



EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: June 27, 2013
Comments Due: October 25, 2013

Insurance Contracts (Topic 834)

This Exposure Draft of a proposed Accounting Standards Update of Topic 834 is issued by the Board for public comment. Comments can be provided using the electronic feedback form available on the FASB website. Written comments should be addressed to:

Technical Director
File Reference No. 2013-290

Financial Accounting Standards Board
of the Financial Accounting Foundation

The *FASB Accounting Standards Codification*[®] is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft and is requesting comments by October 25, 2013. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at [Exposure Documents Open for Comment](#)
- Emailing a written letter to director@fasb.org, File Reference No. 2013-290
- Sending written comments to “Technical Director, File Reference No. 2013-290, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116.”

Do not send responses by fax.

All comments received are part of the FASB’s public file. The FASB will make all comments publicly available by posting them to the online public reference room portion of its website.

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Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

Proposed Accounting Standards Update

Insurance Contracts (Topic 834)

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

Existing U.S. generally accepted accounting principles (GAAP) for insurance contracts have evolved over many years as a result of new insurance products and new contract terms and features. Those changes have resulted in multiple models that vary based on the nature of the insurance contract. Existing U.S. GAAP on insurance applies only to insurance entities and not to contracts issued by noninsurance entities that contain identical or similar economic characteristics to insurance contracts. That guidance has not been subject to comprehensive reconsideration by the Board before the beginning of this project. International Financial Reporting Standards (IFRS) do not contain a comprehensive standard that addresses the accounting for insurance contracts. IFRS 4, *Insurance Contracts*, published in 2004, was intended to be an interim standard that permits a wide range of practices. IFRS resulted in substantial differences in how different companies account for insurance contracts.

In May 2007, the International Accounting Standards Board (IASB) issued the Discussion Paper, *Preliminary Views on Insurance Contracts*, and in August 2007, the FASB issued an Invitation to Comment, *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts*.

The feedback received on the Invitation to Comment was overwhelmingly in support of the FASB and the IASB working together on an insurance contracts project. Several respondents indicated that it was critical that the FASB be actively involved in the development of any international accounting standard for insurance transactions. According to those respondents, insurance is a global industry with many U.S. insurers having a significant global presence, and convergence of accounting standards in a global marketplace is essential to providing users of financial statements with comparable, decision-useful information. Many respondents thought the FASB's understanding of U.S. insurance products and the insurance marketplace was important to bring to the joint deliberations. Some respondents commented that existing U.S. GAAP was the most logical starting point for a new global standard and that it was important that deliberations give more consideration to elements of existing U.S. GAAP, including but not limited to retaining different approaches to reflect differences between life and long-duration health insurance contracts, and property/casualty and short-duration health insurance contracts.

Several respondents noted that, absent the IASB's project on insurance contracts, a comprehensive reconsideration of U.S. GAAP was not needed. However, some respondents noted that there would be a substantial benefit in

creating a single comprehensive standard on accounting guidance for insurance contracts and that there were a number of areas in existing U.S. GAAP that could be improved. Those respondents noted that having multiple standards contributes to confusion and misunderstanding of insurance accounting, which leads to a higher risk for errors in financial reporting and a steep learning curve for those entering the business and for those users following the business. A specific area for improvement noted by respondents was that if a noninsurance entity becomes party to an arrangement with economically similar attributes, risk transfer, and cash flows as those of an insurance contract, the arrangement should be accounted for as an insurance contract.

Regarding the long-duration contract model, respondents noted that potential areas for improvement include:

1. Resolving the issue with the current mixed-attribute accounting model that results in accounting mismatches without real economic substance (that is, fair value measurement of most investment assets while the measurement of many insurance liabilities is based largely on assumptions locked in at issuance)
2. Eliminating the product-specific accounting that is rules based including but not limited to the differences in the measurement of the liability, amortization of deferred acquisition costs, and recognition of certain options and guarantees.

Regarding the short-duration contract accounting model, respondents noted that potential areas for improvement include:

1. Using probability-weighted averages to measure claim liabilities
2. Clarifying the risk transfer requirements for insurance contracts
3. Disclosing actuarial reserve ranges.

In addition, the Board identified several areas for potential improvement and areas where there were inconsistencies between existing U.S. GAAP for insurance contracts and other more recently issued U.S. GAAP guidance. Those include, among other items, the following:

1. Reflection of the time value of money for property, liability, and short-term health insurance contract liabilities when claims are paid over a year after the insured event (reflected in limited circumstances under current accounting)
2. Recognition of revenue for long-duration contracts in a manner consistent with the principles in revenue recognition guidance and the guidance for contracts accounted for using the short-duration model
3. Areas in which diversity exists in practice.

After considering feedback on the FASB's Invitation to Comment and other areas identified for improvement, in October 2008, the Board decided to work with the IASB on a joint insurance project. The Boards undertook the project to develop

common, high-quality guidance that establishes the principles that an entity would apply in the recognition, measurement, presentation, and disclosure of insurance contracts issued and reinsurance contracts held in an entity's financial statements. The main objective of the guidance in this proposed Update is to increase the decision usefulness of the information about an entity's insurance liabilities, including the nature, amount, timing, and uncertainty of cash flows related to those liabilities, and the effect on the statement of comprehensive income, and to provide comparability, regardless of the type of entity issuing the contract.

The FASB issued a Discussion Paper, *Preliminary Views on Insurance Contracts*, in September 2010 (2010 FASB Discussion Paper). In July 2010, the IASB published the Exposure Draft, *Insurance Contracts* (2010 IASB Exposure Draft). The FASB has considered feedback on its 2010 Discussion Paper and on the 2010 IASB Exposure Draft in developing the guidance contained in this proposed Update.

Who Would Be Affected by the Amendments in This Proposed Update?

The guidance in this proposed Update would apply to all entities that issue insurance contracts as defined in this proposed Update (including entities other than insurance companies) or that hold reinsurance contracts, unless those contracts are specifically excluded from the scope of this proposed Update. The guidance in this proposed Update would not apply to the holder (that is, policyholder) of insurance contracts unless the contract is a reinsurance contract. The extent of the effect on an individual entity would depend on the significance of insurance contracts issued or reinsurance contracts held to the entity's operations and financial position.

The guidance in this proposed Update would supersede the requirements in Topic 944, Financial Services—Insurance, which currently apply to insurance entities.

What Are the Main Provisions?

The guidance in this proposed Update would require an entity to measure its insurance contracts under one of two measurement models, referred to as the building block approach (for most life, annuity, and long-term health contracts) and the premium allocation approach (for most property, liability, and short-term health contracts).

Under the guidance in this proposed Update, contracts accounted for using the building block approach generally would be measured in a way that portrays a

current assessment of the insurance contract. That measurement has the following two components:

1. The present value of the unbiased probability-weighted mean of the future net cash flows ("expected value") that the entity expects in fulfilling the contract
2. A margin representing profit at risk, which is deferred and recognized as income as the uncertainty in the cash flows decreases.

An entity applying the premium allocation approach would initially measure its liability for remaining coverage as the contractual premiums that are within the boundary of the existing contract. In subsequent periods, the entity would reduce the measurement of the liability for remaining coverage on the basis of the expected timing of incurred claims and benefits and would recognize the amount of that reduction as insurance contract revenue. When insured events occur, an entity generally would measure a separate liability for incurred claims as the expected value of future cash flows to settle the claims and related expenses.

The guidance in this proposed Update generally would require an entity to present the following in net income:

1. Insurance contract revenue:
 - a. For the building block approach—over the coverage and settlement periods as the obligation to provide coverage and other services is satisfied.
 - b. For the premium allocation approach—over the coverage period on the basis of the expected timing of incurred claims.
2. Claims and expenses as they are incurred, and for contracts measured using the building block approach, changes in assumptions regarding expected cash flows.
3. Interest expense using the discount rates determined when the contract was initially recognized. Those rates would be periodically reset for insurance contracts with discretionary participation features that change the expected cash flows.

How Would the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?

Appendix A includes a comparison of the guidance in this proposed Update and current U.S. GAAP. The more significant differences are discussed in the following paragraphs.

The guidance in this proposed Update would require contracts that transfer significant insurance risk to be accounted for in a similar manner, regardless of the type of entity issuing the contracts. The scope of existing U.S. GAAP for

insurance contracts only applies if the entity providing insurance is an insurance company. That proposed change would result in noninsurance entities accounting for certain arrangements as insurance contracts that they currently account for using other models in other Topics (including revenue recognition, contingencies, guarantees, and financial instruments, among others). Under existing U.S. GAAP, those entities generally measure the obligation (or update that measurement if the obligation has already been recognized) only after the obligation has been incurred and an entity can reasonably estimate the amount (in many cases, based on a best estimate, which is a point estimate). In addition, when recognized, the obligation is typically undiscounted. The measurement in this proposed Update considers various possible outcomes on an expected value basis reflecting the time value of money, thus resulting in more relevant and timely information about those obligations communicated to users of financial statements. That proposed change to existing practice would enhance comparability of contracts that contain identical or similar economic characteristics, making it easier for users to analyze financial information and make meaningful comparisons.

The guidance in this proposed Update would require an entity to apply one of two models on the basis of characteristics of the insurance contracts. The premium allocation approach would be applied if the coverage period of an insurance contract is one year or less, or, at contract inception if it is unlikely that during the period before a claim is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract. The building block approach would be applied to all other contracts. Existing U.S. GAAP requires application of different models depending on the nature of the insurance contract—one primary model for short-duration insurance contracts (that is, for most property, liability, and short-term health contracts), several models for long-duration insurance contracts (that is, most life, annuity, and long-term health contracts), and additional guidance developed incrementally over time as separate pieces of literature. Therefore, in some ways, existing U.S. GAAP is not cohesive and has led to diversity in practice. The guidance in this proposed Update would minimize the number of models for measuring insurance contracts. Additionally, for preparers, auditors, and regulators, that change would serve to reduce existing complexity that has resulted from a product-specific evolution of insurance guidance over the years.

The guidance in this proposed Update would require an entity to measure all expected cash flows that arise from insurance contracts and to update assumptions each reporting period to reflect all available information for contracts that will be measured using the building block approach. The assumptions used to calculate traditional long-duration contract policyholder benefits under current U.S. GAAP are locked in at contract inception (that is, they are not updated unless the existing contract liabilities, together with the present value of future gross premiums, become insufficient to cover the present value of future benefits to be paid to or on behalf of the policyholders and to recover unamortized

acquisition costs). The liability recognized for nontraditional long-duration contracts (for example, universal life-type contracts, deferred annuities, and variable and equity-based life and annuity products) generally reflects the account balance that accrues to the benefit of the policyholders. Additionally, some guarantee and option features included in insurance contracts either may not be accounted for under current U.S. GAAP or may be measured at amounts that are less than the present value of the expected cash flows. The proposed requirements would result in more timely communication of the value of an entity's rights and obligations that relate directly to the fulfillment of insurance contracts.

For contracts measured using the premium allocation approach, the guidance in this proposed Update would require an entity to measure the liability for incurred claims as the probability-weighted expected amount of cash outflows (that is, the mean) and to reflect the time value of money. Under existing U.S. GAAP, for contracts accounted for under the short-duration model, insurers generally determine a liability for unpaid claims based on the best estimate of the undiscounted costs of the claims (most likely outcome). The FASB defines *best estimate* in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, as the single most-likely amount in a range of possible estimated amounts, that is, in statistics, the estimated mode. As accounting pronouncements have evolved, the term *best estimate* has been used in a variety of contexts that range in meaning from "unbiased" to "most likely," thus resulting in diversity in the application of the term. Because there are numerous potential loss scenarios as of any balance sheet date, the proposed requirement would be more representationally faithful. For some entities, the amount recorded may not change as a result of the proposed requirement. The proposed requirement is expected to enhance consistency and comparability in the measurement of the liability for incurred claims because it would mitigate estimation bias. Also, requiring discounting of the liability for incurred claims, where material, would more accurately reflect the value of the insurance liability, especially in circumstances in which the expected claims settlement (payment) period extends for many years. Under the current Securities and Exchange Commission (SEC) guidance, entities are allowed to discount the liability for incurred claims when the payment pattern and costs are fixed and determinable on an individual claim basis. The proposed guidance would extend discounting to all claims where material.

Under the guidance in this proposed Update, an explicit margin for contracts accounted for under the building block approach would be presented in the financial statements. That is in contrast to current U.S. GAAP, in which the margin is implicitly included as part of the insurance contract liabilities for contracts accounted for under the long-duration model. The disaggregation of the estimated future net cash flows and the remaining deferred profit should provide further transparency into the liability measurement and an entity's expected profit.

For contracts that are accounted for under the building block approach, the guidance in this proposed Update would require that an entity recognize both of the following:

1. Revenue attributable to the fulfillment of cash flows over the coverage period in proportion to the value of coverage and any other services that the entity has provided in fulfilling its insurance obligation
2. Revenue attributable to the margin over the coverage and settlement periods as the entity is released from exposure to risk as evidenced by a reduction in the variability of cash outflows.

Under the long-duration model in current U.S. GAAP, an entity generally recognizes the premium from traditional life insurance contracts in income based on contractual due dates stipulated in the policy (that is, a premium due method). For limited-payment contracts, an entity defers a portion of the premium and recognizes that premium in net income in a constant relationship with insurance in force. Premiums collected for universal life-type contracts, deferred annuities, and variable and equity-based life and annuity products are not recognized as income in the statement of comprehensive income under current U.S. GAAP. Instead, revenue from those contracts is based on actual amounts assessed against the policyholder account balance.

Under the premium due method to revenue recognition applied under existing U.S. GAAP for traditional life insurance contracts, an entity often recognizes insurance contract revenue before the entity has performed the corresponding service, and similarly often recognizes expenses before they have been incurred. For that reason and because the amounts presented as insurance contract revenue and claims, benefits, and expenses vary depending on the contractual due date rather than when services are provided, the timing of revenue and expense recognition in the net income is inconsistent with the principles in Topic 606, Revenue Recognition.¹

The guidance in this proposed Update would require an entity (1) to exclude from revenue any amounts received that the entity is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs and (2) to exclude from expenses the corresponding repayment of those amounts. That requirement would be applicable for all insurance contracts with those characteristics. Because the cash flows are considered akin to deposits that are not subject to insurance risk, excluding them from net income is intended to better reflect the consideration received for the insurance risk taken on by the entity. Additionally, this presentation allows for greater consistency with the

¹Although the document is not yet finalized, the Board will be issuing the Accounting Standards Update, *Revenue Recognition (Topic 606): Revenue from Contracts with Customers*. Therefore, the guidance in this proposed Update refers to the forthcoming Topic 606 instead of Topic 605 on revenue recognition.

amounts presented as revenue by other entities that provide services to customers.

When Would the Amendments Be Effective?

The Board will establish the effective date of the requirements when it issues the final amendments. The effective date for nonpublic entities would likely be a minimum of one year after the effective date for public entities. An entity would apply the guidance in this proposed Update retrospectively, restating all comparative periods presented. Early adoption of the guidance in this proposed Update would be prohibited.

How Do the Proposed Provisions Compare with International Financial Reporting Standards (IFRS)?

In contrast to existing U.S. GAAP, IFRSs do not contain comprehensive guidance on accounting for insurance contracts. The lack of uniform international accounting standards results in inconsistent accounting practices for reporting under IFRS.

From October 2008, when the FASB joined the IASB in the project, many of the decisions on the features of the model were made jointly with the IASB.

Notwithstanding the Boards' publication of separate Exposure Drafts, joint decisions have included the following:

1. The insurance contracts guidance would apply to all contracts that transfer significant insurance risk, regardless of the type of entity issuing the contract, unless explicitly excluded from the scope.
2. Entities would measure insurance contracts using all of the following:
 - a. An unbiased probability-weighted estimate of the future cash flows expected to arise as the entity fulfills the contract, adjusted to reflect any contractual linkage between the contract and any underlying assets
 - b. Updated estimates and assumptions that are, to the extent applicable, consistent with prices in financial markets
 - c. Discount rates that reflect only the characteristics of the liability, including the extent of the dependency of the liability cash flows on asset returns.
3. Entities would not recognize gains at inception of insurance contracts issued or reinsurance contracts held.
4. Entities would include the following in net income:
 - a. Insurance contract revenue, such that revenue is allocated to periods in proportion to the value of coverage (and other services

- related to the insurance obligation for contracts measured using the building block approach) provided in the period
- b. Claims and related expenses when incurred.
- 5. The effect of changes in the discount rates would be presented in other comprehensive income except for contracts that are contractually linked to underlying assets.
- 6. Entities would present in net income the interest accretion determined using the discount rates at inception of the contract, updated only to the extent of the dependency of the liability cash flows on asset returns.
- 7. The premium allocation approach would, in general, be applied to the measurement of the liability for remaining coverage of contracts with a coverage period of one year or less or contracts that meet specified criteria.

Both the FASB and the IASB proposals generally produce the same measurement at initial recognition of the insurance contract for contracts measured using both the building block approach and the premium allocation approach. For the building block approach, this is because both models calibrate the margins to the consideration received or receivable from the policyholder that is related to the insurance component. For the premium allocation approach, this is because the liability for remaining coverage is calibrated to the consideration received or receivable. However, differences could arise after initial recognition because of the following:

1. In the FASB's building block approach, the margin (that is, the excess of the expected present value of cash inflows over the expected present value of cash outflows to fulfill the policyholder contract) is viewed as unearned profit that is ratably recognized as revenue as the associated cash flows become more certain. In contrast, the IASB's model includes an explicit risk adjustment in the measurement of the insurance contract liability and a contractual service margin (that is, the excess of the expected present value of cash inflows over the expected present value of cash outflows to fulfill the policyholder contract, plus a risk adjustment) that is recognized on a systematic basis in line with the pattern of services provided under the contract.
2. In the FASB's building block approach, all changes in estimates are recognized immediately in net income (other than the effect of changes in the discount rates) and as an adjustment to the insurance liability. In contrast, under the IASB's model, a net increase in expected future cash outflows relating to future coverage or future services is offset against the remaining contractual service margin (other than for the effect of changes in the discount rates), and a net decrease in expected future cash outflows is added. The risk adjustment is remeasured each reporting period with changes recognized immediately in net income.
3. In the FASB's premium allocation approach, the measurement of the liability for incurred claims is based on the present value of the expected

cash flows. In contrast, under the IASB's model, the liability also includes a risk adjustment.

Additional differences of significance between the FASB's and the IASB's decisions include the following:

1. Premium allocation approach:
 - a. Under the guidance in this proposed Update, the premium allocation approach is a separate model that would be required to be applied for all contracts meeting specified criteria. A cedant would account for a reinsurance contract using the same approach (building block approach or premium allocation approach) that the cedant uses to account for the underlying insurance contracts.
 - b. Under the 2013 IASB revised Exposure Draft, *Insurance Contracts*, the premium allocation approach is a simplification of the IASB's main approach (that is, the building block approach). An entity would be permitted to apply the premium allocation approach for contracts when it produces similar measurements to the main approach. A ceded reinsurance contract may be accounted for using a different approach than the approach applied to the underlying contracts.
2. Allocation period for recognizing margin:
 - a. Under the guidance in this proposed Update, the margin would be recognized in net income as part of revenue over the coverage and settlement period for contracts that apply the building block approach. The implicit margin in the premium allocation approach would be allocated over the coverage period.
 - b. Under the 2013 IASB revised Exposure Draft on insurance contracts, the contractual service margin would be recognized in net income as part of revenue over the coverage period for all contracts. The risk adjustment would be recognized in net income over the coverage and settlement period for all contracts.
3. Acquisition costs:
 - a. Under the guidance in this proposed Update, the acquisition costs included in the measurement of the liabilities would be limited to acquisition costs directly attributable to a portfolio of insurance contracts that are successfully obtained (that is, excluding the portion of acquisition costs deemed not to result in the issuance of contracts). Under the building block approach, the margin would reflect expected profit after deducting acquisition costs incurred.
 - b. Under the 2013 IASB revised Exposure Draft, the acquisition costs included in the measurement of the liabilities would include all acquisition costs directly attributable to obtaining a portfolio of insurance contracts, including costs related to unsuccessful efforts. Under the building block approach, the fulfillment cash flows would include expected acquisition costs.

4. Participation features:
 - a. Under the guidance in this proposed Update, fulfillment cash flows that are dependent on the performance of an underlying item should reflect the measurement of the underlying item. However, for any fulfillment cash flows based on (1) policyholders' rights to receive the performance of an underlying item based on something other than the measurement of the underlying item in U.S. GAAP financial statements and in which the difference does not reflect a timing difference that will reverse and enter into future calculations of participating benefits, the measurement of the liability should instead reflect the contractual feature or (2) a feature that allows the entity discretion about the amount to pass through to policyholders, the measurement of the liability should instead reflect the entity's expectations of the timing and amount of payments to policyholders.
 - b. Under the 2013 IASB revised Exposure Draft, fulfillment cash flows for all participation features specifically linked to, and that are expected to vary directly with, the returns on underlying items should reflect the measurement of the underlying items. For contracts without any specified linkage to underlying items (for example, universal life contracts or other contracts in which all the participation features are discretionary), the measurement of the liability should reflect the entity's expectations of the timing and amount of payments to policyholders. The measurement of the fulfillment cash flows for a discretionary participation feature that provides policyholders with the right to participate in any surplus of the entity should include the relevant remaining surplus of the entity. That means that there would be no profit reported in any accounting period or equity for mutual insurers (that is, companies owned entirely by their policyholders).
5. Interest accretion rates for insurance contracts with discretionary participation features (for example, universal life contracts):
 - a. Under the guidance in this proposed Update, upon any change in expectations of the crediting rates that will affect the measurement of the insurance contract liability, the interest accretion rates should be reset in a manner that recognizes any changes in estimated interest crediting and related expected cash flows on a level-yield basis over the remaining life of the contracts. The degree to which the interest accretion rates for the portfolio are adjusted should reflect the relative value of the account balance to be credited and the extent to which the change in expected interest crediting rates for the portfolio related to the changes in expected asset returns affects the present value of expected cash flows on the account balance. That decision does not require an insurer to disaggregate cash flows of a contract into those affected by returns from assets

and those not affected by returns from assets for purposes of resetting the interest accretion rates.

