass all investment result to the assuming company (e.g., fixed interest rates or guaranteed minimum returns), ceding commissions or other experience adjustments that limit coverage or require more premium to be paid, and exclusion of lapse experience.</p>
<p>Paragraph 2.g- If the investment risks (credit quality, reinvestment, and disintermediation) are significant, they must be transferred by transferring the underlying asset to the reinsurer or legally segregating the assets.</p>	<p>Asset segmentation generally would not meet this requirement as it is not legally separating the payments on the assets for the benefit of the reinsurer. However, Appendix A-791 provides an exemption to legal segregation for lines of business that do not have significant credit quality, reinvestment, or disintermediation risk, which includes health insurance, traditional permanent (par and non-par), adjustable and indeterminate premium permanent, and universal life fixed premium. This guidance also requires a specific formula for determining the reserve interest rate adjustment.</p> <p>If all rights of the reinsurer are a proportionate share, the assets underlying the entire block of policies can be segregated and not just the proportion reinsured.</p> <p>Additionally, when ceding a portion of each policy in a block of policies to multiple reinsurers, it is not required to segregate assets separately for each reinsurer.</p>
<p>Paragraph 2.h- Settlements must be made at least quarterly.</p>	<p>This assures there is transfer of timing risk.</p>
<p>Paragraph 2.i- The ceding insurer cannot be required to make representations or warranties about unrelated business or the future performance of the reinsured business.</p>	<p>All representations need to be reasonable in relation to the business being reinsured.</p>

Question IG 13-1 provides an example of the SAP risk transfer requirements.

Question IG 13-1

When is it likely a life reinsurance contract would fail risk transfer under SAP?

PwC response

A life reinsurance contract would fail risk transfer under SAP when not all of the significant risks of the contract are transferred under the reinsurance contract. For example, a coinsurance agreement when there is an upper limit on losses in the event of pandemic (e.g., defined as amounts of deaths in a certain geographic area) would violate the requirement to transfer all of the mortality risk. Similarly, limitations on investment returns for a whole life policy when the return on the modified coinsurance receivable/payable is not based on the total return of the ceding company's general account investment portfolio or a specified portfolio of investments but is based on a fixed or variable interest rate return, would not transfer all of the investment risk.

13.10.1 *SAP implications of retroactive versus prospective contracts*

Under SAP, retroactive reinsurance does not require discounting of recoverables, so an immediate increase to surplus, akin to changing to discounted loss reserves, is achieved if risk transfer requirements are met on a retroactive reinsurance contract. As a result, insurance companies that purchase retroactive reinsurance coverage may obtain statutory accounting benefits, even though there is little or no benefit for GAAP purposes.

13.10.1.1 *Exceptions to retroactive reinsurance accounting in SSAP 62R*

SSAP 62R, paragraph 31, specifies five situations in which retroactive reinsurance is given prospective reinsurance accounting treatment. Those are:

- Structured settlement annuities for individuals purchased to settle policy obligations
- Novations
- The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business
- Intercompany reinsurance agreements among companies 100% owned by a common parent or ultimate controlling person "provided there is no gain in surplus as a result of the transaction" (i.e., no net gain at inception, calculated as reinsurance premium paid less losses ceded less ceding commission received). If the intercompany reinsurance agreement results in a gain in surplus (e.g., reserves of \$100 million are transferred for \$90 million in cash and assets), the transaction is accounted for as retroactive reinsurance (i.e., no reduction in loss reserves) and the consideration paid by the ceding company is recorded as a deposit and non-admitted asset;
- Reinsurance/retrocession agreements that meet the criteria of property/casualty run-off agreements, which must be accounted for as described in paragraphs 81-84 of SSAP 62R. This exemption only applies to third-party agreements, not intercompany agreements subject to paragraph 31d of SSAP 62R.

13.10.2 *SAPreinsurance accounting versus deposit accounting*

For a summary of the prospective, retroactive, and deposit accounting models that would be applied by a ceding company under GAAP, refer to IG 8.

Figure IG 13-2 is a summary of the prospective, retroactive, and deposit accounting models that would be applied by a ceding company under statutory accounting.

