

GAAP Targeted Improvements: Diving Into Details

By Steve Malerich

Amid the major improvements to GAAP for long-duration contracts, Accounting Standards Updates No. 2018-12 (the ASU) includes some subtle refinements of existing provisions and some simplifications that require careful consideration. This article discusses the details of two subtle refinements (related to maintenance expenses for traditional contract reserves and the inclusion of interest in assessments for non-traditional contract reserves), and two simplifications (related to DAC amortization and loss recognition testing).

SUBTLE REFINEMENTS

Some refinements were made to add clarity where inconsistent practices have emerged. Though greater consistency was the reason for these changes, they are included as changes to accounting standards. Any change in practice should be treated as a change in accounting principle—not a correction of error and not a change in estimate—and the transition provisions applied.

Maintenance Expenses

For traditional contracts, FAS 60 had two paragraphs describing expenses to include and to exclude from the reserve calculation. This has been interpreted to include maintenance expenses when inflation makes them non-level.

The ASU combines these two paragraphs into one (944-40-30-15) with some modification. (In this and following excerpts

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from the ASU, new wording is indicated as underlined text, and wording that has been removed is indicated with strikethrough.)

Expense assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected nonlevel costs, such as termination or settlement costs, and costs after the premium-paying period. Renewal expense assumptions shall consider the possible effect of inflation on those expenses. 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...

The ASU clarifies that regardless of inflation, the cost of routine policy maintenance is not included in the reserve calculation.

Assessments—Interest Spread

For universal life (UL) contracts, SOP 03-1 was interpreted by some to include additional reserves as “policyholder balances” when measuring the investment margin to include in gross profits and assessments.

With the elimination of gross profit as a basis for amortizing DAC, assessments had to be defined without reference to gross profit. This was accomplished by deleting gross profits from paragraphs 944-40-30-22 and 30-27, and inserting the language formerly in 944-30-35-5 to describe investment margin. To resolve the differing interpretations, FASB also added a paragraph reference.

For contracts in which the assets are reported in the general account ~~and that include investment margin in their estimated gross profits~~, the investment margin (that is, the amounts expected to be earned from the investment of policyholder balances less amounts credited to policyholder balances [see paragraph 944-40-25-14]) shall be included with any other assessments for purposes of determining total expected assessments....

Paragraph 944-40-25-14 describes policyholder account values. Additional (SOP 03-1) reserves are defined in paragraphs 944-40-25-27 and 25-27A. Therefore, the only interest to include in assessments is the investment margin earned on policyholder account values.

SIMPLER METHODS

Two other areas require close attention to detail. Deferred acquisition cost (DAC) amortization, though simplified, requires interpretation of a complex interrelationship among the new provisions. Loss recognition may also be simpler, but getting there requires careful consideration of new flexibility.



Amortization of Deferred Acquisition Costs

DAC must be amortized over expected term (944-30-35-3A) under assumptions that are consistent with reserve measurement (944-30-35-3). Paragraph 35-3A also sets the ideal technique as a straight-line, individual contract basis (subparagraph a). Cohort-based amortization is permitted, as long as it approximates the ideal (subparagraph b).

Amortizing an individual contract over expected term using reserve assumptions means the amortization rate must anticipate future terminations. When a contract terminates, its unamortized DAC balance is immediately written off.

Since individual contracts either terminate or persist in their entirety, we must expect that some will persist and some will terminate in any given year. We find that, for a pool of individual contracts, we effectively amortize twice for terminations—first through an amortization rate that anticipates some and then through the write-off of remaining DAC on actual terminations.

Straight-line has turned into accelerated amortization. Strict application of the standard as worded produces a result that is contrary to the standard.

The easiest way to avoid accelerated amortization would be to calculate expected term assuming no terminations before maturity. Then, every lapse is excess and the full effect of lapse

is captured in the release of DAC upon actual termination of each contract. To do that, however, would mean ignoring the requirement to be consistent with reserve assumptions.

Another way involves something the ASU doesn't address directly but implies in an illustration (944-30-55-7B). For this cohort illustration to match the result of individual contract calculations, we would have to adjust persisting contract balances upward for the fact that they didn't terminate. On the individual contract, this would appear to be slower than straight-line. For a collection of contracts, however, the upward adjustment would be counterbalanced by the release on terminating contracts. For the entire pool, amortization is consistent with straight-line and expected term, though revisions of the remaining expected term (944-30-35-3B) will bend the line.

Based on my discussion with FASB staff during their outreach and my observations of FASB deliberations, I believe the second approach to be most consistent with FASB intent—with one caveat.

If the expected termination rate is high enough, the true-up adjustment could cause the unamortized balance on a persisting contract to increase, even after taking current amortization. If actual terminations are near expected levels, such an increase will be offset by the heavy release on terminating contracts. If, however, actual terminations are much less than expected, the heavy release won't happen and the total unamortized balance

could increase. That would conflict with the standards. We'll need some constraint or adjustment to prevent that increase.

Loss Recognition Testing

Loss recognition remains a requirement (944-60-15-5) for UL and participating contract reserves, and for the present value of future profit (PVFP) associated with any acquired blocks of long-duration contracts.

Under FAS 60, a gross premium reserve discounted at the expected asset yield had become the norm for loss recognition. Except for any unamortized PVFP, however, the ASU eliminates loss recognition testing for traditional insurance contracts. And, some of the provisions that led to this practice are either gone or altered in a way that no longer supports this norm.

Rather than prescribe any practice, existing or new, FASB added disclosure requirements (944-60-50-2):

For annual reporting periods... an insurance entity shall disclose the following:

- a. The amount of a liability that is established as a result of ... loss recognition testing ... and a description of the factors that led to the establishment of the liability
- b. Information about the methodology used when performing premium deficiency testing ...
- c. Whether the entity considered anticipated investment income when performing premium deficiency testing ...



This gives companies more flexibility in how to test and measure loss recognition. I say “companies” because company policy should place some limits on actuarial discretion to ensure consistency among products and across time.

Some obvious approaches are to use projected cash flows or margins—discounted at expected asset yield, at an expected crediting rate, or at an observable market rate.

Except for exclusion of maintenance expense, discounting cash flows at expected asset yield would match the current gross premium reserve.

A simpler alternative might be discounting margins at the crediting rate (for UL) or at the market rate (for traditional PVFP). The new reserve disclosures should already include everything needed for such measures, thereby eliminating the need for separate loss recognition models.

If a company prefers to minimize the incidence of ongoing losses (after maintenance expenses and DAC amortization) from unprofitable business, it might decide to not consider

anticipated investment income. This wouldn’t guarantee the avoidance of ongoing losses, but it would allow investment margins to mitigate such drain.

To achieve that objective for UL, discount either margins without interest spread or cash flows at the crediting rate. To achieve it for traditional PVFP, discount either margins or cash flows at the market rate. This would not violate the prohibition of taking losses to produce future income (944-60-35-5) since any expected future gains would be a product of investment strategy, not contract performance. ■

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