- b. Under the 2013 IASB revised Exposure Draft, when an entity expects changes in the returns of underlying items to affect insurance contracts' cash flows, the interest accretion rates should be reset for only the subset of cash flows that vary with returns on underlying items (and those that are not directly measured on the same basis as the underlying item because there is no specified link to the performance of that underlying item that the entity must hold). That decision implicitly requires an insurer to disaggregate cash flows of a contract into those affected by returns from assets and those not affected by returns from assets for purposes of resetting the interest accretion rates.

There are also relatively less significant differences in scope, measurement, presentation, and disclosures between the guidance in this proposed Update and the 2013 IASB revised Exposure Draft. Appendix B includes a comprehensive comparison of the guidance in this proposed Update and the IASB's proposals. The FASB decided that the remaining differences are necessary to achieve appropriate accounting in the pertinent areas.

The Board believes that the changes considered on an overall basis would be an improvement to U.S. GAAP and would eliminate diversity in practice in the United States, and for several aspects of the model, globally.

The FASB invites comments on all aspects of this proposed Update, as well as comments on the conclusions reached by the IASB in its 2013 revised Exposure Draft.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below, including identification of any unique considerations for nonpublic entities. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Scope

Questions for All Respondents

Question 1: Do you agree with the scope and scope exceptions of this proposed guidance, including its applicability to contracts written by noninsurance entities? If not, what types of contracts or transactions also should be included or excluded from the scope and why?

Recognition

Questions for All Respondents

Question 2: Do you agree with the requirements included in this proposed Update for when noninsurance components of an insurance contract, including embedded derivatives, distinct investment components, and distinct performance obligations to provide goods or services, should be separately accounted for under other applicable Topics? If not, why?

Initial and Subsequent Measurement

Questions for Users

Question 3: Will the proposed measurement model produce relevant information that will help users of an entity's financial statements make economic decisions? If not, what changes do you recommend and why?

Question 4: Which aspects of the proposed measurement model most significantly improve the information that will be used in making economic decisions and why?

Measurement Approaches

Questions for All Respondents

Question 5: Do you agree that entities should apply different approaches to contracts with different characteristics, described as the building block approach and the premium allocation approach? If not, which model do you think should apply and do you think there should be any changes made to that model?

Question 6: Do you agree that entities should be required to apply the premium allocation approach if the coverage period of the insurance contract, considering

the contract boundary guidance, is one year or less? If not, what would you recommend and why?

Question 7: Do you agree that entities should be required to apply the premium allocation approach if, at contract inception, it is unlikely that during the period before a claim is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract? If not, what do you recommend and why?

Portfolio and Contract Boundary

Questions for Preparers and Auditors

Question 8: Do you agree with the definition of a portfolio of insurance contracts as included in this proposed Update? If not, what do you recommend and why?

Question 9: Do you agree with the requirements included in this proposed Update on contract boundary (that is, the requirements that establish how to identify the future cash flows that will arise as the insurer fulfills its obligations)? If not, what do you recommend and why?

Fulfillment Cash Flows

Questions for Preparers and Auditors

Question 10: Do you agree with the types of cash flows that would be included in the measurement of the fulfillment cash flows, including embedded options and guarantees related to the insurance coverage under existing insurance contracts that are not separated and accounted for as embedded derivatives? If not, what cash flows do you think also should be included or excluded and why?

Question 11: Do you agree that the assumptions used in the measurement of the fulfillment cash flows should be updated each reporting period? If not, what do you recommend and why?

Question 12: Do you agree that the fulfillment cash flows for contracts measured using the building block approach and the liability for incurred claims for contracts measured using the premium allocation approach should be based on an explicit, unbiased, and probability-weighted estimate (that is, the mean) of the future cash flows, as of the reporting date, expected to arise as the entity fulfills the contract, adjusted to reflect any contractual linkage between the contract and any underlying assets? If not, what do you recommend and why?

Questions for All Respondents

Question 13: Do you agree with the approach in this proposed Update to recognize changes in estimates of cash flows (other than the effect of changes in the liability arising from changes in the discount rates) in net income in the reporting period? If not, what do you recommend and why?

Discount Rates and Discounting

Questions for All Respondents

Question 14: Do you agree that the discount rates used by the entity for nonparticipating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

Question 15: For contracts measured using the premium allocation approach, do you agree that an entity should discount the liability for incurred claims? Do you agree that an entity should be allowed to elect not to discount portfolios when the incurred claims are expected to be paid within one year of the insured event? Why or why not? If not, what would you recommend and why?

Question 16: Do you agree that an entity should segregate the effects of underwriting performance from the effects of changes in discount rates (which would reverse over time) by recognizing changes in the present value of the fulfillment cash flows due to changes in the discount rates in other comprehensive income? If not, do you think that the effect of changes in the discount rates should be presented in net income? Please explain your reasoning.

Question 17: Because the proposed guidance includes the approach under which changes in the insurance liability arising from changes in the discount rates should be recorded in other comprehensive income, do you think that a test should be required to trigger recognition in net income of some or all of the amounts in accumulated other comprehensive income (that is, a loss recognition test based on asset-liability mismatches)? Why or why not?

Questions for Preparers and Auditors

Question 18: Do you agree that the method for calculating the discount rates should not be prescribed? Is the proposed guidance on determining the discount rates understandable and operable? If not, what do you recommend?

Question 19: Do you agree that interest expense generally should be based on the discount rates determined at the date the portfolio of contracts was initially recognized? Why or why not? If not, what do you recommend?

Question 20: Do you agree that upon any change in expectations of the crediting rates used to measure the insurance contract liability for insurance contracts with discretionary participation features, the interest accretion rates should be reset in a manner that recognizes any changes in estimated interest crediting and related expected cash flows on a level-yield basis over the remaining life of the contracts? If not, what do you recommend?

Margin for Contracts Measured Using the Building Block Approach

Questions for All Respondents

Question 21: Do you agree that an insurer should not recognize a gain at initial recognition of an insurance contract (such a gain would arise when the expected present value of the cash outflows is less than the expected present value of the cash inflows) but, rather, should defer that amount as profit to be recognized in the future? Why or why not?

Question 22: Do you support using a one-margin approach, as is included in this proposed guidance, or an explicit risk adjustment and a contractual service margin (as the IASB proposes)? Please explain the reason(s) for your view.

Question 23: If you support a risk adjustment and a contractual service margin, do you agree with the IASB's approach to adjust the contractual service margin for changes in estimates of cash flows? Why or why not? Do you agree with the IASB's approach to not specify acceptable approaches to determine the risk adjustment? Why or why not?

Question 24: Do you agree that a loss at initial recognition of a portfolio of insurance contracts should be recognized immediately in net income (such a loss would arise when the expected present value of the cash outflows exceeds the expected present value of cash inflows)? Why or why not?

Questions for Preparers and Auditors

Question 25: Do you agree with the proposed method(s) of recognizing the margin (that is, as the entity is released from risk under the insurance contracts as evidenced by a reduction in the variability of cash outflows)? If not, what do you suggest and why?

Question 26: Do you agree that interest should be accreted on the margin and therefore affect insurance contract revenue? If not, why?

Question 27: Do you agree that if the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance contracts will exceed the

expected cash inflows, an entity should recognize the remaining margin immediately in net income? Why or why not?

Acquisition Costs

Questions for Preparers and Auditors

Question 28: Do you agree that the direct acquisition costs presented with the margin should include only the costs directly related to the entity's selling efforts that result in obtaining the contracts in the portfolio and that all other acquisition costs should be recognized as expenses when incurred? If not, what do you recommend and why?

Question 29: Do you agree that the measurement of the margin for contracts measured using the building block approach and the liability for remaining coverage for contracts measured using the premium allocation approach should be reduced for direct acquisition costs incurred? If not, what do you recommend?

Question 30: Do you agree that an entity should recognize acquisition costs as an expense in net income in the same pattern that it recognizes the margin for contracts measured using the building block approach or in the same pattern that it reduces the liability for remaining coverage under the premium allocation approach? If not, why not?

Insurance Contract Revenue

Questions for All Respondents

Question 31: Do you agree that users of financial statements would obtain relevant information that faithfully represents the entity's financial position and performance if, in net income, for all insurance contracts, an entity presents insurance contract revenue and incurred expenses, rather than only information about changes in margins (that is, the net profit)? If not, why not?

Question 32: Do you agree that, for all contracts, revenue should exclude any amounts received that an entity is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs and that expenses should exclude the corresponding repayment of those amounts? If not, what do you recommend? Please specify whether your view depends on the type of contract.

Question 33: For contracts measured using the premium allocation approach, do you agree that if the contract has a financing component that is significant to the contract, an entity should adjust the liability for remaining coverage to reflect the time value of money and recognize the accretion of interest with insurance revenue? Do you agree with the practical expedient that an entity should not be

required to reflect the time value of money in measuring the liability for remaining coverage (that is, if the entity expects, at contract inception, that the time period between when the policyholder pays all or substantially all of the premium and when the entity provides the corresponding part of the coverage is one year or less)? If not, what do you recommend and why?

Questions for Preparers and Auditors

Question 34: For contracts measured using the building block approach, does this proposed Update contain sufficient guidance on how to determine insurance contract revenue in accordance with the principle that it should be allocated between reporting periods as performance obligations are satisfied over time (that is, to allocate consideration between periods by reference to the relative value of the services provided in each period)? If not, explain what additional guidance is necessary.

Participating Contracts

Questions for Preparers and Auditors

Question 35: Do you agree that participation features that are contractually dependent on the performance of other assets or liabilities of the insurer or the performance of the entity itself should be measured on the same basis used to measure the underlying items and changes in the measurement should be presented in the same statements (that is, net income or other comprehensive income)? Do you agree that this approach should be limited to only participating features for which the amount of the performance of the underlying items passed through to policyholders is contractually determined and not extended to participating features that allow an entity discretion about the amount of the performance of the underlying item to pass through to the policyholders? If not, what do you recommend and why?

Reinsurance

Questions for All Respondents

Question 36: Do you agree that a cedant should record a margin if the expected present value of the cedant's future cash inflows exceed the expected present value of the cedant's future cash outflows (thus prohibiting the recognition of a gain at inception upon entering into a reinsurance arrangement) for (a) retrospective reinsurance contracts accounted for using either the building block approach or the premium allocation approach and (b) prospective reinsurance contracts accounted for using the building block approach? If not, what do you recommend and why?

Questions for Preparers and Auditors

Question 37: Do you agree that a cedant should estimate the fulfillment cash flows (including the ceded premium) for a reinsurance contract using assumptions consistent with those used to measure the corresponding fulfillment cash flows for the underlying insurance contract or contracts, without reference to the margin on the underlying contracts? If not, what would you recommend and why?

Insurance Contracts Acquired in a Business Combination

Questions for All Respondents

Question 38: Do you agree that entities should record a loss at the acquisition date in the amount by which any excess of the asset and liability balances related to insurance contracts measured in accordance with the guidance in this proposed Update exceeds the fair value of those assets and liabilities? Do you agree that entities should record a margin (not an immediate gain) for the amount that the fair value of the asset and liability balances exceeds those assets and liabilities measured in accordance with the guidance in this proposed Update? If not, do you think an entity should instead increase or decrease goodwill for the differences between the fair value and the measurement in accordance with the guidance in this proposed Update on those assets and liabilities? Why or why not?

Contract Modifications

Questions for Preparers and Auditors

Question 39: Do you agree that for a substantial modification (a) an entity should recognize a gain or loss as the difference between the measurement of the modified contract using the current entity-specific price that the entity would hypothetically charge the policyholder for a contract equivalent to the new contract and the carrying amount of the existing contract and (b) that the carrying amount of the existing contract should be derecognized? If not, what do you recommend?

Presentation

Questions for All Respondents

Question 40: Do you agree with the presentation requirements included in this proposed Update? If not, what would you recommend and why?

Disclosure

Questions for All Respondents

Question 41: Do you agree with the disclosure requirements included in this proposed Update? If not, which disclosure requirement(s) would you change and why? Are there any additional disclosures that would provide decision-useful information and why? Do you think that any of the disclosure requirements included in this proposed Update would not provide decision-useful information and should not be required? If so, which ones and why?

Effective Date and Transition

Questions for Preparers and Auditors

Question 42: The Board will establish the effective date of the requirements when it issues the final amendments. However, the Board is interested in determining the key drivers affecting the timing of implementation. What are those key drivers? How do those drivers affect the time it will take to implement this proposed guidance?

Question 43: Do you think the effective date should be the same for both public and nonpublic entities? Do you think the effective date should be the same for regulated insurance entities and other entities that issue insurance contracts within the scope of this proposed guidance? Why or why not?

Question 44: Do you agree that the practical expedients relating to transition included in this proposed guidance are sufficient for retrospective application (that is, are the transition provisions in this proposed guidance operable)? If not, what would you recommend and why?

Question 45: For business combinations that occurred before the transition date, is the requirement included in this proposed Update on reallocating the fair value of the asset and liability balances related to insurance contracts between the expected fulfillment cash flows and the margin operable? Why or why not? If not, what would you recommend and why?

Questions for Users and Auditors

Question 46: Do you agree that the proposed approach to transition would provide users of financial statements with relevant information that faithfully represents the entity's financial position and performance in a way that appropriately balances comparability with verifiability? Why or why not?

Costs and Complexities

Questions for Preparers

Question 47: Describe the nature of the incremental costs of adopting the guidance in this proposed Update, distinguishing between one-time costs and ongoing costs. Explain which aspects of the guidance in this proposed Update are driving those costs and include ideas to make the proposal more cost effective.

Questions for Auditors

Question 48: Describe the nature of the incremental costs of auditing the financial reporting requirements included in this proposed Update, distinguishing between one-time and ongoing costs. Explain which aspects of the model in this proposed Update are driving those costs.

Public Roundtable Meetings

The Board plans to hold public roundtable meetings on this proposed Update. The purpose of roundtable meetings is to listen to the views of, and obtain information from, interested stakeholders about this proposed Update. The Board plans to seek participants for the meetings that represent a wide variety of stakeholders, including users, preparers, auditors, and others to ensure that broad input is received. Any individual or organization desiring to participate must notify the FASB by sending an email to director@fasb.org and submitting its comments on the proposed Update in writing by October 25, 2013. Roundtable meetings can accommodate a limited number of participants. Depending on the number of responses received, the Board may not be able to accommodate all requests to participate.

Proposed Guidance

Introduction

1. The Proposed Guidance section of this proposed Accounting Standards Update would supersede Topic 944, Financial Services—Insurance, in the *FASB Accounting Standards Codification*® (with a link to transition paragraph 834-10-65-1) as a result of this proposed Update.
2. None of the proposed guidance is shown underlined as new text, nor is the existing guidance shown ~~struck out~~ as amended or deleted text.
3. This proposed guidance uses the terms in Section 834-10-20 with specified meanings. Terms defined in Section 834-10-20 (the glossary) are in **bold type** the first time they appear in each Section.
4. The proposed guidance will apply to *all* entities that issue insurance contracts as defined in this proposed Update (including entities other than insurance companies) or that hold reinsurance contracts, unless those contracts are specifically excluded from the scope of the guidance in this proposed Update.
5. This proposed Update also contains guidance that would be added to Subtopic 825-10, Financial Instruments—Overall. Amendments as a result of the proposed guidance to Subtopic 825-10 will be included along with other amendments to various Topics as discussed in the preceding paragraph.
6. Although the document is not yet finalized, the Board will be issuing an Accounting Standards Update, *Revenue Recognition (Topic 606): Revenue from Contracts with Customers*. Therefore, the guidance in this proposed Update refers to the forthcoming Topic 606 instead of Topic 605 on revenue recognition. On December 20, 2012, the Board issued proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)*. Similarly, the guidance in this proposed Update refers to Subtopic 825-15 on credit losses.
7. The proposed amendments to the XBRL Taxonomy that would result from this proposed Update are expected to be issued during the comment period of this proposed Update.

Subtopic 834-10

Insurance Contracts—Overall

Overview and Background

General

834-10-05-1 This Topic addresses financial accounting and reporting for **insurance contracts**.

Objectives

General

834-10-10-1 The objective of the guidance in the Overall Subtopic is to establish the principles that an entity shall apply in the measurement, recognition, presentation, and disclosure of **insurance contracts** that it issues and of **reinsurance** contracts that it holds in its financial statements. The guidance in this Subtopic is meant to do both of the following:

- a. Provide decision-useful information about an entity's insurance contracts in its financial statements, including the nature, amount, timing, and uncertainty of cash flows related to those contracts
- b. Faithfully represent the economics of the transaction and improve comparability, regardless of the type of entity issuing or holding the contract.

Scope and Scope Exceptions

General

834-10-15-1 An entity shall apply the guidance in this Subtopic to **insurance contracts** that it issues and to **reinsurance** contracts that it holds.

834-10-15-2 References to insurance contracts in this Subtopic also shall apply to reinsurance contracts in this Subtopic.

834-10-15-3 An insurance contract is a contract under which one party (the issuing entity) accepts significant **insurance risk** from another party (the policyholder) by agreeing to compensate the **policyholder** or its designated

beneficiary if a specified uncertain future event (the **insured event**) adversely affects the policyholder (see paragraphs 834-10-55-1 through 55-26).

834-10-15-4 Contracts, regardless of form, entered into simultaneously with a single counterparty for the same risk or contracts that are interdependent that are entered into with the same party or a related party shall be considered a single contract for the purpose of determining risk transfer in an entity's consideration of whether a contract meets the definition of an insurance contract (see paragraph 834-10-55-14).

834-10-15-5 An entity shall apply the guidance in this Subtopic to all contracts that meet the definition of an insurance contract, except for all of the following:

- a. Product warranties issued by a manufacturer, dealer, or retailer (see Topic 606 on revenue recognition).
- b. Employers' assets and liabilities under employee benefit plans (see Topic 715 on retirement benefits) and retirement benefit obligations reported by defined benefit retirement plans (see Topic 960 on defined benefit pension plans).
- c. Employer-provided insurance.
- d. Contractual rights or contractual obligations that are contingent on the future use of, or right to use, a nonfinancial item (for example, some license fees, royalties, contingent lease payments, and similar items; see Topics 840 on leases, 350 on intangibles, and 606).
- e. Residual value guarantees provided by a manufacturer, dealer, or retailer, as well as a lessee's residual value guarantee embedded in a finance lease (see Topics 840 and 350).
- f. Fixed-fee service contracts that have as their primary purpose the provision of services and that meet all of the following conditions (see paragraphs 834-10-55-28 through 55-39):
 1. The price of the contract is not based on an assessment of the risk associated with an individual customer unless that assessment is limited to consideration of the customer's credit risk.
 2. The contract compensates customers by providing a service rather than by making a cash payment to the customer or to a third-party provider.
 3. The insurance risk transferred by the contract arises primarily from uncertainty about the utilization of the policyholder's use of services (that is, **frequency** risk) relative to the overall risk transferred in the contract.
- g. Contingent consideration payable or receivable in a business combination (see Topic 805 on business combinations).
- h. Charitable gift annuities that possess a donation element and are issued by not-for-profit entities (see Topic 958 on not-for-profit entities).
- i. Insurance contracts in which the entity is the policyholder, unless those contracts are reinsurance contracts (that is, they compensate the entity

- for losses on one or more insurance contracts that are within the scope of this Topic issued by that entity).
- j. Contracts within the scope of Topic 815 on derivatives and hedging.
 - k. Contracts that have any of the following characteristics:
 1. A guarantee that does not expose the counterparty to risk throughout the term of the guarantee, that is, from inception of the guarantee contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation (see paragraph 834-10-55-40)
 2. A guarantee or an indemnification of an entity's own future performance (see paragraph 834-10-55-40)
 3. A guarantee that is both unusual or nonrecurring and unrelated to the type of risk that is the subject of other guarantees issued by the entity (see paragraph 834-10-55-41).
 - l. A guarantee that is addressed in the following guidance:
 1. Topic 840
 2. Topic 606
 3. Topic 360 on property, plant, and equipment
 4. Transactions described in paragraphs 860-20-55-20 through 55-23 (that is, a guarantee or an indemnification whose existence prevents the guarantor from either accounting for a transaction as the sale of an asset that is related to the guarantee's underlying or recognizing in earnings the profit from that sale transaction)
 5. A guarantee for which the guarantor's obligation would be reported as an equity item rather than a liability under Topic 480 on distinguishing liabilities from equity or Topic 505 on equity.
 - m. A guarantee between related parties or entities under common control when the issuer of the guarantee also is not issuing similar guarantees to third parties, unless issuance of those guarantees is the primary business purpose of the issuing entity.
 - n. A guarantee of debt owed to a third party by a related party or entity under common control when the issuer of the guarantee also is not issuing similar guarantees of debt owed by third parties, unless issuance of those guarantees is the primary business purpose of the issuing entity (see paragraph 834-10-55-42).

Glossary

Acquisition Costs

Costs that are related to the acquisition of new or renewal **insurance contracts**.

Annuitization

The process of converting an annuity into a series of periodic payments.

Carrying Amount

The amount of an item as displayed in the financial statements.

Ceding Entity (Cedant)

The party in a reinsurance contract that acquires insurance **coverage** on its underlying insurance contracts. The ceding entity compensates the **reinsurer** for insurance risk transferred to the reinsurer. The ceding entity receives the right to reimbursement from the reinsurer under the terms of the reinsurance contract.

Claim

A demand for payment of a policy benefit because of the occurrence of an **insured event**.

Claim Adjustment Expenses

The amount to provide for the estimated cost required to investigate and settle **claims** relating to insured events.

Closed Block

A defined, limited group of policies and a defined set of assets that are governed by a set of operating rules.

Commutation

An agreement between two parties, such as a cedant and a reinsurer, that terminates all rights and obligations between the parties under a particular insurance or reinsurance contract.