Figure IG 13-2

Summary of the prospective, retroactive, and deposit accounting models

Prospective reinsurance accounting	Retroactive reinsurance accounting	Deposit accounting (timing risk only, or no timing or underwriting risk)
While GAAP requires a reinsurance recoverable asset to be reported separately from direct unpaid claim liabilities, statutory loss reserves on direct business are presented net of "ceded reserves" for unpaid claims.	Statutory loss reserves on direct business are presented gross and the "ceded reserves" are reported separately as a retroactive reinsurance contra liability. Any gains or losses resulting from the retroactive reinsurance are recognized in the statement of income and are classified as "special surplus," and should not be reduced from "special surplus" until the actual retroactive reinsurance recovered exceeds the consideration paid.	Statutory deposit accounting is consistent with GAAP.

13.10.3 *SAP for reinsurance of existing blocks of business*

Statutory accounting for the reinsurance of life and health insurance blocks of business is governed by SSAP 61R. The ceding insurer must determine if the transaction is an assumption or an indemnity arrangement. In an assumption, the ceding insurer effects a novation in which it extinguishes its liability to the policyholder. An assumption typically results in a gain to the cedant because the liabilities (recorded at their ultimate value) are greater than the assets transferred in the transaction. The cedant should record a gain on the transaction once it has been relieved of its liability in the transaction (in some cases, this may not be immediate because the transfer of liability has to be approved by the policyholders in accordance with state insurance laws). The assuming company values the assets acquired at fair value and the liabilities in accordance with statutory guidelines. Any difference between the two is recorded as goodwill. More common than assumption reinsurance, indemnity arrangements are those in which the insurer has not been released from liability and are recorded consistent with other typical reinsurance arrangements. In addition, there are very specific and complex rules for the treatment of IMR when a large block of business is reinsured. In general, the ceding company releases the IMR associated with the block of business reinsured, and the assuming company records a liability for IMR in the amount of IMR released by the ceding company. See the life and health Annual Statement instructions for more detail.

Statutory accounting for retroactive property/casualty reinsurance, which are agreements to cover liabilities that occurred prior to the effective date of the reinsurance agreement, is governed by SSAP 62R. The ceding company receives immediate gain recognition for the difference between the reserves transferred to the reinsurer and the cash or assets paid, if any, but must maintain that gain in a special surplus account that is not transferred into unassigned surplus (and therefore generally not allowed to be dividended) until all losses are paid by the reinsurer. In addition, the ceding company does not reduce loss reserves for the reserves transferred, but instead records a contra liability called Retroactive Reinsurance Reserves Ceded. As a result, the ceding company receives no reduction in risk-based capital for the reinsurance because RBC is calculated using gross reserves (not net of Retroactive Reinsurance Reserves Ceded). As discussed in IG 13.10.1.1, there are five significant exceptions to the retroactive reinsurance accounting rules.

13.10.3.1 Ceding commissions in life and health reinsurance agreements

Under SSAP 61R, gains (net of income tax expense) on indemnity reinsurance transactions are recognized in surplus at inception, not net income, and are amortized into income "as earnings emerge from the business reinsured." An amount equal to the income tax effect of the gain is immediately recorded in "commissions and expense allowance on reinsurance ceded" as income. The Appendix A-791 guidance is not explicit on the use of either a statutory or effective rate to determine the income tax effect; therefore, we believe it is an accounting policy decision that that should be followed consistently. The ceding company can only amortize the surplus gain into income to the extent there are earnings on the business reinsured during that reporting period regardless of the expected future earnings, per Appendix A791, paragraph 3. As noted in that guidance, commissions received by the ceding company are included in the calculation of the gain that is recognized as a component of surplus.

In practice, we are aware that there are various ways to amortize the gain "as earnings emerge from the business reinsured." Ceding companies should have established procedures to assess the emergence of profits of the business reinsured and should follow these procedures on a consistent basis. Amortization is not in constant relation to profit (like a GAAP DAC calculation); rather, it is as income emerges versus in relation to how income emerges.

Novations cause immediate gain recognition for the portion of the ceding business novated that was previously reinsured.

