Targeted improvements to the accounting for long-duration contracts

The 1-2-3s of the implementation journey

In August 2018, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2018-12 (the "ASU"), amending the accounting model under US GAAP for certain long-duration insurance contracts and requiring insurers to provide additional disclosures in annual and interim reporting periods.

ASU 2018-12 introduces new reporting complexities and will require more integration of finance and actuarial teams across processes and systems. Meeting the standard will be a challenging multiyear effort, but as with any major change, the ASU presents opportunities to achieve business goals and improvements. Insurers should consider the relative merits of minimum viable compliance versus a more strategic implementation that delivers value to the organization over and above meeting mandatory requirements.

The FASB believes that the ASU's targeted improvements will provide more timely and useful information to financial statement users in addition to simplifying how insurers apply certain aspects of the accounting model for some long-duration contracts. Specifically, the board believes the changes will result in the following improvements:[1]

Contents

1. FASB In Focus: Targeted improvements to the accounting for long-duration contracts issued by insurance companies, https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176171063168&d=&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay

A more current measure of the insurance liability. The liability for future policy benefits for traditional and limited-payment contracts will be regularly refined for actual experience and updated future assumptions. Also, the liability will be discounted at an upper-medium-grade (low-credit-risk) fixed-income instrument yield that reflects the characteristics of the liability rather than the invested assets supporting the liability.

A more uniform and current measure of market-based options or guarantees. Market risk benefits will be measured at fair value, with the effect of changes in the insurance entity's credit risk recognized in other comprehensive income.

Simplified amortization of deferred acquisition costs. Deferred acquisition costs will be amortized on a constant-level basis over the expected life of the contract. As a result, the expense pattern will be more easily predictable and will no longer fluctuate in tandem with an insurance company's investment or underwriting performance. Also, deferred acquisition costs will not be subject to impairment testing; instead, deferred costs will be amortized as long as the related contracts remain outstanding.

Enhanced disclosures. Several new disclosures will be required, including liability rollforwards and information about significant inputs, judgments, assumptions, and methods used in measurement.

Key dates

Public company transition date:
January 1, 2019

Public company effective date:
January 1, 2021

Organizations should begin preparing for implementation now. For public entities, ASU 2018-12 is effective for fiscal years beginning after **December 15, 2020**, including interim periods therein. Nonpublic entities must adopt in fiscal years **beginning after December 31, 2021**, and in interim periods within fiscal years beginning after **December 15, 2022**.

With a transition date of **January 1, 2019**, the window is quickly closing for public entities to verify they are collecting sufficient data for transition.

Four key changes from current guidance

1. Assumptions

While ASU 2018-12 retains certain elements of the net premium reserving model applied under current US GAAP, the amendments change several aspects of how an insurer will measure the liability for future policy benefits. These include the nature of cash flow and discount rate assumptions, the timing of assumption updates, and how insurers will account for updated assumptions. Under the new standard, an insurer must use a current discount rate that (1) is based upon yield of an "upper-medium-grade (low-credit-risk) fixed-income instrument" and (2) reflects the duration characteristics of the liability.[2] This contrasts with the existing guidance that prescribes a rate based on the insurer's estimate (at inception of the contract) of the anticipated investment yield on the underlying asset portfolio over the life of that contract. Additionally, we no longer expect that a premium for adverse deviation (PAD) will be added to the cash flow assumptions going forward.

The standard also requires insurers to review and update cash flow assumptions used to measure the liability for future policy benefits at least annually, with more frequent (i.e., interim period) updates required when evidence suggests that additional revisions are warranted. These assumptions should represent current estimates and should not include a provision for adverse deviation. An insurer may also make an entity-wide election to lock in its expense assumption(s) at contract inception and not update for subsequent cash flow changes. When cash flow assumptions are updated, a revised net premium ratio will be calculated using actual historical experience, the updated future period cash flow assumptions, and the discount rate applied at inception. This net premium ratio will then be used to determine the revised liability as of the balance sheet date, with the difference reflected in current period earnings. At the transition date, and on an ongoing basis, the computation of the liability for future policy benefits contracts in force at the transition date must be aggregated into quarterly or annual groups on the basis of original contract issue date (the acquisition date is considered the original contract issue date for acquired contracts, inclusive of reinsurance).