Coverage

An entity's exposure to loss. The concept of coverage would typically include policy limits, deductible, insured, and covered property or insured event.

Coverage Period

The period over which insured events that occur are covered by an insurance contract. It is defined by the contract boundary. Commonly referred to as the period that the contract is **in force**.

Demutualization

The conversion of a mutual insurance entity to a stock insurance entity.

Estimated Returnable Amount

The estimate of the component of an insurance contract that the entity is required to repay the **policyholder** or the beneficiary that does not depend on whether an insured event occurs.

Fair Value

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Financial Risk

The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable.

Frequency

The number of insured events that occur.

Fulfillment Cash Flows

The present value of the unbiased, probability-weighted estimate of the future cash flows that will arise as an entity fulfills the insurance contract.

Incurred-but-Not-Reported Claims

Claims relating to insured events that have occurred but have not yet been reported to the entity as of the date of the financial statements.

In Force

Insurance contracts written and recognized on the books of an entity that are unexpired as of a given date.

Insurance Contract

A contract under which one party (the issuing entity) accepts significant **insurance risk** from another party (the policyholder) by agreeing to compensate the policyholder or its designated beneficiary if a specified uncertain future event (the **insured event**) adversely affects the policyholder.

Insurance Contract Asset

An entity's net expected contractual rights less obligations under an insurance contract, if the rights exceed the obligations as of the reporting date.

Insurance Contract Liability

An entity's net expected contractual obligations less rights under an insurance contract, if the obligations exceed the rights as of the reporting date.

Insurance Contract Premium

The amount charged to a policyholder for an insurance contract (that is, the total consideration provided by the policyholder under the terms of the contract).

Insurance Contract Revenue

Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from providing insurance coverage. This excludes from **insurance contract premium** any **estimated returnable amounts**.

Insurance Risk

The risk arising from uncertainties about **underwriting risk** as opposed to **financial risk**. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

Insured Event

An uncertain future event that is covered by an insurance contract and creates insurance risk.

Investment Component

A component included in an insurance contract that contains financial risk and no significant insurance risk.

Lapse Rate

The rate at which insurance contracts terminate through failure of the policyholders to continue required premium payments. The lapse rate also may be considered a rate of nonpersistence.

Liability for Incurred Claims

In the premium allocation approach, the amount needed to provide for the estimated cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the reporting date). Includes the liability for **incurred but not reported claims** and **claim adjustment expenses**.

Liability for Remaining Coverage

In the premium allocation approach, an entity's stand-ready obligation to provide coverage for future insured events that arise under existing contracts (that is, the obligation that relates to the unexpired portion of coverage).

Loss Sensitive Feature

A provision within a contract that causes the premium, insured loss or benefit, or commission to vary based on the loss experience of that contract. Examples include reinstatement premium provisions, retrospective premium adjustments, profit commissions, and sliding scale commissions, all of which limit the risk for an entity and reward the policyholder based on favorable loss experience and/or penalize the policyholder for unfavorable loss experience.

Maintenance Costs

Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

Margin

The excess of the expected present value of the cash inflows over the expected present value of the cash outflows to fulfill an insurance contract at the initial recognition of a portfolio of insurance contracts, less any amounts recognized in net income over time.

Morbidity

The relative incidence of disability due to disease or physical impairment.

Mortality

The relative incidence of death in a given time.

Mortality Risk

The risk arising from uncertainties about the obligation to make payments that are contingent upon the death or continued survival of a specific individual or group.

Net Amount at Risk

That portion of the amount insured that exceeds the amount retained by an entity for the policyholder. Sometimes referred to as the face value of a contract less the accumulated policyholder account value or premiums received.

Onerous Contract

A contract in which the present value of the future costs of fulfilling the unexpired portion of coverage (that is, the **liability for remaining coverage**) and the expected qualifying acquisition costs are expected to exceed the **carrying amount** of the liability related to the unexpired portion of coverage.

Participating Insurance

Insurance in which the policyholder is entitled to participate in either of the following:

- a. The earnings or surplus of the insurance entity
- b. The performance of an underlying item.

Performance Obligation

A promise in a contract with a customer to transfer a distinct good or service to the customer.

Persistency

As the complement of the lapse rate, persistency refers to the number of policyholders that keep their insurance coverage in force during a period. Persistency varies by plan of insurance, age at issue, year of issue, **frequency** of premium payment, and other factors.

Policyholder

A party that has a right to compensation under an insurance contract if an insured event occurs. The policyholder may elect that a beneficiary receive claim or benefit payments under the contract.

Policyholder Dividends

Amount of dividends to policyholders, representing the policyholders' share of divisible surplus.

Portfolio of Insurance Contracts

A group of insurance contracts that both:

- a. Are subject to similar risks and priced similarly relative to the risk assumed
- b. Have similar duration and similar expected patterns of release from risk, that is, reduction in variability in cash flows.

Portfolio Transfer

The transfer of an entity's entire liability for in-force insurance contracts or outstanding losses, or both, of a portfolio or portfolios of the entity's business to another entity.

Prospective Reinsurance

Reinsurance in which an assuming entity agrees to reimburse a ceding entity (cedant) for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance.

Qualifying Acquisition Costs

Costs that are related directly to the successful acquisition of new or renewal insurance contracts.

Reinsurance

A transaction in which a reinsurer (assuming entity) assumes all or part of insurance risk undertaken originally by another entity (ceding entity or cedant) in exchange for compensation. For indemnity reinsurance, the legal rights of the policyholder are not affected by the reinsurance transaction, and the entity issuing the underlying insurance contract remains liable to the policyholder for payment of policy benefits.

Reinsurance Asset (Reinsurance Recoverable)

A ceding entity's net contractual rights under a **reinsurance** contract, including amounts recoverable from a reinsurer for paid and unpaid claims and/or benefits and claim settlement expenses, including claims incurred but not reported.

Reinsurer

The assuming entity in a reinsurance transaction.

Retroactive Reinsurance

Reinsurance in which an assuming entity agrees to reimburse a ceding entity (cedant) for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance.

Salvage

The amount received by an entity from the sale of property (usually damaged) on which the entity has paid a claim to the policyholder and has obtained title to the property.

Segregated Account

A separate investment account (that is, portfolio of assets) established and maintained by an entity to which funds have been allocated for certain contracts of the entity.

Segregated Fund Arrangement

A participation feature within an insurance contract that is contractually linked to a **segregated account** and that meets both of the following conditions as a result of contractual, statutory, or regulatory requirements:

- a. The entity must invest the policyholder's funds directed by the policyholder in designated investment alternatives or in accordance with specific investment objectives or policies.
- b. All investment performance, net of contract fees and assessments, must be passed through to the individual policyholder.

Settlement Period

The estimated period over which claims or benefits are paid. For reinsurance contracts, the estimated period over which a ceding entity (cedant) expects to recover substantially all amounts due from the reinsurer under the terms of the reinsurance contract.

Severity

The amount of the claim to be paid under an insurance contract.

Statutory Accounting Practices

Accounting principles required by statute, regulation, or rule, or permitted by specific approval, that an insurance entity must follow when reporting to an insurance regulator.

Subrogation

The right of an entity 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 entity.

Surrender Charges

Amounts expected to be assessed against policyholder balances at contract redemption, whole or partial, regardless of how the charges are labeled, such as contingent deferred sales charges.

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.

Underwriting Risk

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

Recognition

General

> Separating the Components of an Insurance Contract

834-10-25-1 Some **insurance contracts** contain one or more components that would be within the scope of other Topics if the entity accounted for those components as if they were separate contracts (that is, they would not meet the definition of an insurance contract on a standalone basis). For example, an insurance contract may include an **investment component** (financial) or a service component. Those contracts may be partially within the scope of this Topic and partially within the scope of other Topics.

834-10-25-2 An entity shall only separate the following components:

- a. An embedded derivative from the host insurance contract that is required to be accounted for separately as a derivative instrument according to Subtopic 815-15 on embedded derivatives. The entity shall attribute cash flows to those embedded derivatives on a standalone basis.
- b. A distinct investment component (see paragraph 834-10-25-3) from the host insurance contract and account for it in accordance with other applicable Topics, including any related transaction costs as allowed by those Topics. The entity shall exclude from the cash flows used to measure the investment component the effect of any cross subsidies, discounts, or supplements.
- c. A distinct **performance obligation** to provide goods or services (see paragraphs 834-10-25-4 through 25-7) from the host insurance contract, and account for it in accordance with other applicable Topics. The entity shall attribute cash flows between the insurance component and any distinct performance obligations to provide goods and services in accordance with paragraph 834-10-25-8.

834-10-25-3 The following are indicators that an investment component may not be distinct (see paragraph 834-10-55-44):

- a. The entity is unable to measure both the insurance component and the investment component separately without considering the other component. Thus, if the value of the individual component depends on the value of the other component, that would indicate an entity shall apply the guidance in this Topic to account for the contract as a whole.
- b. The **policyholder** or its beneficiary is unable to benefit from one component unless the other component also is present. For example, if the lapse or maturity of one component in a contract causes the lapse or maturity of the other component, that would indicate an entity shall apply the guidance in this Topic to account for the contract as a whole.
- c. The investment component and the insurance component are not individually sold or are not sold separately in the same market or jurisdiction. An entity need not perform an exhaustive search to make that determination, but the entity shall use information reasonably available.

834-10-25-4 Performance obligations include promises that are implied by an entity's customary business practices, published policies, or specific statements if those promises create a valid expectation by the policyholder that the entity will transfer a good or service to the policyholder or its beneficiary. Performance obligations do not include activities that an entity must undertake to fulfill a contract unless the entity transfers a good or service to the policyholder or its beneficiary as those activities occur. For example, an entity may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder or its beneficiary as the tasks are

performed. Hence, those promised set-up activities are not a performance obligation (see paragraph 834-10-55-45).

834-10-25-5 A performance obligation to provide a good or service is distinct if either of the following criteria is met:

- a. The policyholder or its beneficiary can benefit from the good or service either on its own or together with other resources that are readily available to the policyholder or its beneficiary (see the following paragraph). Readily available resources are goods or services that are sold separately (by the entity or another entity) or resources that the policyholder or its beneficiary has already obtained (from the entity or from other transactions or events) (see paragraph 834-10-25-6).
- b. The entity's promise to transfer the good or service to the policyholder or its beneficiary is separable from the promises associated with the insurance component of the contract (see paragraph 834-10-25-7).

834-10-25-6 In evaluating whether a policyholder or its beneficiary can benefit from a good or service in accordance with paragraph 834-10-25-5(a), an entity shall consider whether the good or service could be used, consumed, sold for an amount other than scrap value, held, or otherwise used in a way that generates economic benefits. The fact that an entity regularly sells a good or service separately would indicate that a policyholder or its beneficiary can benefit from the good or service either on its own or together with other readily available resources.

834-10-25-7 In applying paragraph 834-10-25-5(b), facts and circumstances that indicate that the entity's promise to transfer the good or service to the policyholder or its beneficiary is separable from the promises associated with the insurance component of the contract include, but are not limited to, the following:

- a. The entity does not provide a significant service of integrating the good or service into the combined insurance contract. In other words, the entity is not using the good or service as an input to produce the output specified in the insurance contract.
- b. The policyholder or its beneficiary was able to purchase or not purchase the good or service without significantly affecting the cash flows and risks associated with the insurance component of the contract.

834-10-25-8 After excluding any cash flows related to embedded derivatives and any cash flows related to distinct investment components, an entity shall attribute both of the following:

- a. Cash inflows (including discounts and supplements) between the insurance component and any distinct performance obligations to provide goods or services in accordance with Topic 606 on revenue recognition.

- b. Cash outflows (including expenses and **acquisition costs**) between the insurance component and any distinct performance obligations to provide goods or services as follows:
 - 1. Cash outflows that relate directly to the insurance component or performance obligation shall be attributed to the insurance component or performance obligation, respectively.
 - 2. Cash outflows that relate to more than one component shall be allocated between those components on a rational and consistent basis, reflecting the costs that the entity would expect to incur if it issued that component as a separate contract.

834-10-25-9 An entity shall reassess whether components shall be separated from an insurance contract at each reporting period only to the extent that there was a substantial modification to the contract in that reporting period (see paragraph 834-10-40-4).

834-10-25-10 Throughout this Topic, an *insurance contract* refers to the components of an insurance contract that remain after an entity separates any components of that contract that are accounted for by applying other Topics in accordance with paragraphs 834-10-25-2 through 25-7.

> Recognizing an Insurance Contract

834-10-25-11 An entity shall recognize an insurance contract at the beginning of the **coverage period** of the insurance contract except as provided for in the following paragraph. Throughout this Topic, an **insurance contract liability** refers to the insurance contract regardless of whether the contract (or portfolio of contracts) is in an asset or liability position.

834-10-25-12 Before the beginning of the coverage period, an entity shall recognize a liability if facts and circumstances indicate that a **portfolio of insurance contracts** (see paragraphs 834-10-55-46 through 55-50) that it issued is onerous and the entity can no longer withdraw from its obligation to provide insurance **coverage** to policyholders for **insured events**. An insurance portfolio is onerous if the sum of the expected present value of the cash outflows within the contracts' boundaries and the qualifying acquisition costs exceed the present value of cash inflows within the contracts' boundaries (see paragraphs 834-10-55-132 through 55-136 for examples of facts and circumstances that may indicate a portfolio of insurance contracts is onerous).

834-10-25-13 Upon recognition of an insurance contract, its measurement shall include expected cash flows (net cash inflows and outflows for contracts measured using the building block approach and cash inflows for contracts measured using the premium allocation approach based on the criteria in paragraph 834-10-25-18) through the contract boundary.

834-10-25-14 The contract boundary is the point at which the entity no longer has a substantive obligation to provide the policyholder with coverage, which occurs when either of the following takes place:

- a. For an individual contract, the entity is no longer required to provide coverage or has the right or the practical ability to reassess the risk of the particular individual policyholder and, as a result, can set a price or level of benefits that reflects that risk.
- b. For a portfolio of contracts, if both of the following criteria are satisfied:
 1. The entity has the right or the practical ability to reassess the risk of the portfolio that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio.
 2. The pricing of the **insurance contract premiums** for coverage up to the date that the risks of the portfolio are reassessed does not take into account risks relating to future periods.

834-10-25-15 An entity shall determine the boundary of an insurance contract considering all substantive rights held by the policyholder, whether arising from contract, law, or regulation. An entity shall reassess its determination of the boundary of an insurance contract at each reporting period to the extent that there are changes in contractual features.

834-10-25-16 A **ceding entity (cedant)** shall recognize a **reinsurance asset (reinsurance recoverable)** or liability to reflect recoveries or payments that it expects related to the underlying insurance contracts covered by the **reinsurance** contract(s) at either of the following occurrences:

- a. If the reinsurance coverage is based on a direct proportion of the underlying insurance contracts within a portfolio when the underlying contracts are recognized
- b. If the reinsurance coverage is based on aggregate losses of the portfolio of underlying insurance contracts from the beginning of the reinsurance contract coverage period.

834-10-25-17 If a reinsurance contract is based on both aggregate losses and a direct proportion to the underlying contracts, an entity shall separately recognize those respective portions of the contract in accordance with the preceding paragraph.

> Determination of the Model

834-10-25-18 An entity shall apply the building block approach to measure its **insurance contract asset** or liability unless either of the following characteristics is present, in which case, an entity shall apply the premium allocation approach (see paragraphs 834-10-55-51 through 55-53):

- a. The coverage period of the insurance contract (determined in accordance with the boundary of the contract in paragraphs 834-10-25-14 through 25-15) is one year or less.
- b. At contract inception, it is unlikely that during the period before a **claim** is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract.

Initial Measurement

General

> Building Block Approach

834-10-30-1 An entity shall measure a **portfolio of insurance contracts** initially as the following:

- a. The **fulfillment cash flows** (see paragraphs 834-10-30-2 through 30-13 and 834-10-55-54 through 55-81).
- b. A **margin** measured as the fulfillment cash inflows in excess of the fulfillment cash outflows. If the fulfillment cash inflows less expected qualifying acquisition costs are less than the fulfillment cash outflows, an insurer shall recognize an immediate loss in net income.

834-10-30-2 The fulfillment cash flows comprise the present value of the unbiased, probability-weighted estimate of the future cash outflows less the future cash inflows (that is, expected value) that will arise as the entity fulfills the insurance contract (the yield curve that discounts those cash flows is discussed in paragraphs 834-10-30-11 through 30-13). The measurement objective of expected value is to determine the mean that considers all relevant information. An entity need not identify and quantify all possible scenarios, provided that the estimate is consistent with the measurement objective of determining the mean.

834-10-30-3 The fulfillment cash flows shall not be adjusted to reflect the risk of nonperformance by the entity, either at initial recognition or subsequently.

834-10-30-4 Estimates of cash flows for a portfolio of insurance contracts shall include all cash flows that relate directly to the fulfillment of the contracts in that portfolio (see paragraphs 834-10-55-54 through 55-81) and do all of the following:

- a. Reflect the perspective of the entity but, for market variables, be consistent with observable market prices
- b. Incorporate, in an unbiased way, all available current information about the amount, timing, and uncertainty of all cash flows that will arise as the entity fulfills the insurance contract

- c. Include only those cash flows that arise within the boundary of existing contracts (that is, all cash inflows and all related cash outflows that the entity will incur directly in fulfilling a portfolio of insurance contracts).

834-10-30-5 The cash outflows shall include all of the following costs:

- a. Costs that relate directly to the fulfillment of the contracts in the portfolio, such as payments to **policyholders**, some **claims** handling costs, and so forth
- b. Costs that relate directly to contract activity as part of fulfilling that portfolio of contracts and that can be allocated to those portfolios such as policy **maintenance costs** and some claims handling costs
- c. Other costs specifically chargeable to the policyholder under the terms of the contract.

834-10-30-6 As an entity receives cash for premiums, the liability increases, whereas as an entity pays claims and/or benefits and expenses to fulfill the contracts in the portfolio, the liability decreases.

834-10-30-7 The measurement of the fulfillment cash flows shall include embedded options and guarantees that are not accounted for as embedded derivatives under Topic 815. Those embedded options and guarantees are a result of features in an insurance contract that enable policyholders or the entity to take actions that change or otherwise affect the amount, timing, nature, or uncertainty of the benefits the policyholders will receive. Examples of those features include surrender options, conversion options, and options to cease paying premiums but still receive some benefits. Those features also may include interest rate guarantees and minimum benefit guarantees.

834-10-30-8 The measurement of the fulfillment cash flows for a participation feature that contractually depends wholly or partly on the performance of an underlying item shall reflect the measurement of the underlying item as described in paragraphs 834-10-35-6 through 35-10.

834-10-30-9 If the participation feature is contractually linked to a segregated portfolio of assets and, if, as a result of contractual, statutory, or regulatory requirements, both of the following conditions are met (**segregated fund arrangement**), an entity shall record the segregated portfolio of assets, which includes policyholder funds and the entity's proportionate interest in the segregated portfolio of assets, at **fair value** through net income (see paragraphs 834-10-55-91 through 55-92):

- a. The entity must invest the policyholder's funds as directed by the policyholder in designated investment alternatives or in accordance with specific investment objectives or policies.
- b. All of the investment performance, net of contract fees and assessments, must be passed through to the individual policyholder.

834-10-30-10 Some cash flows are received or paid on or before the day the insurance contract is initially recognized. Those cash flows shall be recorded when received or paid as part of the portfolio of insurance contracts to which the cash flows will relate.

834-10-30-11 The measurement of the fulfillment cash flows shall reflect the time value of money using discount rates that reflect the characteristics of the **insurance contract liability** (see paragraphs 834-10-55-93 through 55-103). Such rates shall do both of the following:

- a. Be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, in terms of, for example, timing, currency, and liquidity
- b. Exclude any factors that influence the observed rates but are not relevant to the insurance contract liability, for example, risks that are not present in the liability but that are present in the instrument for which the market prices are observed.

834-10-30-12 To the extent that the amount, timing, or uncertainty of the cash flows arising from an insurance contract depends wholly or partly on the performance of specific assets, the discount rates used in measurement of the insurance contract liability shall reflect that dependence.

834-10-30-13 Estimates of cash flows and discount rates shall be internally consistent to avoid double counting or omissions. For example, real cash flows (that is, those that include the effect of inflation) shall be discounted at rates that include the effect of inflation. Nominal cash flows (that is, those that exclude the effect of inflation) shall be discounted at rates that exclude the effect of inflation. Furthermore, the discount rates shall reflect only risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.

834-10-30-14 The margin shall include:

- a. The present value of expected **qualifying acquisition costs** to be incurred (that is, only those qualifying acquisition costs that will be paid in the future)
- b. Less the qualifying acquisition costs not yet recognized as an expense.

834-10-30-15 The direct **acquisition costs** shall include only the costs directly related to the entity's selling efforts that result in obtaining the insurance contracts in the portfolio, that is, qualifying acquisition costs (see paragraphs 834-10-55-104 through 55-111).

834-10-30-16 If the present value of the direct acquisition costs expected to be paid for acquiring a portfolio of insurance contracts exceeds the margin on the portfolio, an entity shall recognize an expense immediately in net income in the amount of such an excess.

> Premium Allocation Approach

834-10-30-17 Under the premium allocation approach, at initial recognition, an entity shall measure the **liability for remaining coverage** as:

- a. The premiums that are within the boundary of the existing contract; less
- b. Any additional **onerous contract** liability.

834-10-30-18 An entity shall recognize cash for the premiums received and a receivable for expected future premiums that are within the boundary of the existing contract.

834-10-30-19 An entity shall adjust the liability for remaining coverage and any premiums receivable to reflect the time value of money if the contract has a financing component that is significant to the contract as defined according to the characteristics of a significant financing component under Topic 606 on revenue recognition (see paragraph 834-10-55-130). For contracts that have a financing component that is significant to the contract, the entity shall use the discount rates specified in paragraphs 834-10-30-11 through 30-13 as determined at initial contract recognition.