Question IG 13-2 addresses the amortization pattern of the gain.

Question IG 13-2

Can a ceding company amortize the gain on reinsurance into the income statement using a ratable pattern over the life of the reinsured block similar to amortizing DAC under GAAP?

PwC response

No. The gain amortized in a reporting period cannot exceed the earnings in the period on the business reinsured. Therefore, unless the earnings on the underlying business are similarly ratable, a ratable amortization pattern will not be appropriate. If there are no earnings in a period on the underlying business then there cannot be any gain amortization. However, if there are sufficient earnings in early years of the reinsurance agreement then the gain could be amortized completely in the early years.

13.10.4 SAP assuming company reinsurance accounting

SAP accounting for the assuming reinsurer is governed by SSAP 61R and SSAP 62R. Ceding commissions paid by the assuming company are recorded as expense in the assuming company's income statement, not as a direct adjustment to surplus as with the ceding company treatment. This treatment is akin to the direct insurer's requirement to expense acquisition costs. In a large reinsurance contract, this ceding commission can be material to the income statement.

13.10.5 SAP for loss commutations

SSAP 62R, *Property and Casualty Reinsurance*, specifically addresses the accounting for a commutation; however, there appears to be a contradiction regarding the prescribed income statement presentation. Paragraph 74 states that the ceding company would eliminate the reinsurance recoverable against loss reserves and record the cash received as a negative paid loss. Paragraph 75 states that the ceding and assuming insurers should report any resulting net gain or loss in underwriting income. These paragraphs support net presentation.

Paragraph 76 states that the commuted balances should be written off through the accounts in which they were originally recorded, which suggests that gross underwriting accounting treatment (similar to a novation) is appropriate. Paragraph 88 supports this gross position by providing the requirement to disclose the effects of the commutation on premiums earned and losses and LAE incurred. The NAIC technical staff has confirmed this ambiguity in discussions but has not taken a position on which presentation is preferable, since that action would have to be taken by the regulators on the Statutory Accounting Principles Working Group.

SSAP 61R, *Life, Deposit-Type and Accident and Health Reinsurance*, paragraph 58, contains similar contradictory language.

We believe that net underwriting presentation is preferable for both SAP and GAAP (i.e., the loss should be recorded through loss expense or loss and LAE expenses). This view is applicable to both the ceding insurer (reassuming insurer) and the reinsurer. However, because there is (1) no clear guidance in GAAP, (2) ambiguous guidance in SAP, and (3) diverse presentation in practice, we would not object to gross underwriting presentation under SAP or GAAP. We believe that whichever method is selected by the company should be used consistently in both accounting models as well as consistently among reporting periods.

13.10.6 SAP accounting for seller's guarantee in a business combination

For statutory accounting purposes, the GAAP guidance on reinsurance in a purchase business combination has been rejected. As a result, reserve guarantees in a purchase business combination of an insurance company should generally be treated as retroactive insurance, in accordance with SSAP 62R. The result of this can be significant, since the RBC formula does not allow a credit for retroactive reinsurance. Therefore, property and casualty insurers must meet the same RBC requirements as if the reinsurance had not been obtained.

13.11 *SAP for policyholder dividends*

The liability for statutory accounting is based solely upon declaration of a dividend by the insurance company's board of directors (SSAP 65, paragraphs 46-47; SSAP 51, paragraphs 30-33). Policyholder dividends are charged against income.

13.12 *SAP for guaranty fund and other assessments*

The statutory guidance for guaranty fund and other assessments is included in SSAP 35R. This guidance, which is based on ASC 405-30, *Insurance - Related Assessments*, with certain modifications, requires accrual when (a) an assessment has been imposed or it is probable that an assessment will be imposed, (b) the event obligating the entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements, and (c) the amount of the assessment can be reasonably estimated. The guidance differs from GAAP in that liabilities for guaranty fund assessments may not be discounted except as discussed below. SSAP 35R also notes that it rejects the use of a valuation allowance for premium tax offsets and policy surcharges, and requires write off to the income statement when it is probable that the asset is no longer realizable; in practice, this difference seems unlikely to be material. With the exception of health-related assessments, all assessments are recorded as part of taxes, licenses, and fees, and not as part of underwriting expenses. Health-related assessments are reported as part of claims expense.