2. Deferred acquisition costs (DAC)

Although ASU 2018-12 does not change the capitalization of acquisition costs, it does change the manner and timing of DAC amortization for all long-duration contracts. Under ASC 944, insurers calculate DAC at a seriatim or cohort level and may use different amortization methods based on the product type. Conversely, the ASU requires DAC to instead be amortized "on a constant-level basis—either on an individual contract basis or on a grouped contract basis—over the expected term of the related contract(s)."[3] While the ASU does not specify the level of aggregation insurers should apply, it does specify that entities that group contracts should use groupings and related assumptions consistent with those used to determine the liability for future policy benefits.

3. Market risk benefits

The ASU establishes new accounting requirements for certain contracts or contract features that provide protection to the holder from capital market risk and expose the insurance entity to other-than-nominal capital market risk. Referred to as "market risk benefits," these features are currently accounted for using different methodologies—with some (e.g., guaranteed minimum death benefits) recognized as insurance contracts under ASC 944 and others (e.g., guaranteed minimum withdrawal benefits) accounted for as embedded derivatives under ASC 815. However, the ASU changes this accounting for market risk benefits by establishing a single measurement model with the benefits reported at fair value. Changes in fair value will generally flow through income, except for any portion attributable to insurers' credit risk that will be reported as other comprehensive income.

4. Disclosures

To achieve the FASB's objective of targeted improvements, the ASU enhances the disclosures that insurers must provide to allow "users to understand the amount, timing, and uncertainty of future cash flows arising from the [insurance] liabilities."[4] Year-to-date disaggregated tabular rollforwards are required for liability for future policy benefits, the liability for policyholders' account balances, market risk benefits, and unamortized DAC, among others. To achieve compliance with these disclosure requirements, insurers will need to evaluate the aggregation methodology applied to product portfolios to ensure "useful information is not obscured by the inclusion of a large amount of insignificant detail or by the aggregation of items that have significantly different characteristics."[5]

2. FASB, Accounting Standards Update No. 2018-12, Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts, August 2018, https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176171066930&acceptedDisclaimer=true.
3. Ibid.
4. Ibid.
5. Ibid.

Five areas your ASU 2018-12 implementation preparation should focus on

1. *Determine the right transition approach*. The FASB provided the following two methods for transition:

- **Modified retrospective** application as of the transition date, done by assuming the contract was issued at the transition date and pivoting on that recorded liability
- **Optional retrospective** application to contract origination, with limitations; actual data experience must be used across the entire entity, by contract year

2. *Capture the right **data***, including:

- Discount rate applied at contract inception and each quarter/annum going forward
- Cash flow assumptions for each contract or contract grouping back to the transition date, if modified retroactive adoption or contract issue date, if retroactive adoption, and each update going forward
- The sufficient disaggregation of the change in the business each quarter to produce the disaggregated tabular rollforward disclosures
- The anticipated or implied ascribed fee for each market risk benefit
- The data availability and how far back in time you can go

3. *Gather the right **resources***. Make sure all data and control requirements for accounting, finance, and actuarial are provided to IT.

4. *Acquire **talent** and expertise to execute the transition.*

5. *Educate **investors** with new profit patterns and tell a new story.*

Three ways your organization may need to change

ASU 2018-12 not only introduces new reporting complexities, it requires more integration between finance and actuarial processes and data systems. Over the course of this two-plus year implementation process, your organization will likely need to integrate finance, risk, and actuarial systems, while making changes within each department to prepare for the new standard.