834-10-30-20 An entity need not adjust the liability for remaining coverage or premiums receivable to reflect the time value of money if the entity expects, at contract inception, that the time period between when the policyholder pays all or substantially all of the premium and when the entity provides the corresponding part of the **coverage** is one year or less (see paragraph 834-10-55-131).

834-10-30-21 The liability for remaining coverage shall include:

- a. The expected qualifying acquisition costs to be incurred (that is, only those qualifying acquisition costs that will be paid in the future on a present value basis if the liability for remaining coverage is discounted); less
- b. The qualifying acquisition costs not yet recognized as an expense.

834-10-30-22 An entity may recognize all costs of acquiring a portfolio of insurance contracts when incurred as an expense in net income if the contracts' **coverage periods** are one year or less.

834-10-30-23 An entity shall determine whether insurance contracts are onerous and, if applicable, measure the amount of the additional onerous contract liability at the portfolio level.

834-10-30-24 When facts and circumstances indicate that the sum of the expected cash outflows of a portfolio of insurance contracts associated with claims to be incurred during the unexpired portion of coverage and the expected qualifying acquisition costs will exceed the carrying amount of the liability related to the unexpired portion of coverage (that is, the liability for remaining coverage), an entity shall perform an onerous contract test. If the test results in determining

a portfolio is onerous, the entity shall recognize an additional onerous contract liability and a corresponding expense for the excess of the fulfillment cash flows relating to future claims and expenses expected to be incurred that are within the boundaries of existing contracts in the portfolio and the expected qualifying acquisition costs over the liability for remaining coverage (that is, the premiums not yet recognized), net of acquisition costs (see paragraphs 834-10-55-132 through 55-136).

834-10-30-25 An entity shall perform the onerous contract test and shall measure the liability in the same manner as it measures the liability for claims incurred for that portfolio of insurance contracts. If an entity elects not to discount the **liability for incurred claims** that are expected to be paid within one year of the claim having been incurred or when the effects of discounting are immaterial, the entity shall use an undiscounted basis in identifying whether contracts are onerous and in measuring the liability for onerous contracts.

> Reinsurance Contracts

834-10-30-26 The guidance in paragraphs 834-10-30-27 through 30-34 addresses the **ceding entity's (cedant's)** accounting for its **reinsurance** contracts held. The guidance in paragraph 834-10-30-35 addresses the assuming entity's accounting.

834-10-30-27 A cedant shall consider whether a reinsurance contract meets the definition of an insurance contract (that is, transfers significant **insurance risk**) after separating any noninsurance components as described in paragraphs 834-10-25-1 through 25-7.

834-10-30-28 A cedant shall account for a reinsurance contract using the same approach (building block approach or premium allocation approach) that the cedant uses to account for the underlying insurance contracts. Reinsurance contracts that reinsure both contracts measured using the building block approach and contracts measured using the premium allocation approach shall be separated on the basis of the underlying contract measurement model, with each component accounted for using the same approach used to account for the underlying insurance contracts.

834-10-30-29 A cedant shall measure a reinsurance contract at initial recognition as the fulfillment cash flows from the reinsurance contract that will arise as parties fulfill the reinsurance contract (that is, the expected net cash flows).

834-10-30-30 For reinsurance contracts that provide coverage for events that occurred before the purchase of the reinsurance contract, that is, **retroactive reinsurance** contracts:

- a. If the expected present value of the cedant's cash inflows from the reinsurance contract are less than the expected present value of the

cedant's cash outflows from the reinsurance contract, an entity shall recognize an immediate loss for the difference in net income.

- b. If the expected present value of the cedant's cash inflows from the reinsurance contract exceeds the expected present value of the cedant's cash outflows from the reinsurance contract (that is, recovery of losses exceeds the premiums ceded), an entity shall recognize a margin measured as that excess.

834-10-30-31 For reinsurance contracts that provide coverage for future events, that is, **prospective reinsurance** contracts:

- a. If the expected present value of the cedant's cash inflows from the reinsurance contract are less than the expected present value of the cedant's cash outflows from the reinsurance contract, an entity shall recognize that amount as part of the cost of reinsurance.
- b. If the expected present value of the cedant's cash inflows from the reinsurance contract exceeds the expected present value of the cedant's cash outflows from the reinsurance contract and the contract is accounted for using the building block approach, an entity shall recognize a margin measured as that excess. Whereas, if the contract is measured using the premium allocation approach, the entity shall not record a separate margin, but instead recognize that amount as it recognizes its cost of reinsurance.

834-10-30-32 A cedant shall estimate the fulfillment cash flows (including the ceded premium) for a reinsurance contract using assumptions consistent with those used to measure the corresponding part of the fulfillment cash flows for the underlying insurance contract(s), without reference to the margin on the underlying contract(s) for contracts measured using the building block approach.

834-10-30-33 A cedant shall recognize ceding commissions and other fees expected to be received from the **reinsurer** that are not contingent on claims and benefits experience as a reduction of the premium ceded to the reinsurer.

834-10-30-34 When measuring the fulfillment cash flows for a reinsurance contract, a cedant shall consider the risk of nonperformance by the reinsurer on an expected loss basis in accordance with Subtopic 825-15 on credit losses.

834-10-30-35 For the purposes of applying the guidance in this Topic, an entity shall treat its reinsurance contracts assumed as direct contracts written, except that ceding commissions and other fees expected to be paid to the cedant that are not contingent on claims and benefits experience shall be reflected in the expected cash inflows (that is, as a reduction in those cash inflows and the assumed premium).

> Insurance Contracts Acquired in a Business Combination or Portfolio Transfer

834-10-30-36 At the acquisition date, an acquiring entity shall measure at fair value, in accordance with Topic 805 on business combinations, the insurance liabilities assumed and insurance assets acquired in a business combination and present as the following components:

- a. Fulfillment cash flows measured using current assumptions in accordance with the acquiring entity's accounting policies for insurance contracts that it issues in accordance with this Topic
- b. A margin measured as the fair value of the insurance contracts in excess of the expected net cash flows determined in (a). If the present value of fulfillment cash flows exceeds the fair value of the insurance contracts, the acquiring entity shall recognize a loss at the acquisition date.

834-10-30-37 An entity shall measure and present a portfolio of insurance contracts acquired in a **portfolio transfer** that does not meet the definition of a business combination in Topic 805 as the following components:

- a. Fulfillment cash flows measured using current assumptions in accordance with the entity's accounting policies for insurance contracts that it issues and adjusting the consideration received for any other assets and liabilities acquired in the portfolio transfer, such as financial assets and customer relationships
- b. A margin measured as the fulfillment cash inflows in excess of the fulfillment cash outflows. If the fulfillment cash outflows exceed the fulfillment cash inflows, an entity shall recognize an immediate loss in net income.

834-10-30-38 For contracts acquired in a business combination or portfolio transfer, the interest accretion rates for purposes of recognizing interest expense on the insurance liability presented in net income in the future shall be calculated based on discount rates at the date of acquisition or the portfolio transfer (see paragraphs 834-10-30-11 through 30-13).

Subsequent Measurement

General

> Building Block Approach

834-10-35-1 An entity shall record the **carrying amount** of a **portfolio of insurance contracts** at the end of each reporting period as both of the following:

- a. The **fulfillment cash flows** at that date
- b. The remaining amount of the **margin**.

834-10-35-2 The fulfillment cash flows shall reflect all available information at the end of the reporting period regarding the amount, timing, and uncertainty of the remaining future cash flows (see paragraphs 834-10-55-71 through 55-77).

834-10-35-3 An entity shall recognize changes in the fulfillment cash flows in net income except as provided for in paragraph 834-10-35-5.

834-10-35-4 The discount rates used to reflect the time value of money and in determining the measurement of the fulfillment cash flows shall be updated to reflect all available information at the end of the reporting period, including the changes in the characteristics of the portfolio of insurance contracts, for example, changes in duration.

834-10-35-5 An entity shall recognize changes in the fulfillment cash flows due to changes in the discount rates in other comprehensive income (see paragraphs 834-10-55-112 through 55-117). An entity shall recognize in accumulated other comprehensive income the difference between the **insurance contract liability** recognized in the statement of financial position, using current discount rates, and the amount the insurance contract liability would be if it were determined at the interest accretion rates (see paragraphs 834-10-35-24 through 35-25 for determining the interest accretion rates).

834-10-35-6 If a participation feature gives a **policyholder** or its beneficiary the right to receive benefits that contractually depend wholly or partly on the performance of an underlying item as measured in accordance with U.S. generally accepted accounting principles (GAAP), the measurement of the liability shall reflect the measurement of the underlying item.

834-10-35-7 If the right to receive benefits related to the performance of an underlying item is based on a contractual feature other than the measurement of the underlying item in the financial statements prepared in accordance with U.S. GAAP and that difference reflects a timing difference that will reverse and enter into future calculations of participating benefits, the measurement of the liability shall be based on the contractual feature and shall be adjusted if necessary to reflect the measurement of the underlying items in accordance with U.S. GAAP (see paragraphs 834-10-55-84 through 55-87).

834-10-35-8 Adjustments to the entity's liability as described in paragraphs 834-10-35-6 through 35-7 shall be presented in the same manner as the changes in the underlying item (that is, either in net income or in other comprehensive income).

834-10-35-9 If the right to receive benefits related to the performance of an underlying item is based on a contractual feature other than the measurement of the underlying item in the financial statements prepared in accordance with U.S. GAAP and that difference does not reflect a timing difference that will reverse and enter into future calculations of participating benefits, the measurement of the liability shall be based on the contractual feature (for example, the contractual

feature passes through to the policyholder the **fair value** of the underlying) (see paragraphs 834-10-55-88 through 55-90). Changes in the entity's liability shall be presented in net income.

834-10-35-10 The measurement of the fulfillment cash flows for a contractual participation feature that includes discretionary elements shall reflect the entity's expectations of the timing and amount of discretionary payments to a portfolio of policyholders.

834-10-35-11 The measurement of the fulfillment cash flows shall exclude premium receivable for any unconditional right to any premiums or other consideration (that is, a right to premiums or other consideration if nothing other than the passage of time is required before payment of that consideration is due). That amount shall be presented separately and accounted for in accordance with Topic 310 on receivables.

834-10-35-12 An entity shall recognize revenue from premiums attributable to the fulfillment cash flows from a portfolio of contracts over the **coverage period** in proportion to the value of **coverage** and any other services that the insurer has provided (see paragraphs 834-10-55-162 through 55-169). An entity's methodology used to determine the value of coverage for each portfolio shall be applied consistently throughout the life cycle of the portfolio. Any effect of the re-estimation of the value of coverage and any other services to be provided in the future shall be included prospectively in revenue recognized from the beginning of the period in which the re-estimation occurs.

834-10-35-13 An entity shall recognize **claims**, benefits, and contract-related expenses when the claim is incurred and other nonclaims fulfillment costs when those costs are incurred. Those amounts shall be adjusted for any previously recognized amounts for losses on initial recognition or changes in fulfillment cash flows related to claims, benefits, and contract-related expenses.

834-10-35-14 If a feature of an insurance contract requires an entity to pay amounts to policyholders or their beneficiaries regardless of whether an **insured event** occurs (**estimated returnable amount**), an entity shall exclude both of the following (see paragraphs 834-10-55-154 through 55-161):

- a. From revenue the amounts that have been received from the policyholder, plus accretion of interest on those amounts, for such repayments
- b. From expenses for claims and benefits the amounts related to the **insurance contract premium** excluded from revenue in (a).

834-10-35-15 To determine the amount of revenue to be recognized, at each reporting date an entity shall estimate the cash flows attributable to the insurance component and to the estimated returnable amount based on current assumptions utilized in the measurement of the insurance contract liability in accordance with paragraph 834-10-35-2. Any effect of this re-estimation on the

cash flows attributable to the insurance component shall be included prospectively in revenue recognized from the beginning of the period in which the re-estimation occurs (see paragraphs 834-10-55-154 through 55-161).

834-10-35-16 Revenue for the fulfillment of cash flows shall include interest accretion on the premiums received for the insurance component and other services related to the fulfillment of cash flows to reflect the time value of money for the period of time between when the entity receives premium and its provision of the corresponding coverage, using the interest accretion rates specified in paragraphs 834-10-35-24 through 35-25.

834-10-35-17 The remaining amount of the margin consists of all of the following:

- a. The carrying amount at the start of the reporting period; plus
- b. Interest accreted on the carrying amount; less
- c. The amount recognized as revenue in net income in the reporting period.

834-10-35-18 An entity shall recognize the margin determined at initial recognition as revenue in net income over the coverage and **settlement periods** as the entity satisfies its **performance obligation** to stand ready to compensate the policyholder on occurrence of a specified event that adversely affects the policyholder.

834-10-35-19 An entity satisfies its performance obligation as it is released from exposure to risk as evidenced by a reduction in the variability of cash flows of a portfolio of insurance contracts. An entity shall consider both of the following facts and circumstances to qualitatively determine whether a reduction in the variability of cash flows of a portfolio of insurance contracts has occurred and an entity is released from risk (see paragraphs 834-10-55-137 through 55-152).

- a. If the variability of the cash flows is primarily due to timing of the insured event, an entity is released from risk on the basis of reduced uncertainty in the timing of the specified event.
- b. If the variability of the cash flows is primarily due to the **frequency** and **severity** of the insured event, an entity is released from risk as variability in the cash flows is reduced as information about expected cash flows becomes clearer throughout the life cycle of the contract.

834-10-35-20 An entity shall consider changes in actual and expected cash flows of a portfolio of contracts in determining its release from risk, which may affect the pattern in which the margin is recognized, but shall not adjust the margin for those changes unless the changes are deemed to be a contract modification (see paragraphs 834-10-40-4 through 40-6 and 834-10-55-170).

834-10-35-21 The amounts included in the margin for qualifying acquisition costs in paragraph 834-10-30-14 shall be recognized as follows (see paragraph 834-10-55-153):

- a. The present value of expected qualifying acquisition costs to be incurred shall be reduced as those costs are incurred with a corresponding offset to cash or a payable.
- b. The qualifying acquisition costs not yet recognized as an expense, including the accretion of interest, shall be recognized as an expense in net income in the same pattern that the margin is recognized as revenue (see paragraphs 834-10-35-17 through 35-19).

834-10-35-22 If the expected cash outflows (including expected qualifying acquisition costs) of a portfolio of insurance contracts exceed the expected cash inflows, an entity shall recognize the remaining margin as revenue in net income.

834-10-35-23 An entity shall accrete interest on the carrying amount of the margin and the qualifying acquisition costs to reflect the time value of money, using the interest accretion rates specified in paragraphs 834-10-35-24 through 35-25 as determined at initial recognition of the portfolio of contracts.

834-10-35-24 Interest expense to reflect accretion on the insurance-related balances shall be reflected in net income based on the interest accretion rates. The interest accretion rates shall be the same as the discount rates that were initially applied at inception of the contract or when the contract was acquired through a business combination or a **portfolio transfer**.

834-10-35-25 An entity shall adjust the interest accretion rates upon any change in expectations of the crediting rates on the affected policies that will affect the measurement of the insurance contract liability. The adjustment to the interest accretion rates shall result in the recognition of interest expense on a level-yield basis over the remaining life of the portfolio of contracts. The degree to which the interest accretion rates for the portfolio are adjusted shall reflect the relative value of the account balances to be credited and the extent to which the change in expected interest crediting rates for the portfolio related to the changes in expected asset returns to that portfolio affects the present value of expected cash flows on those account balances (see paragraphs 834-10-55-124 through 55-129).

> Premium Allocation Approach

834-10-35-26 At the end of each subsequent reporting period, the amount of the **liability for remaining coverage** shall be:

- a. The carrying amount at the start of the reporting period plus interest accreted on that amount, determined in accordance with paragraphs 834-10-30-19 through 30-20; less
- b. The amount released as **insurance contract revenue** in respect of coverage provided in the period in accordance with paragraph 834-10-35-27; plus or minus

- c. Any changes in estimate relating to any **onerous contract** liability recognized in accordance with paragraphs 834-10-30-23 through 30-25.

834-10-35-27 An entity shall reduce the measurement of the liability for remaining coverage, gross of the qualifying acquisition costs incurred, and recognize a corresponding amount of revenue, in proportion to the value of coverage that the insurer has provided. That amount of revenue shall be based on the passage of time or on the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

834-10-35-28 If a feature of an insurance contract requires an entity to pay amounts to policyholders or their beneficiaries regardless of whether an insured event occurs (estimated returnable amount), an entity shall exclude both of the following (see paragraphs 834-10-55-160 through 55-161):

- a. From revenue the amounts that have been received from the policyholder, plus accretion of interest on those amounts, if interest is accreted on the liability for remaining coverage for such repayments
- b. From expenses for claims and benefits the amounts related to the insurance contract premium excluded from revenue in (a).

834-10-35-29 An entity shall reevaluate whether a portfolio of contracts is onerous (see paragraphs 834-10-30-23 through 30-25) and update the measurement of any additional onerous contract liability at the end of each reporting period and reverse it to the extent that the portfolio is no longer onerous.

834-10-35-30 An entity shall reduce the expected qualifying acquisition costs included in the liability for remaining coverage as those costs are incurred with a corresponding offset to cash or a payable.

834-10-35-31 The amounts included in the liability for remaining coverage for qualifying acquisition costs in paragraph 834-10-30-21 shall be recognized as follows (see paragraph 834-10-55-153):

- a. The expected qualifying acquisition costs to be incurred shall be reduced as those costs are incurred with a corresponding offset to cash or a payable.
- b. The qualifying acquisition costs not yet recognized as an expense, including the accretion of interest if initially measured on a present value basis, shall be recognized as an expense in net income in the same pattern that the liability for remaining coverage is recognized as revenue (see paragraph 834-10-35-27).

834-10-35-32 Upon the occurrence of insured events, an entity shall recognize the **liability for incurred claims** measured as the present value of expected fulfillment cash flows reflecting all available information on the amount, timing, and uncertainty of the remaining future cash flows (see paragraphs 834-10-55-54 through 55-81) and a corresponding expense in net income.

834-10-35-33 The discount rates used to measure the liability for incurred claims shall reflect the characteristics of the liability in accordance with paragraphs 834-10-30-11 through 30-13. The discount rates used to recognize the corresponding expense shall be the discount rates determined at initial recognition of the portfolio of contracts. As a practical expedient, an entity need not discount a portfolio or portfolios of incurred claims when the effects of discounting are immaterial to the portfolio(s) or when the incurred claims are expected to be paid within one year of the insured event.

834-10-35-34 If a participation feature gives a policyholder the right to receive benefits that contractually depends wholly or partly on the performance of an underlying item, the measurement of that feature within the liability for incurred claims shall be determined in a manner that is consistent with the measurement of such participating features for contracts measured using the building block approach (see paragraphs 834-10-35-6 through 35-10).

834-10-35-35 An entity shall update the measurement of the liability for incurred claims at the end of each reporting period with any changes recognized in net income other than changes described in paragraph 834-10-35-37.

834-10-35-36 An entity shall consider the portion of the cash flows that are contingent on claims or benefits experience (that is, **loss sensitive features**) as part of the claims and benefits cash flows.

834-10-35-37 When the liability for incurred claims is discounted, an entity shall recognize the changes in the fulfillment cash flows due to changes in the discount rates in other comprehensive income (see paragraphs 834-10-55-118 through 55-123). An entity shall recognize in accumulated other comprehensive income the difference between the insurance contract liability recognized on the statement of financial position, using current discount rates, and the amount the insurance contract liability would be if it were determined at the interest accretion rates in accordance with paragraph 834-10-35-24 through 35-25, if applicable.

834-10-35-38 To reflect the accretion of the discount on the insurance-related balances, interest expense shall be reflected in net income based on the interest accretion rates (see paragraphs 834-10-35-24 through 35-25).

> Reinsurance

834-10-35-39 A cedant shall record the carrying amount of a **reinsurance** recoverable at the end of each reporting period as the sum of all of the following:

- a. The fulfillment cash flows at that date
- b. The remaining amount of the margin, if applicable
- c. Any changes in the risk of nonperformance by the **reinsurer**.

834-10-35-40 The fulfillment cash flows shall reflect all changes in the measurement of those cash flows for the underlying insurance contract(s)

covered by the reinsurance contract. Changes in the fulfillment cash flows shall be presented in the same manner as the changes in the underlying item (that is, in net income or in other comprehensive income).

834-10-35-41 A cedant shall recognize the remaining margin on **prospective reinsurance** contracts measured using the building block approach as the cedant satisfies its performance obligation on the underlying insurance contracts covered by the reinsurance contract (that is, over the coverage and settlement period).

834-10-35-42 For **retroactive reinsurance** contracts, a cedant shall recognize the margin in net income over the remaining settlement period for contracts measured using both the building block approach and the premium allocation approach.

834-10-35-43 To reflect any changes in the risk of nonperformance by the reinsurer, a cedant shall apply Subtopic 825-15 on credit losses to assess the recoverability of a **reinsurance asset**. In accordance with that Subtopic, the cedant shall consider all facts and circumstances, including collateral (for example, funds held by or deposited with the cedant and letters of credit), when assessing the risk of nonperformance by the reinsurer.

834-10-35-44 Any losses from disputes with a reinsurer shall be reflected in the measurement of the reinsurance recoverable when current information indicates the cedant may be unable to collect amounts due according to the contractual terms of the reinsurance contract.

834-10-35-45 For reinsurance contracts that a cedant holds, the cedant shall recognize:

- a. Consideration paid to the reinsurer (that is, ceded premium amounts) in net income (excluding amounts that were excluded from the cedant's recognition of revenue related to estimated returnable amounts) in the same manner as the cedant recognizes revenue on the underlying portfolio of the contract(s) subject to the reinsurance contract.
- b. Expected reinsurance recoverables in net income in the same manner as the cedant recognizes in net income claims and/or benefits incurred on the underlying insurance contracts.

834-10-35-46 A cedant shall consider the portion of the cash flows within the reinsurance contract, including premiums and ceding commissions, that are contingent on claims or benefits experience (that is, loss sensitive features) as part of the claims and benefits cash flows. Any features that provide a cedant with a unilateral right but not an obligation to pay an additional premium to reinstate a reinsurance contract shall not be considered to be contingent on claims and benefits experience for purpose of applying the guidance in this Topic.