GAAP guidance (refer to ASC 405-30-30-9) specifically allows the liability to be discounted when the amount and timing of the cash payments are fixed or reliably determinable.

Effective January 1, 2017, SSAP 35R was revised to require discounting of long-term care guaranty fund assessment liabilities and related premium tax credit assets for insurers that wrote long-term care contracts. The guidance requires the use of the maximum valuation interest rate for whole life policies, updated annually. Detailed disclosures are required, including the undiscounted and discounted amounts, discount rate, range of years to discount the asset and liability, and other requirements. The new guidance is applicable only to long-term care guaranty fund liabilities and assets.

In connection with considering special guidance for long-term care guaranty fund assessments, the NAIC also adopted revisions to the premium tax offset guidance. In-force policies do not include expected renewals of short-term contracts except in situations where retrospective-premium-based assessments are imposed on contracts for the insolvencies of insurers that wrote long-term care contracts. In which case, to the extent that it is probable that accrued liability assessments will result in a recoverable amount in a future period from business currently in force, appropriate renewal rates of short-term health contracts shall be taken into consideration when recognizing the asset." This revision creates a GAAP to statutory difference for premium tax offset assets.

13.13 *SAP for state-sponsored insurance fund assessments*

In addition to guaranty fund assessments, many states established some form of state-supervised or state-created entity to provide insurance coverage in high-risk areas or for high-risk insureds, which are often referred to as "FAIR Plans" (Fair Access to Insurance Requirements). FAIR Plans operate as insurance companies by charging premiums to the high-risk insureds, but the plans also have the ability to assess insurers operating in the state, and in some cases insureds purchasing insurance in the state, in the event that the plans have insufficient funds to pay claims.

13.14 SAP for guaranty accounting

Statutory accounting adopted ASC 460/FIN 45 on guaranties for all guaranties except for certain guaranties described in SSAP 5R, paragraph 17. Certain related party guaranties are exempted from liability recognition but are required to have extensive disclosure. Related party guaranties that are exempted from liability recognition are those made to or on behalf of 100% owned subsidiaries or those considered "unlimited," which the NAIC states are "typically in response to a rating agency's requirement to provide a commitment to support." However, a parental commitment to support a non-wholly owned subsidiary up to a maximum of \$50 million (for example) is not considered "unlimited" and would therefore be required to be considered for liability recognition. The exemption for wholly-owned subsidiaries applies to both direct and indirect subsidiaries of an insurance company, and to both insurance and non-insurance subsidiaries.

SSAP 5R requires extensive disclosure of all guaranties, including related party guaranties. The NAIC has provided a disclosure template as Appendix A to SSAP 5R. These disclosures are required in both the Annual Statement and the audited financial statements.

13.15 SAP for statement of cash flows

The statutory basis statement of cash flow should reconcile the change in the sum of cash, cash equivalents, and short-term investments, and should be prepared using the direct method, in accordance with SSAP 69. The cash, cash equivalents, and short-term investments total appearing on the statement of cash flow should agree with the sum of those three items appearing as one line on the balance sheet.

For statutory reporting purposes, cash reported on the balance sheet includes money (cash on hand), negotiable money orders, bank drafts and checks (received but not deposited), and balances on deposit with banks after any outstanding items have been deducted. Cash on deposit with banks includes demand deposits and non-negotiable temporary investments in banks, such as savings accounts, demand certificates of deposit, and funds in transit at the statement date. Demand certificates of deposit are non-negotiable certificates of deposit that can be redeemed prior to maturity, usually with an "early-withdrawal" penalty. Cash would include any interest that has been credited to bank accounts but would exclude interest accrued but not credited. Interest accrued but not credited would be included with interest income or investment income due and accrued. In some states, interest accrued on demand certificates of deposit may be nonadmitted to the extent of any early-withdrawal penalties. Overdrafts should also be included in cash on deposit. Cash equivalents include money market mutual funds registered under the Investment Company Act of 1940 and regulated under its rule 2a-7.