Finance and accounting changes

- Update account mapping of financial information, including significantly more extensive disclosure requirements
- Redesign processes for reconciliations, controls, and workflow automation
- Restructure G/L posting logic to accommodate new accounts and transactions
- Ensure the reporting system can support additional data volume from increased disclosure and presentation requirements
- Reassess tax reporting

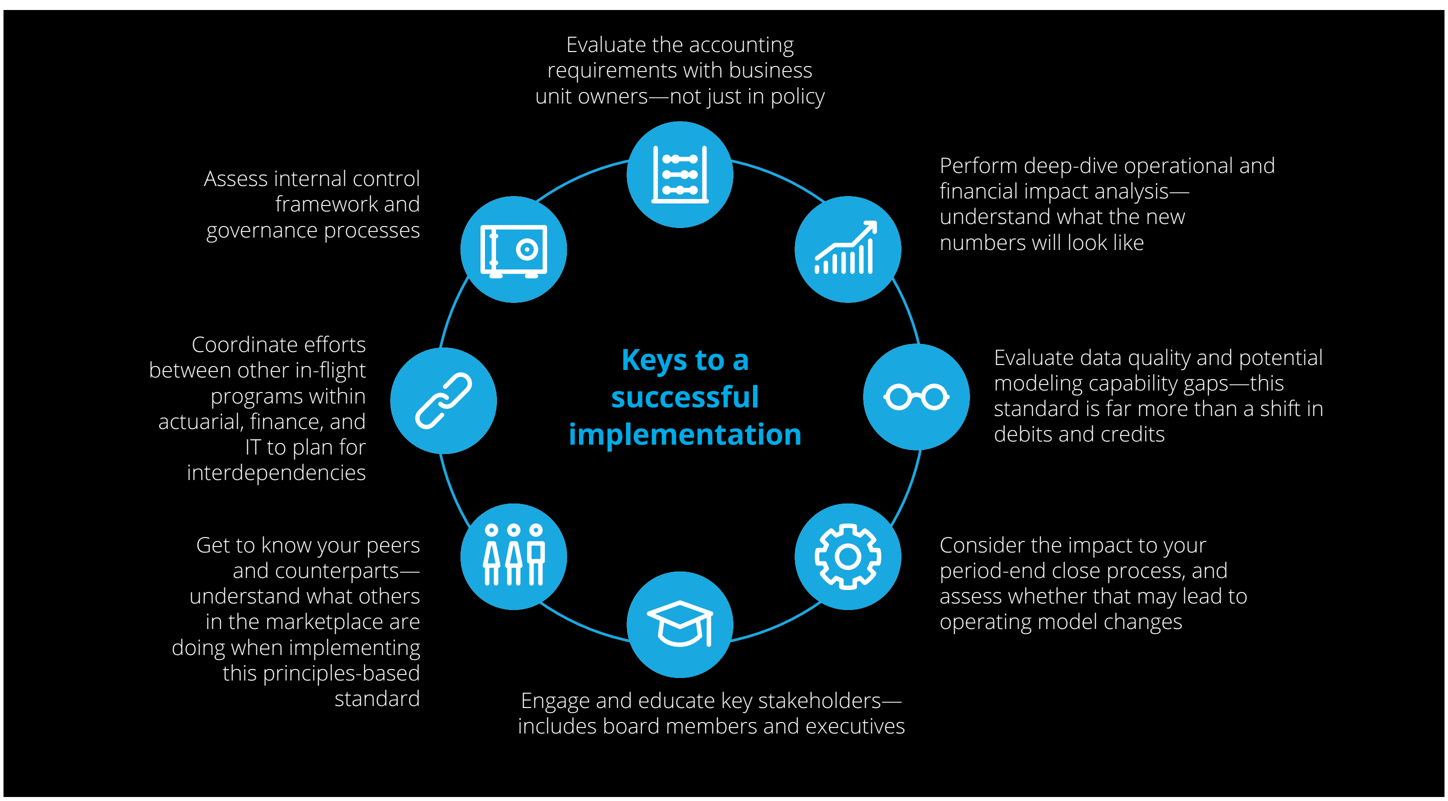
Actuarial changes

- Modifications to existing code libraries for actuarial models
- New actuarial valuation platforms for fair value calculations and updated DAC amortization methods
- More robust assumption setting and experience analysis processes to support annual reviews and updates of cash flow assumptions for liability of future policy benefits
- New processes, calculations, and analytics for retrospective unlocking