> Foreign Currency Transactions

834-10-35-47 When remeasuring insurance transactions denominated in a foreign currency in accordance with Subtopic 830-20 on foreign currency matters, all financial statement components related to an insurance contract shall be classified as monetary.

Derecognition

General

834-10-40-1 An entity shall derecognize an **insurance contract liability** (or part of it) from the statement of financial position when, and only when, it is extinguished (that is, when the obligation specified in the insurance contract is discharged, cancelled, or expires). At that point, the entity is no longer at risk and is, therefore, no longer required to transfer any economic resources to satisfy the insurance obligation.

834-10-40-2 When a **ceding entity (cedant)** enters into a **reinsurance** contract, it shall derecognize the underlying contract(s) if, and only if, its obligation to the **policyholder(s)** is extinguished.

834-10-40-3 A **commutation** of a reinsurance contract shall be treated as a cancellation of the reinsurance contract, and therefore any related balances shall be derecognized from an entity's statement of financial position. Any gains or losses on commutations shall be recognized as an adjustment to the following:

- a. **Claims** or benefits through net income for contracts (or portions of contracts) in which the **coverage period** has ended
- b. Premiums ceded for future **coverage**.

> Contract Modifications

834-10-40-4 A contract modification occurs when the parties to the contract approve a change in the terms of a contract. An entity shall derecognize the original insurance contract and recognize the modified contract as a new contract if there is a substantial modification. Paragraph 834-10-55-170 includes criteria to consider in determining if a modification is substantial.

834-10-40-5 For a substantial modification, an entity shall adjust the **margin**, that is, recognize a gain or loss for the difference between the measurement of the modified contract using the current entity-specific price that the entity would hypothetically charge the policyholder for a contract equivalent to the new contract and the **carrying amount** of the contract to be derecognized. In addition, an entity shall recognize an expense for the related portion of **qualifying acquisition costs**.

834-10-40-6 If the modification is not substantial, an entity shall account for the modification as follows:

- a. If the modification eliminates the entity's obligation to provide some of the benefits that the contract would have previously required it to provide, the entity shall derecognize that portion of its obligation, including any related portion of the margin (and an expense for any related qualifying acquisition costs) if the contract is accounted for using the building block approach.
- b. If the modification entitles the policyholder to additional benefits, the entity shall treat the modification as if the amendment was a new contract (that is, the entity shall recognize an obligation to provide additional coverage or services). In that case, if the contract is accounted for using the building block approach, the margin related to the modification shall be added to the margin on the original contract using the same discount rates and interest accretion rates as the original contract.

Other Presentation Matters

General

> Statement of Financial Position—Building Block Approach

834-10-45-1 An entity shall separately present all of the following in the statement of financial position (see paragraph 834-10-55-171):

- a. Premium receivable for any unconditional right to any premiums or other consideration (that is, a right to premiums or other consideration if nothing other than the passage of time is required before payment of that consideration is due)
- b. Expected net **reinsurance** recoverable (payable)
- c. Net **insurance contract liability** for the **fulfillment cash flows**
- d. Net **insurance contract asset** for the fulfillment cash flows
- e. Insurance contract **margin**.

834-10-45-2 If the expected cash inflows exceed the expected cash outflows, an entity shall present a portfolio as an asset in the statement of financial position, whereas, if the expected cash inflows are less than the expected cash outflows, an entity shall present a portfolio as a liability in the statement of financial position. A portfolio in an asset position and a portfolio in a liability position shall not be netted together.

> Statement of Financial Position—Premium Allocation Approach

834-10-45-3 An entity shall separately present all of the following in the statement of financial position (see paragraph 834-10-55-171):

- a. Premium receivable for expected cash inflows (that is, both premium conditional on the entity's future performance and any unconditional right to any premiums or other consideration as described in paragraph 834-10-45-1(a))
- b. Expected net reinsurance recoverable (payable)
- c. **Liability for remaining coverage**
- d. **Liability for incurred claims.**

> Statement of Comprehensive Income

834-10-45-4 An entity shall separately present in net income all of the following (see paragraph 834-10-55-172):

- a. **Insurance contract revenue** from contracts accounted for using the building block approach separately from contracts accounted for using the premium allocation approach, including interest accreted on the expected cash inflows and the margin in the respective revenue line item
- b. Benefits and claims expenses, including other costs to fulfill the **insurance contracts**, arising from contracts measured using the building block approach separately from claims expenses arising from contracts measured using the premium allocation approach
- c. Consideration ceded for reinsurance contracts, separately for contracts accounted for using the building block approach and the premium allocation approach
- d. Income from reinsurance recoverables for benefits, claims, and expenses arising from ceded reinsurance contracts, separately for the building block approach and the premium allocation approach
- e. **Qualifying acquisition costs** expensed during the period
- f. Interest expense:
 - 1. On the expected cash inflows and the margin
 - 2. For interest accreted on the expected cash outflows and the qualifying acquisition costs.

834-10-45-5 An entity shall either present as a separate item in net income or disclose in the notes all of the following, if applicable:

- a. Changes in estimates of future expected cash flows and reversals thereof (see paragraph 834-10-55-168)
- b. Losses on insurance contracts acquired in a **portfolio transfer** and/or business combination
- c. Losses at initial recognition of an insurance contract.

834-10-45-6 An entity shall either present as a separate item in net income or disclose in the notes a subtotal of the amounts from paragraph 834-10-45-4(a) through (e) and the preceding paragraph as underwriting margin.

834-10-45-7 An entity shall present investment income generated from the assets in the qualifying **segregated fund arrangements** and the interest credited to **policyholders** as a pass through of that investment income as part of investment income and interest expense, respectively, in net income.

Disclosure

General

> Objective

834-10-50-1 The objective of the disclosure requirements is to enable users of the financial statements to understand the amount, timing, and uncertainty of future cash flows arising from **insurance contracts**. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

- a. The amounts recognized in its financial statements arising from insurance contracts
- b. The significant judgments and changes in judgments made in applying the guidance in this Topic
- c. The nature and extent of risks arising from insurance contracts.

834-10-50-2 An entity shall consider the level of detail necessary to satisfy the disclosure objective and the degree of emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures 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 different characteristics.

834-10-50-3 An entity shall disaggregate disclosure information into primary categories. To meet that disclosure objective, an insurer may need to use more than one category to disaggregate the qualitative and quantitative disclosures. An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position. Examples of categories for disaggregation that might be appropriate include all of the following:

- a. Type of **coverage** (for example, major product lines)
- b. Geography (for example, country or region)
- c. Reportable segment, as defined in Topic 280 on segment reporting.

834-10-50-4 An entity shall disclose the information in paragraphs 834-10-50-5 through 50-35 for each reporting period presented in the annual financial statements.

> Reconciliations of Opening and Closing Balances

834-10-50-5 For contracts measured using the building block approach, an entity shall disclose reconciliations from the opening to the closing balances of all of the following:

- a. The insurance contract liabilities for the **fulfillment cash flows**
- b. The **insurance contract assets** for the fulfillment cash flows
- c. The insurance contract **margin**
- d. Reinsurance assets or liabilities arising from **reinsurance** contracts held by the **ceding entity (cedant)**.

834-10-50-6 For contracts measured using the premium allocation approach, an entity shall disclose reconciliations from the opening to the closing balances of both of the following:

- a. The **liability for incurred claims**
- b. Reinsurance assets or liabilities arising from reinsurance contracts held by the insurer as cedant.

834-10-50-7 For the reconciliations required by paragraphs 834-10-50-5 through 50-6, an entity shall provide information (see paragraphs 834-10-55-174 through 55-176) that would depict the following:

- a. New contracts
- b. Cash flows
- c. Changes in assumptions
- d. Derecognition of contracts.

> Disaggregation of Amounts

834-10-50-8 When applying the disaggregation criteria in paragraph 834-10-50-3 to the reconciliation of the opening and closing balances of the **insurance contract liability** and the liability for incurred claims, an entity shall not aggregate amounts from different reportable segments according to Topic 280.

834-10-50-9 An entity shall disaggregate the information disclosed in paragraphs 834-10-50-10 through 50-37 in the same way the entity disaggregates its reconciliation of the insurance contract liabilities or assets for those portfolios of contracts accounted for under the building block approach and the liability for incurred claims for those portfolios of contracts accounted for under the premium allocation approach, if applicable.

834-10-50-10 An entity shall disclose explanations of amounts disclosed in the reconciliations required in paragraphs 834-10-50-5 through 50-6 if additional relevant information would communicate incremental information not apparent from the captions and amounts alone. Those explanations may include any of the following:

- a. The reasons for the changes in the current period of prior estimates of the expected cash flows
- b. Whether changes are attributed to the **estimated returnable amount** or the insurance component
- c. The primary drivers behind the amount disclosed.

834-10-50-11 In addition to disclosures that would be made in accordance with Subtopic 825-15 on credit losses, an entity shall disclose both of the following amounts related to the reinsurance recoverable:

- a. Amounts of the reinsurance recoverable related to paid claims
- b. Amounts included in the allowance for the reinsurance recoverable during the reporting period disaggregated in a manner consistent with the disaggregation of the reconciliation of the opening and closing balance of the reinsurance recoverable.

834-10-50-12 An entity shall disclose all of the following amounts:

- a. The balance of premiums received but not yet earned, excluding the estimated returnable amount, for contracts measured using the building block approach
- b. The amounts payable on demand (from the estimated returnable amount), if any, disaggregated between those portfolios of contracts accounted for under the building block and the premium allocation approaches
- c. The estimated returnable amount of the fulfillment cash flows that represents the aggregate portions of the expected premiums received and claims and/or benefits that are expected to be excluded from revenue in net income, disaggregated between those portfolios of contracts accounted for under the building block and the premium allocation approaches
- d. The portion of the fulfillment cash flows paid during the current period attributable to the estimated returnable amount disaggregated between those portfolios of contracts accounted for under the building block and the premium allocation approaches.

834-10-50-13 An entity shall disclose amounts released from the margin to revenue during the period if the expected cash outflows (including qualifying acquisition costs) of a **portfolio of insurance contracts** will exceed the expected cash inflows.

834-10-50-14 An entity shall disclose the amount of the **qualifying acquisition costs** incurred but not yet recognized as an expense that are included in the margin for contracts measured using the building block approach or the liability for remaining coverage for contracts measured using the premium allocation approach.

834-10-50-15 An entity shall disaggregate all of the following amounts reported within line items in net income:

- a. Gains or losses from **commutations** of reinsurance agreements
- b. Amounts recognized for onerous portfolios
- c. The amount of interest included in the revenue line item
- d. The significant components of interest expense attributable to insurance contracts (for example, accretion of interest on the fulfillment cash inflows, cash outflows, and margin).

834-10-50-16 For qualifying **segregated fund arrangements**, an entity shall disclose all of the following:

- a. The amount of the assets in the qualifying **segregated fund arrangements** and those amounts that:
 - 1. Are legally insulated from the entity's other assets (that is, the entity's **general account**) and those that are not
 - 2. Represent the insurer's proportionate interest.
- b. The portion of the liability directly linked to segregated fund arrangements.
- c. The interest credited to **policyholders** as a pass through of the investment income if not presented separately in the statement of comprehensive income.

834-10-50-17 For participating contracts that do not qualify as segregated fund arrangements, an entity shall disclose both of the following:

- a. The general criteria on which the participation features of the contracts are based and the amount during the period that accrued to the benefit of the policyholders because of those features
- b. For contracts in which the entity's nondiscretionary obligation is contractually dependent on the performance of other assets or liabilities of the entity or the performance of the entity itself, and the contract does not qualify as a segregated fund arrangement:
 - 1. How participation features are measured (that is, what the participating features are based on)
 - 2. The quantitative amount of the adjustment, if any, to the gross obligation in (1) (that is, the measurement of the asset or liability to which the measurement of the liability is adjusted) and whether the adjustment is recognized in net income or in other comprehensive income.

834-10-50-18 An entity shall disclose the present value of expected dividends to policyholders not yet declared that are included in the measurement of the liability.

834-10-50-19 An entity shall disclose the significant differences between gross premiums ceded and net premiums ceded (that is, premiums net of ceding

commissions and other costs paid to the cedant), excluding any estimated returnable amount.

834-10-50-20 For transactions and events during the reporting period that are significant to the reporting entity for which there are no specific disclosure requirements in other Topics, an entity shall include disclosures that provide sufficient information to understand the nature and effect of the transaction (see paragraph 834-10-55-177).

> Discount Rates and Expected Cash Flows

834-10-50-21 An entity shall disclose the expected fulfillment cash flows for the insurance contract liability, the liability for incurred claims, and reinsurance recoverables (with an indication of whether the amounts are discounted or undiscounted) in a manner consistent with how the entity disaggregates its reconciliation of liability balances. An entity shall disclose those amounts in both of the following time bands with the respective weighted-average discount rates used to determine the measurement of the expected fulfillment cash flows recognized in the statement of financial position (that is, the current rates) and the interest accretion rates recognized in net income:

- a. For contracts measured using the building block approach:
 1. The two five-year time bands up to the 10th year
 2. Each of the next 2 10-year time bands following the 10th year and up to the 30th year
 3. The total for years following the 30th year after the reporting date.
- b. For contracts measured using the premium allocation approach:
 1. Each of the first five years after the reporting date
 2. The next two five-year time bands following the first five years after the reporting date
 3. The total for years following the 15th year after the reporting date.

834-10-50-22 An entity shall disclose any additional information about amounts and rates within the time bands provided that significantly affect the weighted-average discount rates and/or the interest accretion rates.

> Inputs, Judgments, and Assumptions

834-10-50-23 An entity shall disclose information about significant judgments and changes in judgments in sufficient detail to explain the methods and inputs that are used to develop the measurements.

834-10-50-24 For the assumptions that have the most significant effect on the measurement of the balances related to insurance contracts, an entity shall disclose the methods used and the processes for estimating the inputs to those methods. When practicable, the entity also shall provide quantitative information about those inputs.

834-10-50-25 If there is a material effect on the financial statements because of changes in the methods and inputs used to measure insurance contracts, an entity shall disclose separately the effect of each change on the financial statements, together with an explanation of the reason for the change, identifying the type of contracts affected.

834-10-50-26 Specific disclosures of inputs, judgments, and assumptions shall include all of the following:

- a. The nature of the key inputs used to measure the liability
- b. Methods, inputs, and assumptions that are used to separate the noninsurance components
- c. Methods and assumptions for measuring the estimates of **policyholder dividends**.

834-10-50-27 An entity shall disclose a narrative description of the sensitivity of the insurance balances to changes in inputs used in the measurement of those balances if a change in those inputs to a different amount might result in a significantly higher or lower measurement in those balances. If there are interrelationships between those inputs, a reporting entity also shall provide a description of those interrelationships and how they might magnify or mitigate the effect of changes in the inputs on the measurement of insurance balances (that is, an entity shall consider correlation between inputs). For purposes of this disclosure, an entity shall not take into account inputs that are associated with remote scenarios.

> Risks

834-10-50-28 An entity shall disclose information about the nature and extent of risks arising from insurance contracts in sufficient detail to help users of financial statements evaluate the amount, timing, and uncertainty of future cash flows arising from insurance contracts.

834-10-50-29 To comply with the guidance in the preceding paragraph, an entity shall disclose all of the following:

- a. The exposures to risks and how they arise
- b. Its objectives, policies, and processes for managing risks arising from insurance contracts and the methods used to manage those risks
- c. Changes in (a) or (b) from the previous reporting period.

834-10-50-30 If applicable, an entity shall disclose information about the effect of the insurance regulatory requirements, including all of the following:

- a. The amount of minimum capital necessary to satisfy the entity's regulatory requirements
- b. The amount of its regulatory capital

- c. Any regulatory restrictions on the entity's ability to pay dividends or principle and interest on loans or notes
- d. Whether a regulatory event would have been triggered had the entity not used a specific practice permitted by a regulator to exempt the entity from an otherwise required statutory accounting regulation (that is, a permitted regulatory/**statutory accounting practice**).

834-10-50-31 An entity shall disclose information about **insurance risk** on a gross and net basis, before and after risk mitigation (that is, through reinsurance), disaggregated in the same way that the entity disaggregates its reconciliation of the insurance contract liabilities or assets, including all of the following:

- a. The sensitivity to insurance risk in relation to the effect on profit or loss and equity. That shall be disclosed by a sensitivity analysis that shows any material effect on earnings and equity that would have resulted from:
 - 1. Changes in the relevant risk variables that were reasonably possible at the end of the reporting period
 - 2. The methods and inputs used in preparing the sensitivity analysis
 - 3. Any changes from the previous period in the methods and inputs used.

However, if an entity uses an alternative method to manage sensitivity to market conditions, such as embedded value or value at risk, it can meet the requirement by disclosing that alternative sensitivity analysis.

- b. Concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each concentration (for example, type of **insured event**, geographical area, or currency). Concentrations of insurance risk can arise if an entity has, for example:
 - 1. Underwritten risks concentrated in one geographical area or one industry
 - 2. Underwritten risks that also are present in its investment portfolio, for example, if an insurer provides product liability protection to a particular industry and also holds investments in those companies.
- c. Actual claims compared with previous estimates of the undiscounted amount of the claims on an accident-year basis (that is, claims development). The disclosure about claims development shall go back to the period when the earliest material claim (or aggregation of claims that reach a material amount) arose for which there is uncertainty about the amount and timing of the claims payments, but need not go back more than 10 years. An entity need not disclose information about the development of claims for which uncertainty about the amount and timing of claim payments is typically resolved within one year of the insured event. An entity shall reconcile the disclosure about claims

development with the **carrying amount** of the insurance contract liabilities recognized in the statement of financial position.

834-10-50-32 For insurance or reinsurance contracts, an entity shall disclose both of the following disaggregated in the same way that the entity disaggregates its reconciliation of the insurance contract liabilities or assets for those portfolios accounted for under the building block approach and the liability for incurred claims for those portfolios accounted for under the premium allocation approach:

- a. Summary quantitative information about its exposure to the significant risks, other than insurance risk, at the end of the reporting period. This disclosure shall be based on the information provided internally to the key management personnel of the entity and shall provide information about the risk management techniques and methodologies applied by the entity.
- b. Concentrations of risk, other than insurance risk, if not apparent from other disclosures. Those concentrations can arise from, for example, interest rate guarantees on a large number of contracts that come into effect at the same rate, for example, 4 percent.

834-10-50-33 With regard to credit risk arising from reinsurance contracts held and, if applicable, insurance contracts, an entity shall disclose both of the following:

- a. The amount that represents its maximum exposure to credit risk considering reasonable scenarios that include all relevant information at the end of the reporting period, or disclose if no maximum exposure exists
- b. Information about the credit quality of reinsurance assets, considering reinsurance receivables and prepaid reinsurance premium.

834-10-50-34 With regard to market risk, an entity shall disclose all of the following:

- a. A sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period (for example, interest rates, equity prices, and foreign currency exchange rates, among others), showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date. If an entity uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis or a sensitivity analysis (for example, value at risk), that reflects interdependencies between risk variables, and uses it to manage **financial risks**, it may use that sensitivity analysis to meet this requirement.
- b. An explanation of the methods and main inputs used in preparing the sensitivity analysis.

- c. An explanation of the objective of the methods used and of limitations that may result in the information not fully reflecting the carrying amount of the insurance balances involved.
- d. Changes from the previous period in the methods and inputs used and the reasons for those changes.

834-10-50-35 If the quantitative information about the entity's exposure to risk at the end of the reporting period is not representative of its exposure to risk during the period, the entity shall disclose that fact and the reasons for those conclusions and shall provide more information that is representative of the exposure during the period.

> Interim Reporting

834-10-50-36 An entity shall provide a reconciliation of opening and closing balances of the insurance liability (or asset) accounted for using the building block approach and the liability for incurred claims accounted for using the premium allocation approach when it reports interim results.

> Nonpublic Entities

834-10-50-37 Nonpublic entities are exempt from the requirement to provide disclosures in paragraphs 834-10-50-1 through 50-35 by reportable segment and are not required to provide the insurance disclosures required for interim periods.

Implementation Guidance and Illustrations

General

> Definition of an Insurance Contract

834-10-55-1 An **insurance contract** is a contract under which one party (the issuing entity) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder or its designated beneficiary if a specified uncertain future event (the **insured event**) adversely affects the policyholder.

834-10-55-2 In determining whether a contract meets the definition of an insurance contract, an entity should consider the following components of the definition.

> > Insurance Risk

834-10-55-3 The definition of an insurance contract refers to insurance risk. A contract that exposes the issuer to **financial risk** without significant insurance risk is not an insurance contract.

834-10-55-4 The definition of insurance risk refers to the risk that the entity accepts from the policyholder. In other words, insurance risk is a preexisting risk that is transferred from the policyholder to the entity.

834-10-55-5 Lapse or **persistence** risk (that is, the risk that the policyholder will cancel the contract earlier or later than the issuer had expected when pricing the contract) alone is not insurance risk because the payment to the counterparty is not contingent on an uncertain future event that adversely affects the counterparty. Similarly, expense risk (that is, the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in costs associated with insured events) alone is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty. Therefore, a contract that exposes the issuer to lapse risk, persistence risk, or expense risk is not an insurance contract unless that contract also exposes the issuer to significant insurance risk.

834-10-55-6 In addition to significant insurance risk, some contracts expose the issuer to financial risk. For example, many life insurance contracts guarantee a minimum rate of return to policyholders (creating financial risk) and, at the same time, promise death benefits that may significantly exceed the policyholder's account balance (creating insurance risk in the form of **mortality risk**). Those contracts are considered insurance contracts because the issuing party accepts significant insurance risk.