For statutory reporting purposes, short-term investments include any investment that had a contractual maturity of one year or less as of the date of acquisition. Included with short-term investments are any negotiable bank certificates of deposit acquired within one year of maturity. Short-term investments are generally valued at amortized cost. Accumulated accretion or amortization of purchase discount or premium is included in the balance of short-term investments.

The statutory cash flow statement is prepared on a direct basis, whereas, for GAAP reporting purposes, most companies use the indirect format. See Figure IG 13-3 for the basic format of the statutory statement of cash flows.

Figure IG 13-3
Direct basis statutory cash flow statement

Cash from operations	
Cash from underwriting	\$ 4,000
Other (investment income, dividends, etc.)	<u>1,000</u>
Net cash from operations	5,000
Cash from investments	
Proceeds from investments sold, matured or repaid*	3,000
Cost of investments acquired	<u>2,000</u>
Net cash from investments	1,000
Cash from financing and misc. sources	
Cash provided	500
Cash applied	<u>800</u>
Net cash from financing and misc. sources	(300)
Net change in cash and short-term investments	5,700
Cash, cash equivalents, and short-term investments, beginning of year	<u>7,000</u>
Cash, cash equivalents, and short-term investments, end of year	<u>\$ 12,700</u>

* Includes gains or losses on cash and short-term investments including amortization/accretion of purchase premium/discount.

The line items in Figure IG 13-3 should generally be included in the statutory statement of cash flow. Note that the Annual Statement Instructions include "worksheets" that show the components of each line of the cash flow statement.

Cash flow from operations should generally be supported at a minimum by: premiums collected, benefits/claims paid, and other expenses paid. Cash flow related to owners (e.g., capital contributions, shares sold or redeemed, dividends paid) should normally be disclosed on the face of the statement.

Only those transactions involving cash, cash equivalents, and short-term investments should be included in the cash flow statement. Disclosure of non-cash items affecting assets and liabilities was

expanded to include non-cash operating items, in addition to financing and investing items. Per discussion with NAIC staff, normal and recurring non-cash operating items, such as depreciation and amortization, changes in reserves that do not result in cash, changes in deferred taxes, or impairment of assets, need not be disclosed. Payment of premiums by a policyholder by transferring bonds is not a cash transaction and should not be included in the statement of cash flows.

13.16 Prescribed or permitted statutory accounting practices

Individual states prescribe the statutory accounting practices insurance companies use for regulatory reporting and can permit companies (either explicitly or implicitly) to use accounting practices different from those prescribed practices.

In accordance with SSAP 1, an insurer who employs accounting practices that differ from those set forth in the Accounting Practices and Procedures Manual is required to disclose the following for those practices that affect statutory surplus or risk-based capital or that result in different statutory accounting reporting (e.g., gross or net presentation, financial statement reporting lines):

- A description of the NAIC accounting practice
- A statement that the accounting practice differs from NAIC statutory accounting practices and procedures
- The monetary effect on statutory surplus of using an accounting practice which differs from NAIC statutory accounting practices and procedures

In addition, if an insurance enterprise's risk-based capital would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements.

Note that these disclosures are required in cases when (1) state prescribed statutory accounting practices differ from NAIC statutory accounting practices or (2) permitted state statutory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices.

The NAIC has adopted disclosures related to permitted or state prescribed practices that differ from NAIC prescribed for parent insurers that directly or indirectly own insurers that have these practices. This disclosure applies to all insurance SCA (subsidiary, controlled and affiliated) entities including captive insurance companies. The disclosure includes a description of whether the RBC of the insurance SCA or the reporting entity parent would have triggered a regulatory event had the insurance SCA not used a state prescribed or permitted practice that differs from NAIC prescribed. Note that this disclosure is not required when the parent insurer removes the dollar impact of permitted or state prescribed accounting practices that depart from NAIC prescribed when calculating its equity earnings of the insurer SCA.

In general, we do not believe that parent insurance entities are required to "reverse" permitted practices obtained by SCA insurers domiciled in a different state than the parent insurer when the parent insurer values the subsidiary insurer in accordance with SSAP 97 for its own financial statements (i.e., the value of the SCA insurer in the parent insurer's audited financial statements is not adjusted to remove the impact of the SCA's statutory permitted practice). Note that SSAP 97,

paragraph 8.b.i (FN 3) allows the parent insurer the option to reverse the dollar effect of an insurer SCA's permitted or state prescribed practice.

