Insurance alert

FASB meeting on insurance contracts - February 18, 2015

Since a variety of viewpoints are discussed at FASB meetings, and it is often difficult to characterize the FASB's tentative conclusions, these summaries may differ in some respects from the actions published in the FASB's Tentative Board Decisions. In addition, tentative conclusions may be changed or modified at future FASB meetings. Decisions of the FASB become final only after completion of a formal ballot to issue a final standard.

FASB decides on insurance in-force as simplifying DAC amortization method for long duration insurance contracts.

Long duration insurance contracts targeted improvements project - Background

This was the third FASB meeting that focused on long-duration contracts. In August 2014, the Board voted unanimously to update assumptions used in determining the liability for future policy benefits for certain long-duration contracts. Those contracts include traditional long-duration contracts, limited-payment contracts, and participating life contracts, as well as the additional liability for universal life-type contracts. The update would be done annually in the 4^{th} quarter, with the impact, including the impact of discount rate changes, recognized immediately in income. Due to the updating of liability assumptions, the Board decided to eliminate the concepts of both provision for adverse deviation and premium deficiency for such contracts.

At the prior meeting in November, the Board voted that the discount rate used to reflect the time value of money in the calculation of the liability for future policy benefits should be the rate of return on a reference portfolio of high-quality fixed income investments. This rate is meant to be a proxy for a liability rate, and this approach is consistent with the approach used to determine the rate used in discounting pension obligations.

Highlights of February 18 FASB Board Meeting

At the February 18 meeting, the Board voted unanimously that deferred acquisition costs (DAC) for long duration insurance contracts would be amortized over the expected life of a book of contracts in proportion to the amount of insurance in-force, or on a straight-line basis if the amount of insurance in-force is variable and cannot be reliably predicted or is otherwise not readily determinable. In computing amortization, no interest would accrue to the undiscounted balance of capitalized acquisition costs.

Additional topics we expect the FASB to deliberate at future meetings include alternatives for updating assumptions for liabilities and DAC (e.g., prospective or retrospective) and accounting for guaranteed minimum insurance benefits. Given that it is early in the deliberations, the Board has not discussed the timing of a final standard or exposure draft.

Details of February 18 FASB Board Meeting

The staff presented the Board with three alternatives for the DAC amortization method. This method would apply to traditional long duration insurance contracts, universal life-type contracts and participating life insurance contracts. It would not apply to investment contracts for which DAC is amortized on the effective interest method. The alternatives included:

A. Balance of insurance in-force: Amortize over the expected life of a book of contracts in proportion to the amount of insurance in-force, or on a straight-line basis if the amount of insurance in-force is variable and cannot be reliably predicted or is otherwise not readily determinable. In computing amortization, no interest would accrue to the undiscounted balance of capitalized acquisition costs.
B. Estimated gross revenues: Amortize over the expected life of a book of contracts in proportion to direct contract revenues or on a straight-line basis if direct contract revenues are nonrecurring, cannot be reliably predicted, or are otherwise not readily determinable.
C. Retain existing amortization methods.

All Board members expressed concern with the complexity of existing methods (Alternative C). One Board member noted that users have difficulty understanding the amortization's effect on the income statement. Several cited that current accounting is also costly for preparers due to the complexity in the calculations. Shadow DAC and negative amortization were noted as examples of both. With the goal of reducing costs and promoting simplicity, Alternative C was rejected.

In discussing Alternative B, one Board member appreciated that, as individual contracts lapsed and no future revenue would be generated, the associated costs would be written off. Another noted that this alternative retained elements of current GAAP for several products.

However, several Board members noted that since the Board decided not to change the current insurance revenue model, revenue will continue to be based on premiums due, which they view as a "cash flow" revenue model rather than an earned revenue model. As such, Alternative B was not ideal, and thus they favored Alternative A over B.

Ultimately there was not significant discussion on Alternative A, and when a vote was proposed, the Board approved this alternative unanimously.

Consideration of the alternative methods for accounting for changes in estimates (e.g., prospective vs. retrospective) for DAC, as well as for insurance liability measurements will be part of a future meeting. The goal is to arrive at an approach for updating assumptions that would be consistent between the liability and the DAC asset.

Additional information

If you have any questions about this summary and the FASB project, please contact:

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