834-10-55-7 The definition of financial risk excludes nonfinancial variables that are specific to a party to the contract, such as the occurrence or nonoccurrence of a fire that damages or destroys an asset of that party. Examples of nonfinancial variables that are not specific to a party to the contract and therefore would not meet the definition of insurance include an index of earthquake losses in a particular region or temperatures in a particular city. Furthermore, the risk of changes in the **fair value** of a nonfinancial asset is not a financial risk if the fair value reflects not only changes in market prices for such assets (that is, a financial variable), but also the condition of a specific nonfinancial asset held by a party to a contract (that is, a nonfinancial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, that risk is insurance risk, not financial risk.

> > Significant Insurance Risk

834-10-55-8 To be considered an insurance contract or a ceded **reinsurance** contract, a contract must transfer significant insurance risk to the entity from the policyholder.

834-10-55-9 Insurance risk is considered significant if, and only if, an insured event exposes an entity to a significant loss. Existence of one scenario in which the present value of the cash flows expected to be paid by the entity can significantly exceed the present value of the premiums and other cash inflows will be considered to satisfy the existence of significant insurance risk. That condition can be met even if the insured event is extremely unlikely or even if the expected (that is, probability weighted) present value of the contingent cash flows is a small proportion of the expected present value of all of the remaining cash flows from the insurance contract.

834-10-55-10 A reinsurance contract that does not meet the condition in the preceding paragraph (that is, it does not expose the **reinsurer** to the possibility of a significant loss) is nonetheless deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the underlying insurance contract is assumed by the reinsurer, considering all features of the contract.

834-10-55-11 An entity should consider all cash flows with the counterparty without regard to how the individual cash flows are characterized. For example, the amount of insurance risk to which an entity is subject may be limited by contractual features such as experience refunds, cancellation provisions, sliding scale and other adjustable commissions, caps that limit the entity's aggregate exposure, corridors or portions of the loss in which the entity is not exposed to risk, other adjustable features to premiums, including reinstatement premiums, or the contract's **coverage**. In addition, an entity should consider retrospectively rated features in multiyear contracts. Those features may result in contracts not transferring significant insurance risk.

834-10-55-12 However, in assessing the significance of insurance risk, an entity should not consider the loss of the ability to charge the policyholder for future services such as future cash inflows that it would receive for asset management fees that the entity will not collect if the insured dies earlier than expected. Similarly, the loss of **surrender charges** that an insurer would have charged if the policyholder cancelled the policy should not be considered.

834-10-55-13 In determining whether an insured event exposes an entity to a loss in a particular scenario, the entity takes into account the effect of the time value of money. As a result, contractual terms that delay timely reimbursement to the policyholder, such as through payment schedules or accumulating retentions from multiple years, can eliminate significant insurance risk.

834-10-55-14 An entity should assess the significance of insurance risk contract by contract rather than by reference to materiality to the financial statements.

Contracts entered into with a single counterparty (or related counterparties) for the same risk or that are otherwise interdependent should be considered a single contract for risk transfer analysis. Indicators that contracts are interdependent include the following:

- a. The contracts are negotiated as a package with a single objective.
- b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

834-10-55-15 Because risk transfer should be analyzed on a contract-by-contract basis, insurance risk can be significant even if there is a minimal probability of material losses for a portfolio of contracts. However, if a portfolio of contracts is relatively homogeneous and the coverage provided is known to transfer significant insurance risk, an entity would not need to examine each contract within that portfolio to determine that the contract transfers significant insurance risk. For example, all contracts within a portfolio of life insurance contracts that pay a death benefit with a present value significantly in excess of the present value of premiums received or receivable would be deemed to transfer significant insurance risk.

834-10-55-16 If a contract is separated into an insurance component and one or more other components (for example, an **investment component**), the significance of the insurance risk transfer is assessed by reference only to the insurance component.

834-10-55-17 Some contracts have the legal form of insurance contracts but do not transfer significant insurance risk to the entity, such as some finite reinsurance contracts in which the insurer bears limited to no underwriting, credit, investment, and **timing risk**. The guidance in this Topic does not treat those contracts as insurance contracts, even though the contracts are traditionally described as insurance contracts and are generally subject to regulation by insurance regulators. Financial statements should reflect the economic substance of the contracts and not merely the legal form. If the economic substance of the transaction does not transfer significant insurance risk, it should not be accounted for as an insurance contract, notwithstanding the form of the contract.

> > Uncertain Future Event

834-10-55-18 Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:

- a. Whether an insured event will occur
- b. When an insured event will occur
- c. How much the entity will need to pay to settle its obligation related to the insured event.

834-10-55-19 In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.

834-10-55-20 Some insurance contracts cover events that have already occurred but whose financial effect is still uncertain. An example is a reinsurance contract that covers the direct insurer against adverse development of **claims** already reported by policyholders. In those contracts, there is uncertainty about how much the entity will need to pay to settle its obligations related to the insured event.

834-10-55-21 Some insurance contracts require or permit in-kind payments to be made to the policyholder, rather than cash payments. The method of compensation does not preclude a contract from meeting the definition of an insurance contract.

> > Adverse Effect on the Policyholder

834-10-55-22 Some contracts require a payment if a specified uncertain event occurs, but they do not require that there be an adverse effect on the policyholder as a precondition for payment. Those contracts are not insurance contracts even if the holder uses those contracts to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying nonfinancial variable that is correlated with the cash flows from an asset of the entity, the derivative is not an insurance contract because payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the underlying asset. Conversely, the definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder is a contractual precondition for payment. That contractual precondition does not require the entity to investigate whether the event actually caused an adverse effect, but the precondition does permit the entity to deny payment if it is not satisfied that the event did cause an adverse effect.

> > Changes in the Level of Insurance Risk

834-10-55-23 Some contracts do not transfer any insurance risk to the issuer at inception, although they do transfer it at a later time. For example, consider a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the annuity rates that are charged by the entity to other new annuitants with a similar risk profile at the time that the policyholder exercises the option. Such a contract transfers no insurance risk to the issuer until the option is exercised because the entity remains free to price the annuity on a basis that reflects the insurance risk that was transferred to the entity at that time. In other

words, the cash flows that would occur on exercise of the option fall outside the boundary of the contract, and there would be no insurance cash flows within the boundary of the current contract. However, if the contract specifies the **annuitization** rates (or a basis for setting the annuitization rates), the cash flows that would occur on exercise of the option would be within the boundary of the current contract and should be considered when determining risk transfer.

834-10-55-24 A contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished (that is, discharged, cancelled, or expired), unless there is a substantial modification to the contract that results in a new contract that no longer qualifies as an insurance contract within the scope of this Topic.

> > Examples of Insurance Contracts

834-10-55-25 All of the following are examples of contracts that are insurance contracts if the transfer of insurance risk is significant:

- a. Insurance against theft or damage to property
- b. Insurance against product liability, professional liability, civil liability, or legal expenses
- c. Life insurance, including traditional whole life insurance, term life insurance, and universal life insurance, and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance)
- d. Life-contingent annuities (that is, contracts that provide compensation for the uncertain future event—the survival of the annuitant—to assist the annuitant in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival)
- e. Insurance against disability and medical cost
- f. Surety bonds, fidelity bonds, performance bonds, and bid bonds (that is, contracts that compensate the holder if another party fails to perform a contractual obligation, for example, an obligation to construct a building)
- g. Product warranties issued by a third party for goods sold by a manufacturer, dealer, or retailer
- h. Title insurance (that is, insurance against the discovery of defects in title to real property)
- i. Travel insurance (that is, compensation in cash or in kind to policyholders for losses suffered during travel)
- j. Catastrophe bonds that provide for reduced payments of principal, interest, or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example, if the event is a change in an interest rate or foreign exchange rate)

- k. Insurance swaps and other contracts that require a payment based on changes in climatic, geological, or other physical variables that are specific to a party to the contract.

834-10-55-26 All of the following are examples of items that are not insurance contracts, assuming there is not a transfer of significant insurance risk:

- a. Guaranteed investment contracts that guarantee the policyholder principal repayment and a fixed or floating interest rate for a predetermined period of time, containing no options to purchase a life-contingent annuity.
- b. Deposit administration contract that functions solely as a vehicle for group pension plan fund accumulations, containing annual interest guarantees but containing no options to purchase a life-contingent annuity.
- c. Funding agreements that pay a guaranteed rate of return to special-purpose entities, corporations, mutual funds, and other institutional investors.
- d. Administrative-services-only contracts for groups or other insurance entities in which the entity is not at risk but only handles the administration of the insurance coverage or other services (for example, investment management, underwriting, group health claims administration, electronic data processing services, employee benefit plan administration, and mortgage services) for a service fee.
- e. Investment contracts that have the legal form of an insurance contract but do not expose the entity to significant insurance risk. For example, life insurance contracts in which the entity bears no significant mortality risk are not insurance contracts (those contracts are noninsurance financial instruments or service contracts).
- f. Contracts that have the legal form of insurance but pass all significant insurance risk back to the policyholder through noncancellable and enforceable mechanisms that adjust future payments by the policyholder to the issuer as a direct result of insured losses. For example, some financial reinsurance contracts or some group contracts pass all significant insurance risk back to the policyholder (those contracts are normally noninsurance financial instruments or service contracts).
- g. Self insurance (that is, an entity retaining its own risk that could have been covered by an insurance contract with a third party). In those situations, there is no insurance contract because there is no agreement with another party. Thus, if an entity (that is, a captive) only issues insurance contracts to other entities within a group, the parent would not account for those contracts as insurance contracts in the consolidated financial statements of the group because there is no contract with another party. However, the captive would account for the contract as an insurance contract in its standalone financial statements.

- h. Contracts that require a payment based on a climatic, geological, or other physical variable that is not specific to a party to the contract.
- i. Catastrophe bonds that provide for reduced payments of principal, interest, or both based on a climatic, geological, or other physical variable that is not specific to a party to the contract.

> Scope

834-10-55-27 In determining whether an entity issues contracts that meet the definition of insurance but are not within the scope of this Topic, an entity should consider paragraphs 834-10-55-28 through 55-42 as they relate to the specified scope exception.

> > Fixed-Fee Service Contracts

834-10-55-28 Entities should not apply the guidance in this Topic to fixed-fee service contracts that have as their primary purpose the provision of services and that meet all three of the conditions identified in paragraph 834-10-15-5(f).

834-10-55-29 The following Examples illustrate how an entity would determine whether typical fixed-fee service contracts meet the conditions to be exempt from applying the guidance in this Topic.

> > > Example 1: Roadside Assistance Programs

834-10-55-30 Entities that issue roadside assistance contracts agree to deploy technicians when a customer experiences an adverse event that affects the drivability of its vehicle. Roadside assistance programs typically transfer insurance risk as a consequence of accepting a fixed amount of consideration to provide an uncertain level of services following adverse events. Those plans often are offered to all customers for the same price (condition 1) and typically provide a service instead of a cash payment to the customer (condition 2). In most cases, the services provided are limited by the contract's provisions. For example, the contract may limit both the number of miles the service provider will tow the car and the cost of other available services. As a result, the primary risk of incurring a loss on an individual contract originates from the possibility that an individual customer experiences multiple events requiring compensation (condition 3). Therefore, that contract likely would meet the criteria to be excluded from the guidance in this Topic. However, if that contract did not limit the services and, thus, the provider could be obligated to tow a customer's car a long distance or provide other costly services for no additional fee, then the risk transferred may not be primarily related to **frequency** risk relative to the other risks in the contract. As a result, that contract would fall within the scope of the guidance in this Topic. Entities should perform an analysis of specific contracts to test them against the conditions.

> > > Example 2: Capitation and Other Fixed-Fee Medical Service Arrangements

834-10-55-31 Some health insurers enter into fixed-fee arrangements with medical service providers (hospitals, individual medical practices, and so forth) related to the provision of medical services to their plan members (patients). Such fixed-fee arrangements may include:

- a. Capitation agreements
- b. Fee-for-service arrangements
- c. Bundled arrangements or episode-based arrangements.

834-10-55-32 Assume that a health insurance entity pays a fee to a medical service provider to provide services to the health insurance entity's policyholders following an uncertain event that adversely affects the health insurer (that is, injury of its policyholders). Therefore, the health insurer is the customer, and the medical services provider is the entity taking on the risk (that is, such an arrangement, if it transfers significant insurance risk, is an insurance contract as defined in this Topic).

834-10-55-33 In exchange for a fixed amount of consideration per patient, a healthcare provider agrees to provide medical services to the portfolio of assigned patients for a specified **coverage period** as part of a capitation agreement. The primary purpose of capitation medical agreements is the provision of medical care services. Although capitation agreements expose healthcare providers to risk related to uncertain events, the cash flows exchanged between the insurer and the physician during the contract period do not vary in accordance with the actual incidence of claims or the provision of healthcare treatments. In addition, because the medical services provided are limited on a per patient basis, the **severity** of loss to the provider is not likely to be significant and, when assessed for the group of patients within the agreement, the severity of loss to the provider is even less likely to be significant.

834-10-55-34 The following table compares traditional health insurance policies to capitation medical agreements according to the conditions for excluding fixed-fee service contracts that apply this Topic:

	Traditional Health Insurance	Capitation Arrangement
Pricing	Contracts usually priced depending on regulatory environment and type of plan. Some plans assess individual riskiness more than others.	Contracts might be priced at a fixed amount per person regardless of individual risk characteristics (although prices are adjusted slightly to reflect age and gender differences).
Form of Compensation	Form of compensation is routinely service.	Form of compensation is routinely service and rarely cash.
Amount of Compensation	Amount of compensation following an individual adverse event generally varies significantly. A health insurer is exposed to a broader range of health outcomes than a capitation agreement for specific procedures.	Amount of compensation following an individual adverse event is more predictable because the healthcare provider only agrees to specific procedures (that is, primary care) for the fixed fee, and additional services beyond those included are billed separately, thereby limiting the healthcare provider's exposure to severity risk.

834-10-55-35 Healthcare providers also enter into fee-for-service arrangements with health insurance entities. Under those arrangements, the provider agrees to provide services related to an individual service event (that is, yearly exam, diagnostic test, and so forth) according to a fee schedule. It is unlikely that those contracts expose the provider to significant insurance risk because the provider incurs relatively predictable costs related to an individual service event and would not accept a fee that did not at least provide reimbursement for the services performed.

834-10-55-36 Similarly, some health insurance entities arrange for bundled or episode-based payments. Those contracts contain terms that blend the "lump sum" per-patient feature of capitation agreements with the event-based schedule of a fee-for-service arrangement.

834-10-55-37 Based on the analysis in the table, it is likely that the three arrangements (capitation, fee-for-service, and bundled or episode-based arrangements) could meet the conditions to be excluded from applying the guidance in this Topic. However, entities should perform an analysis of specific contracts to test them against the conditions.

> > > Example 3: Equipment Maintenance Contracts

834-10-55-38 A boiler maintenance and repair contract and a boiler insurance contract both include terms that provide routine maintenance services for a fixed amount of consideration. The following table compares the two types of contracts according to the conditions for excluding fixed-fee-service contracts in this Topic:

	Boiler Breakdown Insurance	Maintenance and Repair Service
Pricing	Often requires additional information to underwrite policy and provide a quote, and typically the equipment is inspected and assessed for risk.	Generally offers a limited range of plans at fixed prices regardless of specific model covered under the contract.
Type of Compensation	Usually provides cash after a deductible relating to an insured event is exceeded.	Generally provides only some level of technician service following an equipment malfunction.
Amount of Compensation	Compensation for insured events typically includes direct property damage and extra expenses of operating business in addition to the service technician fee.	Compensation for insured event is limited to waiver of service technician fee and, in some cases, a limited amount of parts.

834-10-55-39 Based on the analysis in the table, it is likely that the maintenance and repair service contract could meet the conditions to be excluded from applying the guidance in this Topic, whereas the boiler breakdown insurance contract would not meet those conditions. However, entities should perform an analysis of specific contracts to test them against the conditions.

> > **Guarantees**

> > > **Example 4: Guarantees**

834-10-55-40 The following table assesses how the first two criteria in paragraph 834-10-15-5(k) are applied to several types of contracts that meet the definition of insurance contracts (the third criterion in that paragraph, which excludes guarantees issued by an entity that are both unusual or nonrecurring and unrelated to the type of risk that is the subject of other guarantees issued by the entity, is addressed in the following paragraph). Entities should consider the presence or the absence of the criteria in the columns in the table to determine whether the contract should be within the scope of the guidance in this Topic. Entities need to perform that analysis based on the specific facts and circumstances regarding the contracts' features to make that determination.

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
Auction Rate Securities Guarantees	Some financial institutions enter into agreements with government agencies, which may require the financial institution to repurchase at par certain auction rate securities held by retail clients that were purchased through the financial institution. Additionally, some financial institutions agree to reimburse retail clients who have sold certain auction rate securities purchased through the financial institution at a loss.	Failed auction	No	No	No	Insurance
Credit Default Swap	Provides for payment in the event that a borrower defaults on its debt. Can be purchased by investors for speculative purposes as well as by holders of the debt as hedges against risk of default.	Default	No	Yes	No	Not insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
	There is no requirement that the buyer of a credit default swap has an insurable interest in the subject debt.					
Financial Guarantee	Sold by financial institutions to a creditor or issuer of debt either to protect against default or to enhance debt, respectively.	Default	No	Depends	No	Insurance, if it exposes the counterparty to risk throughout the contract term
General Partner Guarantees	If a financial institution is a general partner in certain private equity and/or real estate partnerships, the financial institution may receive distributions from the partnerships according to the provisions of the partnership agreements. The financial institution may be required to return all or a portion of those distributions to the limited partners in the event the limited partners do not achieve a certain return as specified in the partnership agreements.	Rate of return achieved by partnership insufficient to allow for full distribution to limited partners	Yes	No	No	Not insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
Guarantees on Securitized Assets	Some financial institutions provide representations and warranties that certain assets transferred in securitization transactions conform to specified guidelines. The financial institution may be required to repurchase those assets or indemnify the purchaser against losses if the assets do not meet certain conforming guidelines.	Representations and/or warranties provided by a third party not met in securitization	No	No	No	Insurance
Indemnities	Financial institutions often provide standard indemnities to counterparties for certain contingent exposures and taxes, including U.S. and foreign withholding taxes, on interest and other payments made on derivatives, securities and stock lending transactions, certain annuity products, and other financial arrangements. Indemnity payments could be required on the basis of a change in the tax laws or change in	Occurrence of indemnified event	No	No	No	Insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
	interpretation of applicable tax rulings or a change in factual circumstances.					
Liquidity Facilities	The financial institution providing the guarantee is required to make certain payments if losses or defaults occur. The financial institution acts as a liquidity provider to municipal bond securitization special-purpose entities and for standalone municipal bonds in which the holders of beneficial interests issued by those special-purpose entities or the holders of the individual bonds, respectively, have the right to tender their interests for purchase by the financial institution on specified dates at a specified price. The financial institution may have recourse to the underlying assets held by the special-purpose entities in the event payments are required	Sale or tender of beneficial interest at a loss	No	No	No	Insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
	under such liquidity facilities as well as under make-whole or recourse provisions with the trust sponsors.					
Market Value Guarantee	Such arrangements are issued to guarantee timely payment of a specified return to investors in certain affordable housing tax credit funds. Those guarantees are designed to return an investor's contribution to a fund and the investor's share of tax losses and tax credits expected to be generated by a fund. The issuer of the guarantee also may guarantee the return of principal, including a specified rate of return.	Market value of property falls below investment and/or investment plus a specified return	Yes	No	No	Not insurance
Merger and Acquisition Guarantees	Some financial institutions may be required to provide guarantees in connection with certain merger and acquisition transactions. As such, the financial institution provides a guarantee that the	Failure by buyer to remit purchase price in accordance with purchase agreement	No	No	No	Insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
	acquirer in the merger and acquisition transaction has or will have sufficient funds to complete the transaction and would then be required to make the acquisition payments in the event the acquirer's funds are insufficient at the completion date of the transaction. Those arrangements generally cover the time frame from the transaction offer date to its closing date.					
Minimum Revenue Guarantee	A guarantee granted to a business or its owner(s) that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified amount, for example, a guarantee granted to a new daycare center by a corporation as an incentive for the center to locate near the corporation's main plant. The corporation,	Failure to meet revenue target	No	No	No	Insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
	as the guarantor, has agreed to make monthly payments to the daycare center (the guaranteed party) over a specified term for any shortfall from the guaranteed minimum amount of revenue for each month. The corporation routinely grants those guarantees to daycare centers near its plant locations.					
Mortgage Guarantee	Private mortgage guarantees are guarantees in which the provider of the guarantee assumes a portion of a lender's risk in making a mortgage loan. For that risk, the provider of the guarantee collects a premium from the lender, who then typically recovers the cost of the premium from the borrower. The risk in private mortgage guarantees is that a borrower will default on a loan, which	Default	No	No	No	Insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
	may ultimately result in the provider of the guarantee having to pay a claim.					
Performance Bonds	A performance bond is a surety bond issued by a financial institution to guarantee satisfactory completion of a project by a contractor.	Nonperformance by contractor	No	No	No	Insurance
Performance Guarantee	Some view these as warranty-type arrangements that guarantee product performance. An example may be an arrangement for a call center that may be based on average speed to answer or abandonment rates. Another example may be a health insurance administrative services only contract that may be based on time to pay, claim adjustment time, or processing accuracy rates. Other types of guarantees may include service call response times, restoration of	Failure to meet guaranteed service performance	No	No	Yes	Not insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
	service times, and maximum percentage of network down time. These guarantees typically provide for a reduction in fees if an entity does not meet a contractual level of performance.					
Residual Value Guarantee	An arrangement that guarantees the value of an entity's properly maintained nonfinancial assets (for example, equipment) at a fixed date.	Selling price of asset is lower than guaranteed at fixed date	No	No	No	Insurance
Stable Value Guarantees (Generally Attached to Guaranteed Investment Contracts)	Some financial institutions enter into agreements whereby the issuer guarantees a specified rate of return to the purchaser, generally a benefit or retirement plan. A financial institution may contribute some money at the start of the agreement and may have a future obligation to contribute additional amounts to the fund, contingent upon the performance of the fund.	Actual return on assets is below the guaranteed return	Yes	N/A	No	Not insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
	Those guarantees are often found in guaranteed investment contracts.					
Standby Letter of Credit	A letter of credit (or similar arrangement however named or designated) that represents an obligation to the beneficiary on the part of the issuer for any of the following: a. To repay money borrowed by or advanced to or for the account of the account party b. To make payment on account of any evidence of indebtedness undertaken by the account party c. To make payment on account of any default by the account party in the	Commencement of actions listed as (a), (b), or (c) in the description. Trigger can be to repay borrowings of the account party either as scheduled or in the event of a default.	No	No	No	Insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
	performance of an obligation. A standby letter of credit would not include the following: a. Commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer and which do not guarantee payment of a money obligation b. A guarantee or similar obligation issued by a foreign branch in accordance with and subject to the limitations of Regulation M of the Federal Reserve Board.					