It is not uncommon for an insurer to be required to file information about significant transactions with insurance departments for their review and/or approval. Such transactions include significant reinsurance transactions, the sale or purchase of companies, and intercompany transactions. Such filings sometimes include discussion of the proposed accounting for the transaction, and other times there is no specific discussion of the accounting. For purposes of confirming permitted practices (or for confirming that the accounting is prescribed), insurance departments often distinguish between approval of entering into the transaction from approval of its accounting. Therefore, we recommend that companies consider requesting approval of the accounting for significant transactions, if desired, when filing the transactions with the domiciliary regulator.

13.17 Statutory disclosure requirements

Statutory-specific disclosure requirements are primarily provided by the NAIC's Statements of Statutory Accounting Principles. Prior to year-end 2016, auditing literature also required consideration of GAAP disclosure requirements in certain circumstances. However, in 2017, the Audit Issues Task Force (AITF) of the ASB adopted revisions to disclosure guidance for statutory basis financial statements to address the application of AU-C 800 (Special Purpose Financial Statements) to financial statements prepared in accordance with the insurance statutory basis of accounting. The revisions state that GAAP disclosure requirements that have been rejected by the NAIC, in whole or in part, do not need to be evaluated by the auditor in order to determine whether the annual audited statutory financial statements achieve fair presentation in accordance with the insurance statutory basis of accounting. However, if the NAIC has not finalized action on GAAP disclosure requirements, an auditor would still need to assess whether informative disclosure in the annual audited statement financial statements would be needed to achieve fair presentation in accordance with paragraph .17 of AU-C section 800. This assessment would occur when the entity is required to adopt the new standard for GAAP.

Also per the AITF, in accordance with AU-C section 730, *Required Supplementary Information*, required supplementary information (RSI) is not part of the basic financial statements and the auditor's opinion on the basic financial statements does not cover RSI. The auditor does not need to apply AU-C 800 to RSI because AU-C 800 addresses the need for disclosure of financial information in order for the basic financial statements to achieve fair presentation and RSI by definition is not part of the basic financial statements.

The guidance applies to all GAAP disclosures that have been rejected by the NAIC, including ASU 2015-09, *Disclosures about Short-Duration Contracts*. The revised guidance has been added to the AICPA Insurance Accounting and Auditing Guides, which are included on the AICPA's Insurance Expert Panel's webpage.

When GAAP financial statements have been prepared by insurance enterprises for regulatory authorities (although most states require statutory basis financial statements), a reconciliation is generally required between GAAP and SAP equity (surplus) and net income by the regulators. This reconciliation may be required to be included in the notes to the financial statements and covered by the auditor's report or may be information outside of the financial statements that is required to be provided by the insurance company. When this reconciliation is covered by an audit report to satisfy the requirements of one or more states, we believe all state insurance departments should receive the

same report. Individual state requirements and guidance on the content of a reconciliation from GAAP to SAP are found in the applicable state regulations and in the AICPA Industry Audit and Accounting Guides for Life and Health Insurance Entities and Property and Liability Insurance Entities. The SEC does not require a reconciliation but will permit one as long as it is not false or misleading.

GAAP guidance requires that insurance enterprises make disclosures in their GAAP and statutory financial statements concerning permitted accounting practices and certain information about the liability for unpaid claims and claim adjustment expenses. The guidance requires that disclosures be made for those permitted practices that individually or in the aggregate materially affect statutory surplus or risk-based capital (refer to ASC 944-505-50-3). An AICPA Notice to Practitioners clarified that these requirements pertaining to the liability for unpaid claims is applicable to all liabilities for unpaid claim and claim adjustment expenses recorded by insurance enterprises subject to short duration and long duration guidance (e.g., accident and health liabilities), not just property/casualty liabilities. In addition, in practice, these disclosure requirements have been adopted by analogy by some entities that enter into predetermined health care arrangements.