IT implications

Organizations should not underestimate the complexity or cost of data systems integration across financial, actuarial, and other IT architecture for ASU 2018-12 implementation. To help limit unnecessary spending, lower risk, and optimize the future state of your data systems, your organization should:

- Look for opportunities to leverage existing models and transformation initiatives
- Use software integration for overlapping functionality
- Include emerging standards from FASB, NAIC, and IFRS, as applicable, in your gap analysis of existing platforms



Source: Deloitte LLP

Four opportunities to add value with ASU 2018-12

1. "Smart compliance"

ASU 2018-12 offers you the opportunity to approach implementation from the perspective of "smart compliance" and provides two ways to add value:

- Build incremental process and technology components to achieve minimum viable compliance, thereby helping lower implementation costs and possibly raising business-as-usual costs.
- Transform business-driven technology and infrastructure across finance, actuarial, and IT to achieve strategic implementation that, while likely resulting in higher implementation costs, may offer efficiencies and lower future costs.

To achieve smart compliance, consider your organization's technology and architecture maturity. Then decide whether to evolve, simplify, or replace your current capabilities and supporting technology in adopting the new ASU 2018-12 requirements. Each insurer will need to evaluate its current framework for capability gaps and then balance the cost and timeline implications of each option.

2. Enhanced efficiency

Actuaries are often overburdened with significant stewardship activities related to maintenance and production of data, processes, systems, and reports. Reorganizing your operating model and using automation tools can increase productivity and enable actuaries to focus on more valued work.

3. Better cost management

ASU 2018-12 will increase both the volume and frequency of data processing, as well as increase storage requirement. This can cause strain on already understaffed IT departments and increase hardware or service fees. Strategically planning your implementation can reduce these back-office costs and allow IT departments to focus on driving efficiency and improvements.

4. More insights

Replacing dated and inflexible technology with modern systems and better reporting tools can deliver significant value to your overall business, providing business insights that help shape your organization's strategy and success.

Where to start your journey

The ASU will have pervasive financial and operational implications across insurance organizations. Frequently referred to as "targeted improvements," the term does not capture the depth and breadth of the standard—which will significantly impact companies' accounting and actuarial functions, external reporting, and data and technology:

- Compliance introduces new reporting complexities that will require more integration between finance and actuarial departments across both processes and systems.
- The standard introduces several changes related to the measurement of the liability for future policy benefits for traditional and limited-payment long-duration contracts, the measurement and presentation of market risk benefits, and the amortization of deferred acquisition costs. These updates will require changes to existing accounting and actuarial policies, assumptions, and methodologies.
- The standard significantly expands the disclosures that an insurer must provide as part of their interim and annual financial statements. In addition to requiring additional data elements, these disclosures may also create stress on existing close processes.

Systems may need to be updated or replaced to comply with new modeling requirements. Furthermore, additional IT resources may be needed to support additional data granularity and volume.

Regardless of where you are on ASU implementation, it's time to begin the journey. Deloitte has worked hand in hand with the industry to prepare for this change. We have actively followed the development of ASU 2018-12, and we have helped to form industry positions through our involvement in various technical organizations. Our professionals have played a key role in drafting the provisions within the *US GAAP for Insurers* publication that provides thought leadership as industry practice develops on the methodologies that will be applied to ASU 2018-12.

Deloitte will use new tools and accelerators specifically to support successful ASU 2018-12 implementation—including a business impact analysis framework, financial impact tools, implementation roadmaps, IT systems implications frameworks, and effort estimations to achieve minimum compliance—or, alternatively, to turn this into a wider finance transformation.

Our understanding of the current state of the industry and ASU 2018-12 gives us valuable context: We can help you assess potential solutions and meet challenges all companies will face implementing the new standard.

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