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
Trust Preferred Securities	Some financial institutions establish trusts for the limited purpose of issuing trust preferred securities to third parties and lending the proceeds to the financial institution in exchange for junior subordinated debentures. The financial institution may directly guarantee the repayment of the trust preferred securities to the holders thereof to the extent the financial institution has made payments to the trusts on the junior subordinated debentures.	Default	No	No	No	Insurance
Whole Loan Sale Guarantees	Financial institutions sometimes provide representations and warranties that certain assets sold as whole loans (sold by the loan originator to a third party) conform to specified guidelines. The financial institution may be required to repurchase those assets or	Actions asserting that sold loans do not meet requirements	No	No	No	Insurance

Instrument	Description	Payout Triggering Event	Financial Risk	Does Not Expose the Counterparty to Risk throughout the Contract Term	Guarantee of an Entity's Own Performance	Potential Categorization Based on Description
	indemnify the purchaser against losses if the assets do not meet certain conforming guidelines.					

834-10-55-41 This Topic would exclude guarantees issued by an entity that are both unusual or nonrecurring and unrelated to the type of risk that is the subject of other guarantees issued by the entity. The following fact patterns illustrate that general principle:

- a. If a bank issues a residual value guarantee only on a single piece of equipment, it would not apply the guidance in this Topic because the guarantee is unusual or nonrecurring. However, if a bank issues residual value guarantees on different equipment on a regular basis, it would apply the guidance in this Topic, even if the specified guarantee is the only guarantee issued on that particular type of equipment.
- b. If a bank issues a guarantee in a form that it has never used before but it is a guarantee of the credit risk of some asset, then that bank would apply the guidance in this Topic because banks typically issue credit guarantees.
- c. If an entity sells a piece of property and simultaneously issues a guarantee on the environmental exposure of the property, the guarantee would not be accounted for in accordance with the guidance in this Topic because the sale of property that has environmental exposure for which the entity will issue an indemnification is unusual and nonrecurring and unrelated to the other types of guarantees issued by the entity.

834-10-55-42 Guarantees between related parties or entities under common control and a guarantee of debt owed to a third party by a related party or entity under common control when the issuer of the guarantee also is not issuing similar guarantees to third parties are excluded from this Topic unless issuance of those guarantees is the primary business purpose of the entity. The following fact patterns illustrate that general principle:

- a. A bank issues a guarantee of its subsidiary's debt. That guarantee will most likely be within the scope of this Topic if that bank issues guarantees of the debt of third parties.
- b. A manufacturer issues a guarantee of its subsidiary's debt. That guarantee would most likely not fall within the scope of the guidance in this Topic if the manufacturer does not issue guarantees on the debt of third parties.
- c. A captive insurance entity provides insurance only for its parent and other entities under common control (that is, it does not provide insurance for third parties). The captive insurance entity would need to apply the guidance in this Topic because the primary business purpose of the captive insurance entity is to provide insurance.

> **Recognition**

834-10-55-43 The following guidance should be considered in determining whether components of an insurance contract should be separated and accounted for in accordance with other Topics.

> > **Separation of Investment Components**

834-10-55-44 Both of the following examples illustrate the guidance in paragraph 834-10-25-3. An entity should consider the contract's specific features to determine whether an investment component should be separated from an insurance contract.

- a. Assume a five-year deposit contract combined with a one-year term life insurance contract (with a fixed death benefit) in which one contract could be terminated or mature but the other would continue to exist. The five-year deposit contract would be measured separately from the insurance component (that is, the one-year term life component), applying financial instrument guidance.
- b. Assume a single up-front payment of \$1,000 for a demand deposit, which also includes a life insurance contract with no explicit premium payment required. Further assume that the life insurance contract terminates upon withdrawal of the deposit. Although both deposit contracts and term life insurance are separately sold in the market, the components of the demand deposit in this example would not be separated because the policyholder is unable to benefit from the life insurance if the deposit component lapses or matures.

> > **Separation of Goods and Services Components**

> > > **Example 5: Separation of Goods and Services Components**

834-10-55-45 The following table contains examples of how the proposed guidance in paragraphs 834-10-25-4 through 25-7 for separation of goods and services should be applied.

Fact Pattern	Applying Criteria for the Separation of Goods and Services from an Insurance Contract—a Distinct Performance Obligation to Provide Goods or Services
1. Sale of automobile and	Is the component a good or service

Fact Pattern	Applying Criteria for the Separation of Goods and Services from an Insurance Contract—a Distinct Performance Obligation to Provide Goods or Services
issuance of insurance contract A contract for a sale of a car with “free” three-year noncancellable motor accident insurance.	that transfers to the policyholder? Yes, the car is a good that transfers to the policyholder. Is the good or service component distinct? Yes, the car is distinct because the policyholder can use the car on its own. The car can be driven with motor insurance provided by another insurer. Result: Separate the sale of the car and account for the sale of the car under Topic 606 on revenue recognition.
1(a). Lease of automobile and issuance of insurance contract Assume the same fact pattern as in the first example except in this example, the vehicle was leased to the customer for a period of three years, as opposed to sold.	[Note: The analysis for this example is identical to that provided in the first example.] Result: Separate the lease contract and account for the lease of the car under Topic 840 on leases.
2. Claims-processing service An insurer may sell claims-processing services on a standalone basis to a customer and also might sell those services bundled with a stop-loss insurance contract. To provide financial	

Fact Pattern	Applying Criteria for the Separation of Goods and Services from an Insurance Contract—a Distinct Performance Obligation to Provide Goods or Services
protection against catastrophic health insurance claims, some self-funding employers purchase stop-loss insurance from insurers. For the purpose of this example, assume the following fact patterns in 2(a) and 2(b).	
2(a). Claims-processing services related to self insurance The customer has chosen to provide health insurance to its employees and has chosen to self insure. Instead of processing the claims of the employees, the customer buys claims-processing services from an insurer but does not purchase insurance coverage. The insurer will process the health insurance claims of the employees of the customer on behalf of the customer.	Not insurance contracts. The claims processing services would not meet the definition of insurance. The insurer is providing claims-processing services and should account for those services under Topic 606.
2(b). Stop-loss coverage Policyholder buys a stop-loss contract that provides the following: One hundred percent insurance coverage for aggregate group claims exceeding \$25 million. The	Is the component a good or service that transfers to the policyholder? Yes, the policyholder is receiving both of the following: a. Stop-loss coverage to protect against aggregate claims exceeding \$25 million (that is,

Fact Pattern	Applying Criteria for the Separation of Goods and Services from an Insurance Contract—a Distinct Performance Obligation to Provide Goods or Services
policyholder will self insure below that amount. The insurer estimates that it is probable that the group claims will not exceed the deductible layer until the second half of the contract coverage period. Claims-processing services will be provided for the entirety of the upcoming 12 months, regardless of whether the policyholder has breached the stop-loss threshold of \$25 million. The insurer is responsible for processing the health insurance claims of the employees on behalf of the employer. The insurer sometimes sells claims-processing services as a standalone service absent any insurance coverage, as do a number of other entities. The insurer processes those claims through its regular claims-processing services, utilizing employees that handle health insurance claims for many of the insurers' insurance customers.	insurance). b. Services to process the individual claims of its employees. Provision of those services to the policyholder represents transfer of a service for the entire 12-month period that enables the policyholder to fulfill its separate obligation to provide health insurance to its employees (because it self insures). Is the good or service component distinct? The claims-processing services are distinct in this example because the provided services benefit the policyholder independent of the insurance (that is, absent the services, the policyholder would have to perform those services for its employees). That is indicated by the fact that the insurer sells those services on a standalone basis. Result: Separate the claims-processing services for the duration of the contract and account for the services under Topic 606.
3. High-deductible health insurance plan	Is the component a good or service that transfers to the policyholder?

Fact Pattern	Applying Criteria for the Separation of Goods and Services from an Insurance Contract—a Distinct Performance Obligation to Provide Goods or Services
Contracts are sold both to individuals and to groups, generally with an annual term. Under those contracts, the policyholder or group member is responsible for 100 percent of the costs at the beginning of the contract period up to a defined threshold or deductible amount. In that case, the deductible (sometimes referred to as an “excess” amount) is \$2,000. After the policyholder meets its deductible, the contract converts into a regular coinsurance arrangement in which the insurer is responsible for 80 percent and the policyholder is responsible for 20 percent until the policyholder reaches an annual out-of-pocket maximum of \$6,000, at which point the insurer is responsible for 100 percent. The insurer provides administrative services to the policyholder for the entire duration of the contract, which includes claims-processing services and network access (the ability to obtain health services from specified health professionals, sometimes at a discount or at different deductible or coinsurance levels). The claims-processing services and network access are not sold separately by the insurer, nor are they available to be purchased from a third party for	In this example, no good or service separately transfers to the policyholder. The claims-processing service and network access would be considered activities of the insurer because those services would be required of the insurer to fulfill its insurance obligation (that is, claims processing allows the insurer to adequately assess a policyholder’s benefit status without having to gather and audit data from the period prior to the policyholder having met its deductible or excess amount). Are the good or service components distinct? Not applicable, because the claims-processing services and network access are activities of the insurer as opposed to performance obligations. The entity does not regularly sell the claims-processing services or network access for this type of policy separately, and those services (that is, servicing of the claims for the amount below the deductible) are not separately available to the policyholder.

Fact Pattern	Applying Criteria for the Separation of Goods and Services from an Insurance Contract—a Distinct Performance Obligation to Provide Goods or Services
this type of contract.	Result: Do not unbundle either service at any point during the contract.
4. Health insurance contract with break in coverage (similar to U.S. Medicare Part D) An insurer contracts with an individual (the policyholder) to provide specified health benefits structured as follows: (a) initial coverage with a limit, then (b) a gap in coverage, and then (c) catastrophic coverage limits. In addition to the provision of insurance coverage, the contract stipulates that the insurer will provide claims-processing services regardless of the insured status of the participants. The insurer does not sell the claims-processing services individually for this type of contract, nor does it sell that type of insurance coverage without the related administrative services.	Is the component a good or service that transfers to the policyholder? The analysis in this example is similar to that in the third example. The claims processing would be required for the insurer to fulfill its obligation under the insurance coverage and, therefore, those services would merely be activities of the insurer that do not need to be evaluated any further. Is the good or service component distinct? Not applicable, because the claims-processing services are merely an activity of the insurer. The entity does not sell those services separately, and the policyholder cannot obtain those services separately (that is, servicing of the claims for the gap in the coverage). Result: Do not unbundle the claims-processing services.
5. Title insurance	Is the component a good or service

Fact Pattern	Applying Criteria for the Separation of Goods and Services from an Insurance Contract—a Distinct Performance Obligation to Provide Goods or Services
An insurer sells a title insurance policy, which indemnifies the policyholder against loss or damage arising out of defects in, liens on, or challenges to its title to real estate. The contract compensates the policyholder for past events that existed before the contract is issued but that are not discovered until after the contract begins. To issue the contract, the insurer performs research on the specific real property to be insured, which is called a title search. The insurer then examines the evidence identified by the title search. The issuance of a commitment for a title insurance contract is predicated on the results of the search and examination. Once a contract is issued, it obligates an insurer to indemnify and defend the title against the risks covered by the contract.	that transfers to the policyholder? In this example, the title search is a good or service that can transfer to the policyholder without the indemnification or insurance component. Is the good or service component distinct? Yes, the title search is distinct because the policyholder can use it on its own to make a purchasing decision on the property without the indemnification component. Some property can be purchased without title insurance (for example, if the purchase is not financed). Result: Separate the contract into both of its components: - A title search component, accounted for using Topic 606. - An insurance component (an indemnification component that would be accounted for using the guidance in this Topic).

> Initial Measurement

> > Portfolio of Insurance Contracts

834-10-55-46 A **portfolio of insurance contracts** is a group of insurance contracts that are both of the following:

- a. Subject to similar risks and priced similarly relative to the risk taken on
- b. Have similar duration and similar expected patterns of release from risk, that is, reduction in variability in cash flows.

834-10-55-47 An entity should not do any of the following when grouping its contracts together as a portfolio:

- a. Group together risks that are not similar or product offerings that are unrelated (for example, protection against a policyholder defaulting on repaying money borrowed to purchase a house [credit insurance] and protection against fire for the house purchased)
- b. Group together contracts for which the pricing, relative to the risk assumed, differs significantly.

834-10-55-48 In determining whether a group of contracts is subject to similar risks, an entity should consider all of the following factors:

- a. Type of coverage (for example, theft, fire, longevity, and mortality)
- b. Product line (for example, annuity, income protection, term assurance, unit-linked, auto, and homeowners)
- c. Type of policyholder (for example, commercial or personal and individual or group)
- d. Geographical location (for example, across continents, countries, states, provinces, and counties).

834-10-55-49 Under the definition of a portfolio of insurance contracts, similar pricing relative to the risk assumed should be interpreted as similar compensation per unit of risk and not as similar pricing by number of currency units per contract (that is, the absolute value paid under the contract). In determining whether a group of contracts is similarly priced for the risk taken on, an insurer should consider whether similar or different prices per unit are charged for the same product offering (that is, whether compensation required for taking on similar insurance risks is similar or different).

834-10-55-50 Under the definition of a portfolio of insurance contracts, contracts that have similar durations can be grouped together into a portfolio, regardless of when the contracts are issued to the policyholder, if the patterns of release from risk are similar. Assume a 5-year contract with an expected **margin** of \$100, in which the margin is recognized over 5 years with the following margin release pattern: 30 percent in each of Years 1 and 2, 20 percent in Year 3, and 10 percent in each of Years 4 and 5. When grouping contracts issued in different years with that pattern, the amounts recognized in net income for those contracts will be similar if the entity released the margin based on the year in which the contract was sold (that is, the margin recognized as revenue each year will be the same for a stable book of business). Therefore, regardless of the years in

which the contracts are issued, an entity may group those contracts together into a portfolio.

> > Determining the Appropriate Approach to Apply—Building Block Approach or Premium Allocation Approach

834-10-55-51 An entity should apply the building block approach to measure its insurance contract asset or liability unless either of the following characteristics is present, in which case, an entity should apply the premium allocation approach:

- a. The coverage period of the insurance contract is one year or less.
- b. At contract inception, it is unlikely that during the period before a claim is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract.

834-10-55-52 All of the following are indicators that an entity should consider in assessing whether at contract inception significant variability in the expected **fulfillment cash flows** is likely during the period before a claim is incurred:

- a. The existence of minimum guarantees of benefits or options may indicate significant variability in expected net cash flows.
- b. An entity expects at contract inception that during the contract's coverage period it will significantly change premium pricing for future contracts written with similar or identical risks. That may indicate significant variability in net cash flows for the existing contract.
- c. The longer the coverage period of a contract, the more likely it is that there will be a significant change in the expected net cash flows before a claim is incurred.
- d. Some cash flow changes are likely but will not significantly contribute to expected variability in those cash flows at contract inception. Other circumstances could cause expected cash flows to change significantly but may not be likely at contract inception. In both of those circumstances, an entity is likely to conclude that there is not significant variability in net cash flows at contract inception.

> > > Example 6: Determining the Appropriate Approach to Apply—Building Block Approach or Premium Allocation Approach

834-10-55-53 The table below indicates the measurement model that would likely be applied to common types of insurance contracts based on their description and specifically the bolded phrases. Entities should consider the criteria in paragraph 834-10-55-51 and the presence or the absence of the indicators in the preceding paragraph in determining which measurement model should be applied. Entities need to perform an analysis of their portfolios of insurance contracts based on the specific facts and circumstances about the

contracts’ features to determine which measurement model should be applied to similar types of insurance contracts.

Type of Contract	Measurement Model
A policy that is designed to provide a fixed amount of insurance coverage over the entire life of the insured, provided that premiums are paid as specified in the policy. The premiums remain level over the life of the insured. Payment of the face value of the contract is made upon the death of the insured. This policy also includes an investment component, which accumulates a cash value against which the policyholder can withdraw or borrow. The policy provides the insured with a guaranteed minimum rate of return on the cash value portion. An example of this type of policy may be a traditional whole life insurance contract.	Building block approach
Life insurance that provides one year of coverage and does not include the accumulation of cash value. After the term expires, the insurer has the ability to fully underwrite the contract and has no constraints on its ability to reprice. An example of this type of policy may be a one-year term life insurance contract.	Premium allocation approach
Life insurance that provides five years of coverage and does not include the accumulation of cash value. The policy may be renewed for subsequent five-year periods without evidence of insurability. Premiums typically increase each time the policy is renewed but will not exceed the maximum premiums stated in the policy. Over the five years, the policy has a level term premium for each renewal period. For purposes of this example, based on historical experience, the insurer expects the average policy to renew five times. An example of this type of policy may be a five-year term life insurance contract.	Building block approach
A contract that provides permanent life insurance with terms that are not fixed or guaranteed with respect to premium amounts, expense assessments, or benefits accruing to the policyholder. The policy contains a savings element that is invested to provide a cash value accumulation. The death benefit, savings element, and premiums can be reviewed and altered as the policyholder’s circumstances change within certain limits stated in the policy. The cash value grows at a variable rate that is adjusted monthly	Building block approach

Type of Contract	Measurement Model
(sometimes it is pegged to a financial index such as a stock, bond, or other interest rate index). The policyholder may use the interest from the accumulated savings to help pay premiums. This policy divides the pure insurance protection, the related expense charge, and the cash value accumulation into separate components. An example of this type of policy may be a universal life contract.	
An arrangement that guarantees that the policyholder will receive benefits over a fixed or variable period, beginning either immediately or at a future date. This contract provides either for the payment of benefits until the insured dies or for continued payments to a beneficiary until a specific number of periods are met . This contract may have both fixed and variable features and other nontraditional features. For purposes of this example, assume a 10-year contract in which the policyholder pays a targeted (with a stated minimum) amount each year. After 10 years, the policy will begin to pay out a fixed amount a year until death of the policyholder . At the annuitization date, the payout amount could be adjusted upward at the entity's discretion based on the account value accumulation at that date. An example of this type of policy may be annuity life insurance.	Building block approach
A policy that provides physical damage and personal injury coverage sustained by the insured party. The policyholder may pay the entire year's premium up front or on a quarterly or monthly basis. For purposes of this example, assume the policy provides coverage for 1 year , the physical damage claim is expected to be paid within 6 months of the accident, and the bodily injury claim is expected to be paid out over 60 months. The insurer has the right to fully underwrite the contract and reprice after one year . An example of this type of policy may be a personal automobile insurance contract.	Premium allocation approach
A contract that provides for monetary compensation to third parties for failure by the construction contractor to construct a building within the estimated time frame for completion. For the benefit of the third party, the insurer agrees to uphold the contractor's obligation to construct a building if the contractor fails to perform within the specified time frame. The contractor's financial position is stable , and the contractor has historically completed construction projects on time . For purposes of this example, assume the	Premium allocation approach

Type of Contract	Measurement Model
contract term is three years. An example of this type of policy may be a contract surety bond.	
A policy that covers damage or destruction to the policyholder's business and its contents caused by earth movement or wind damage. For purposes of this example, assume the coverage period is one year . The insurer has the right to fully underwrite the contract and reprice after one year . An example of this type of policy may be a catastrophe insurance contract.	Premium allocation approach
A policy that compensates employees for injuries or illnesses sustained in the course of their employment . The payments replace employees' wages and provide additional compensation for the past and future economic losses of the employee. For purposes of this example, assume the policy provides coverage for 18 months and the payout period is estimated to be 20 years. The insurer has the right to fully underwrite the contract and reprice after 18 months . An example of this type of policy may be a workers' compensation insurance contract.	Premium allocation approach
A policy that protects an individual policyholder against loss of income as a result of the partial or total inability to work as a result of injury, illness, or disease. Typically, long-term disability insurance can be purchased to replace 50 to 70 percent of an employee's salary. Long-term disability policies vary in the length of payout: some policies will only pay out for 5 or 10 years, some will pay out until age 65. For purposes of this example, assume the payout period is until age 65 and a one-year term with guaranteed renewability (the insurer may not cancel the policy under any circumstances). The premiums are intended to cover risks of loss related to future periods . However, the insurer may increase premiums subject to certain conditions, for example, regulatory approval or adverse morbidity experience. Based on historical experience, the insurer expects the average policy to renew five times . An example of this type of policy may be a long-term disability insurance contract.	Building block approach
A policy that provides liability insurance payable to the directors and officers of a company, or to the organization itself, to cover damages or defense costs in the event they suffer such losses as a result of a lawsuit for alleged wrongful	Premium allocation approach

Type of Contract	Measurement Model
acts while acting in their capacity as directors and officers for the organization. Litigation could take months or years to settle and, therefore, the payout period is unknown. For purposes of this example, assume the policy provides coverage for one year. The insurer has the right to fully underwrite the contract and reprice after one year. An example of this type of policy may be a directors and officers insurance contract.	
A one-year policy that is designed to indemnify the insured against incurred losses covering virtually all kinds of expenses associated with medical care and related services. The contract states the total dollar limits and specific benefits covered. The contract contains some method of cost sharing of medical costs with the policyholder through either copayment plans, which specify a formula for the sharing of actual medical expenses between the insurer and the policyholder, or deductibles, which specify a dollar amount of medical expenses the policyholder generally must pay before the insurance coverage begins, or both. The premiums are intended to cover risks of loss in the first year of coverage, but the insurer has the right to fully underwrite the contract and reprice after one year. An example of this type of policy may be a one-year health insurance contract.	Premium allocation approach
A policy that provides the insured with coverage for loss or damage to assets, including a building and its contents, as a result of specified insured events for 30 years. Those specified insured events include fire and explosion, lightning, windstorm, water damage, and theft. The amount payable to the policyholder depends on the type of insured event. The policy includes a savings component if the policyholder so chooses. The policy is sold in conjunction with the mortgage loan. The premiums are calculated using the applicable discount rates and are level over the 30-year coverage period. For purposes of this example, assume the insurer cannot reprice the contract. An example of this type of policy may be a 30-year fire insurance contract.	Building block approach

> > Measurement of the Fulfillment Cash Flows

> > > Expected Value Approach

834-10-55-54 The objective in estimating cash flows is the expected value, or statistical mean of the full range of possible outcomes. Thus, a starting point for an estimate of cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome to derive an expected present value (that is, the measurement objective of expected value refers to the probability-weighted mean). Thus, the aim is not to develop a single best estimate of future cash flows but, in principle, to identify all possible scenarios and make unbiased estimates of the probability of each scenario. In some cases, an entity has access to considerable data and may be able to develop those cash flow scenarios easily. But, in other cases, the entity may not be able to develop more than general assumptions about the variability of specific aspects of the cash flows without incurring considerable cost. In those cases, the entity could use those general assumptions in estimating the future cash flows.

834-10-55-55 When considering possible scenarios, the objective is not necessarily to identify every possible scenario but, rather, to recognize the statistical mean of possible scenarios that incorporate all relevant information and not simply ignore data or information that is difficult to obtain. In practice, it is not always necessary to develop explicit scenarios if the resulting estimate is consistent with the measurement objective of considering all relevant information in determining the mean. For example, if an entity estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will suffice to estimate those parameters. Similarly, in some cases, relatively simple modeling may give an answer within a tolerable range of precision, without the need for a large number of detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and respond in a highly nonlinear fashion to changes in economic conditions (for example, if the cash flows reflect a series of interrelated implicit or explicit options). In those cases, more sophisticated stochastic modeling is likely to be needed, including the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes. In summary, enough scenarios should be performed to incorporate all relevant information; if an entity has a sufficient basis to support the mean and if performing additional scenarios is not likely to change the mean, an entity does not need to run additional scenarios.

834-10-55-56 The probability assigned to each scenario should reflect conditions at the end of the reporting period (for purposes of measuring the portfolio of insurance contracts at that date).

> > > Level of Measurement

834-10-55-57 Certain measurements may be, and in some cases need to be, measured at the portfolio level. In principle, the expected (probability-weighted) cash flows from a portfolio of insurance contracts equal the sum of the expected cash flows of the individual contracts, as long as there are no interdependencies in contract outcomes across the portfolio (for example, a contract that pays a policyholder living benefits in the same portfolio with a contract that pays a policyholder death benefits). Therefore, in those circumstances, the level of aggregation for measurement does not affect the expected present values of future cash flows.

834-10-55-58 However, from a practical point of view, it often will be easier to perform some types of estimates in aggregate for a portfolio rather than for individual insurance contracts. For example, **incurred but not reported claim** estimates are typically made in aggregate. Similarly, if expenses, for example, **qualifying acquisition costs** and certain claims processing costs, are directly attributable to the portfolio but not to an individual insurance contract, it may be easier, and perhaps even necessary, to estimate them at an aggregate level. In principle, as long as there are no interdependencies in contract outcomes across a portfolio, a portfolio estimation should not be different from the expected value estimates for individual insurance contracts that are aggregated to determine the portfolio amount.

> > > Estimates of Future Cash Flows

834-10-55-59 The cash flows should reflect the manner in which the entity expects to fulfill the contract. Therefore, this implementation guidance distinguishes between the following two types of variables:

- a. Market variables—variables that can be observed in, or derived directly from, markets (for example, prices of publicly traded securities and interest rates)
- b. Nonmarket variables—all other variables (for example, the frequency and severity of insurance claims and mortality).

> > > Market Variables

834-10-55-60 Estimates of market variables should be consistent with observable market prices at the end of the reporting period. An entity should not substitute its own estimates for observed market prices.

834-10-55-61 Market prices blend a range of views about possible future outcomes and also reflect the risk preferences of market participants. Therefore, they are not a single-point forecast of the future outcome. If the actual outcome

differs from the previous market price, that does not mean that the market price was wrong.

834-10-55-62 In some circumstances, the most appropriate way to reflect any dependence of the cash flows arising from an insurance contract on specified assets would be to use a replicating portfolio technique. A replicating asset is one whose cash flows exactly match those contractual cash flows in amount, timing, and uncertainty. In some cases, a replicating asset may exist for some of the cash flows arising from an insurance contract. The fair value of that asset reflects the expected present value of the cash flows from the asset, and it also reflects the risk associated with those cash flows. If a replicating portfolio of assets exists for some or all of the cash flows arising from an insurance contract liability, the entity can, for those contractual cash flows, simply include the fair value of those assets in the present value of the fulfillment cash flows instead of explicitly estimating the expected present value of those particular cash flows; but the entity might need to adjust the fair value to remove the estimate of any premium for the risk associated with those cash flows that is included in the fair value.

834-10-55-63 As an example of a replicating portfolio technique, suppose an insurance contract contains a feature that generates cash flows equal to the cash flows from a put option on a basket of traded assets. The replicating portfolio for those cash flows would be a put option with the same features. The entity would observe or estimate the fair value of that option and include that amount, adjusted to reflect the difference between the estimate of the premium for the risk associated with the assets when compared to the characteristics of the liability, in the measurement of the entire insurance contract.

834-10-55-64 For cash flows not measured by a replicating portfolio of assets, an entity explicitly estimates the expected present value of those particular cash flows.

> > > Nonmarket Variables

834-10-55-65 Estimates of nonmarket variables should reflect all available evidence, both external and internal.

834-10-55-66 Depending on the circumstances, nonmarket external data (for example, national mortality statistics) may have more or less relevance than internal data (for example, internal mortality statistics). For example, an entity issuing life insurance contracts should not rely solely on national mortality statistics but should consider all other available internal and external sources of information in developing unbiased estimates of probabilities for mortality scenarios. In developing those probabilities, an entity should consider all evidence available and give more weight to evidence that is more persuasive. Consider, for example, both of the following:

- a. Internal mortality statistics may be more persuasive than national mortality data if the internal statistics are derived from a large population, the demographic characteristics of the insured population differ significantly from those of the national population, and the national statistics are out of date; in that case, an entity would place more weight on the internal data and less weight on the national statistics.
- b. Conversely, if the internal statistics are derived from a small population with characteristics believed to be close to those of the national population and the national statistics are current, an entity would place more weight on the national statistics.

834-10-55-67 Estimated probabilities for nonmarket variables should not contradict observable market variables. For example, estimated probabilities for changes in claim payments related to future inflation rate scenarios should be as consistent as possible with probabilities implied by market interest rates.

834-10-55-68 In some cases, an entity concludes that market variables vary independently of nonmarket variables. If so, the entity should prepare scenarios that reflect the range of outcomes for the nonmarket variables, and each scenario should use the same observed value of the market variable.

834-10-55-69 In other cases, market variables and nonmarket variables may be correlated. For example, sometimes there may be evidence that **lapse rates** are correlated with interest rates. Similarly, sometimes there may be evidence that claim levels for house or automobile insurance are correlated with economic cycles and, hence, with interest rates and expense amounts. In those cases, an entity should develop scenarios for different outcomes of the variables. The entity should calibrate the probabilities for the scenarios relating to the market variables so that they are consistent with observed market prices that depend on those market variables.

> > Sources of Estimates

834-10-55-70 An entity estimates the probabilities associated with future payments under existing contracts on the basis of all of the following:

- a. Information about claims already reported by policyholders.
- b. Other information about the known or estimated characteristics of the portfolio of insurance contracts.
- c. Historical data about the entity's own experience, supplemented when necessary with historical data from other sources. Historical data are adjusted if, for example, any of the following occur:
 - 1. The characteristics of the portfolio differ (or will differ, because of adverse selection) from that of the population used as a basis for the historical data.
 - 2. There is evidence that historical trends will not continue, that new trends will emerge, or that economic, demographic, and other

changes may affect the cash flows arising from the existing insurance contracts.

3. There have been changes in items such as underwriting procedures and claims management procedures that may affect the relevance of historical data to the portfolio of insurance contracts.
- d. Current price information, if available, for reinsurance contracts and other instruments (if any) covering similar risks, such as catastrophe bonds and weather derivatives, and recent market prices for transfers of portfolios of insurance contracts. That information is adjusted for differences between the cash flows arising from those reinsurance contracts or other instruments and the cash flows that would arise as the entity fulfills the underlying contracts with the policyholder. That information also is adjusted to remove any implicit margin that the reinsurers and other parties are charging for the reinsurance contracts and other instruments.

> > > Using Current Estimates

834-10-55-71 In estimating the probability of each cash flow scenario relating to nonmarket variables, an entity should use all available current information at the end of the reporting period. An entity should review the estimates of probabilities it made at the end of the previous reporting period and update them if evidence indicates that the previous estimates are no longer valid. In doing so, an entity should consider whether both of the following occur:

- a. The updated estimates faithfully represent conditions at the end of the reporting period.
- b. Changes in estimates faithfully represent changes in conditions during the period. If an entity's most recent estimates are different from its previous estimates but conditions have not changed, the entity should assess whether the new probabilities assigned to each scenario can be justified. In updating its estimates of those probabilities, the entity should consider both the evidence that supported its previous estimates and all available new evidence, giving more weight to evidence that is more persuasive.

834-10-55-72 Current estimates of expected cash flows are not necessarily identical to the most recent actual experience. For example, suppose that mortality experience in 20X1 was 20 percent worse than previous experience and previous expectations. Several factors could have caused the sudden change in experience, including any of the following:

- a. Lasting changes in mortality
- b. Changes in the characteristics of the insured population (for example, changes in underwriting or distribution or selective lapses by policyholders in unusually good or bad health)

- c. Flaws in the estimation model or incorrect calibration of parameters, such as mortality and lapse rates, used in the model
- d. Random fluctuations
- e. Identifiable nonrecurring causes.

834-10-55-73 An entity should investigate the reasons for the change in experience and develop new probability estimates for the possible outcomes, considering the most recent experience, earlier experience, and other information. Typically, the result in the fact pattern in the preceding paragraph may be that the expected present value of death benefits increases, but that increase would not be as much as 20 percent. Actuaries have developed various credibility techniques that an entity could use in assessing how new evidence affects the probability of different outcomes. In this case, if mortality continues to be significantly higher than previous estimates, the estimated probability assigned to high-mortality scenarios will increase as new evidence becomes available.

> > > Future Events

834-10-55-74 Estimates of nonmarket variables should consider not just current information about the current level of insured events, but also information about trends. For example, mortality rates have declined consistently over long periods in many countries. In developing cash flow scenarios, an entity should assign probabilities to those scenarios considering all available information.

834-10-55-75 Similarly, if cash flows from the insurance contract are sensitive to inflation, cash flow scenarios should reflect possible future inflation rates. Because inflation rates are likely to be correlated with interest rates, an entity should calibrate the probabilities for each inflation scenario so that they are consistent with probabilities implied by market interest rates (for example, those used in estimating the discount rates used to measure the corresponding insurance contract liabilities).

834-10-55-76 In estimating the cash flows from an insurance contract, an entity should take into account future events that might affect the cash flows without changing the nature of the obligation. The entity should develop cash flow scenarios that reflect those future events as well as unbiased estimates of the probability weights for each scenario.

834-10-55-77 However, an entity should not take into account future events that occur after the reporting period, such as a change in enacted legislation, that would change or discharge the present obligation or create new obligations under the existing insurance contract. Similarly, an entity should not take into account an event that occurs after the end of the reporting period that resolves a condition that existed at the reporting date. Accordingly, the occurrence or nonoccurrence of a possible event after the statement of financial position date does not provide evidence of a condition that existed at the end of the reporting

period. As a result, the occurrence of an event after the end of the reporting period is a nonadjusting event applying Topic 855 on subsequent events.

> > Which Cash Flows?

834-10-55-78 Estimates of cash flows in a scenario should include all cash flows within the boundary of an existing contract at the level of a portfolio of insurance contracts. In principle, the estimate of cash flows should include all of the following:

- a. Costs that relate directly to the fulfillment of the contracts in the portfolio, such as payments to policyholders, some claims handling costs, and so forth
- b. Costs that are directly attributable to fulfilling the portfolio of insurance contracts if those costs can be allocated on a rational and consistent basis to the individual portfolios of insurance contracts
- c. Other costs that are specifically chargeable to the policyholder under the terms of the contract.

834-10-55-79 Therefore, the relevant cash flows include all of the following:

- a. Premiums (including premium adjustments and installment premiums) from policyholders and any additional cash flows that result from those premiums
- b. Payments to (or on behalf of) policyholders, including claims that have already been reported but have not yet been paid (that is, reported claims), claims that have already been incurred but have not yet been reported, and all future claims and other benefits under the existing contract
- c. Claim handling costs (that is, the costs that the entity will incur in processing and resolving claims under existing insurance contracts, including legal and adjusters' fees and internal costs of processing claim payments)
- d. The costs that the entity will incur in providing contractual benefits that are paid in kind
- e. Cash flows that will result from options and guarantees embedded in the contract, to the extent those options and guarantees are not separated from the insurance contract
- f. Policy administration and **maintenance costs**, such as costs of premium billing and costs of handling policy changes (for example, conversions and reinstatements)
- g. Policy loans and the repayment of those loans in which the net present value is material
- h. Potential recoveries (such as **salvage** and **subrogation**) on future claims covered by existing insurance contracts and, to the extent they

do not qualify for recognition as separate assets, potential recoveries on past claims

- i. Payments to current or future policyholders as a result of a contractual participation feature (including those features implied in the contract by regulatory or legal requirements) that provides policyholders with participation in the current performance of a portfolio of insurance contracts or pool of assets.

834-10-55-80 All of the following cash flows should not be considered in estimating the cash flows that will arise as the entity fulfills a portfolio of existing insurance contracts:

- a. Investment returns—the investments are recognized, measured, and presented separately. However, the measurement of a **participating insurance** liability is affected by the cash flows, if any, that depend on the investment returns.
- b. **Acquisition costs** paid and expected to be incurred, including recurring commissions expected to be paid to intermediaries if a particular policyholder continues to pay the premiums specified in the insurance contract.
- c. Cash flows that are outside the boundary of existing contracts. Nevertheless, estimates of cash flows from existing contracts are not performed on a run-off basis. In other words, cash flow estimates from existing contracts do not incorporate changes in the cash flows from existing contracts that could take place if the insurer stopped issuing new contracts, unless the insurer actually stops issuing new contracts.
- d. Cash flows arising from abnormal amounts of wasted labor or abnormal amounts of other resources used to fulfill the contract.
- e. Costs that cannot be directly attributed to the portfolio of insurance contracts, for example, product development and training costs.
- f. Transaction-based taxes (such as premium taxes, value-added taxes, and goods and services taxes) that arise directly from existing insurance contracts or that can be attributed to them on a reasonable and consistent basis.
- g. Insurance-related assessments including those by state guaranty funds, workers' compensation second injury funds, and annual fees imposed on health insurers by the Patient Protection and Affordable Care Act.
- h. Income tax payments and receipts in the scope of Topic 740 on income taxes. Cash flows from income tax payment obligations of the entity should not be considered, even if the insurance contract permits the entity to pass through those amounts to policyholders.
- i. Cash flows arising from components that are separated from the insurance contract and accounted for using other applicable Topics.

834-10-55-81 Comparable cash flows to those listed in paragraph 834-10-55-79 and the preceding paragraph for reinsurance contracts (that is, ceded and

assumed) should be considered in determining cash flows associated with those reinsurance transactions.

> > Determining When the Fulfillment Cash Flows Should Be Adjusted for Participating Features

834-10-55-82 In some cases, an obligation to the policyholder is contractually based on an underlying item measured on a basis different from U.S. generally accepted accounting principles (GAAP) (for example, U.S. statutory accounting principles). Applying the general principles in this Topic, an entity should recognize a liability based on the measurement of the underlying item using that other basis. However, because the underlying item affects the payments to the policyholder and, therefore, any movement in the underlying item is returned to the portfolio of policyholders, regardless of when that movement occurs or what causes that movement, the ultimate obligation to the portfolio of policyholders will be the same regardless of the measurement basis. Therefore, any difference in the measurement of the underlying between the two bases (that is, U.S. GAAP and the other measurement basis) is considered a timing difference that will reverse and enter into future calculations of the participating policyholders' benefits. To account for that timing difference and to reflect the relationship of the liability and the underlying item, an entity should adjust the measurement of the liability to reflect the measurement of the underlying item in accordance with U.S. GAAP.

834-10-55-83 The following Examples are intended to illustrate when the fulfillment cash flows should be adjusted for participating features. They do not address other aspects of the model in this Topic.

> > > Example 7: Participation Feature—Portfolio of Bonds

834-10-55-84 Assume a portfolio of insurance contracts with a performance-linked participation feature that obligates the entity to return 90 percent of the movement of the statutory/regulatory carrying value of a portfolio of bonds to the portfolio of policyholders. The portfolio of bonds is purchased at \$800, pays no interest or dividends, and will mature in 5 years, returning expected proceeds of \$1,300. The bonds are recognized at amortized cost in the entity's statutory/regulatory financial statements and at fair value through other comprehensive income in the entity's U.S. GAAP financial statements. This difference is a timing difference that will reverse and enter into future calculations of participating benefits.

834-10-55-85 At the end of the first year, the amortized cost of the asset is \$900, and the fair value of the asset is \$1,200.

834-10-55-86 The entity's current obligation for the contractual participation feature is \$90 (90 percent of the change in statutory amortized cost of \$900 at

the end of the first year and amortized cost of \$800 when purchased). However, under U.S. GAAP the **carrying amount** of the underlying bonds increased by \$400 (fair value of \$1,200 at the end of the first year less purchase price of \$800). One hundred dollars of the \$400 is recognized in net income because of the movement in amortized cost. If the portfolio of bonds was sold at the end of the first year at fair value, the entity would be obligated to return \$360 (90 percent of the \$400 increase in bonds during the first year) to the portfolio of policyholders.

834-10-55-87 Because of the terms of the portfolio of contracts, the shareholders would be entitled to benefit from only 10 percent of any appreciation in the bonds. Therefore, to address the measurement mismatch between statutory and U.S. GAAP basis measurements, the entity should record \$90 as an expense in net income for the change in expected cash flows related to the entity's current obligation and an additional \$270 (\$360 – \$90) in its fulfillment cash flows to adjust the liability to reflect the U.S. GAAP basis measurement of the underlying item. The corresponding debit would reduce other comprehensive income and result in a reduction in shareholder's equity reflecting the expected amounts to be returned to the policyholder (that is, the shareholder is entitled to only 10 percent of the change in the fair value of the underlying).

> > > **Example 8: Participation Feature—Fair Value of Real Estate**

834-10-55-88 Assume a portfolio of insurance contracts with a performance-linked participation feature obligates the entity to return 90 percent of the movement of the fair value of real estate to the portfolio of policyholders. The real estate is purchased at \$800. The real estate is recognized at amortized cost in the entity's U.S. GAAP financial statements.

834-10-55-89 At the end of the first year, the fair value of the real estate is \$1,200.

834-10-55-90 The entity's obligation for the contractual participation feature is \$360 (90 percent of the difference between the fair value at the end of the first year of \$1,200 and the purchase price of \$800) and should be measured accordingly rather than measured based on 90 percent of the changes in carrying value of the assets (that is, adjusted to \$0 if the carrying value of the real estate did not change). The movement in the carrying value of the real estate does not affect the entity's obligation, and, therefore, does not represent a timing difference that will reverse. If the policyholder surrendered the policy, the policyholder would be entitled to the \$360 whether or not the entity continued to hold the real estate or sold the real estate. This change in the measurement of the liability should be recognized in net income.

> > Segregated Fund Arrangements

834-10-55-91 Common types of arrangements that may be considered to be **segregated fund arrangements** include separate accounts, unit-linked contracts, and super annuitization funds.

834-10-55-92 In determining whether a segregated fund arrangement meets the conditions specified in paragraph 834-10-30-9, an entity should consider all of the following:

- a. Whether only a portion of the policyholder's funds is invested. That is common when actuarial funding is applied in which a portion of the premium received is not invested but is held by the entity in its general account. That would not meet the conditions in paragraph 834-10-30-9 because the amounts credited to the policyholder are not a pass through of the performance of those investments.
- b. Whether contracts specify a minimum guarantee. That would not preclude an arrangement from meeting the conditions in paragraph 834-10-30-9 because all investment performance could be passed through to the policyholder and, if that investment performance is not the specified minimum, the entity is absorbing the additional risk.
- c. Whether contracts specify a ceiling. Because a ceiling would prohibit all investment performance from being passed through to the policyholder, this would not meet the conditions in paragraph 834-10-30-9.
- d. Whether contractual features give the insurer discretion on the amount or timing of the pass through of the investment performance. For example, performance is passed through to individual policyholders on the basis of realized gains on the investment portfolio or when the insurer declares a "dividend." That would not meet the conditions in paragraph 834-10-30-9 because the investment performance is only passed through to the individual policyholder when the entity acts, either by selling an asset and realizing the gain or declaring a dividend. If a policyholder was to surrender its contract or a portion of its contract, the policyholder would not be entitled to the investment performance that has not yet met the specified criteria (that is, gains have not yet been realized or the dividend has not yet been declared).
- e. Arrangements in which policyholder funds are maintained in a segregated fund to fund fixed account options of variable contracts, market value adjusted contracts, guaranteed investment contracts, and indexed contracts are examples of arrangements that would not meet the criteria in paragraph 834-10-30-9 because all of the investment performance on those investments are not passed through to the policyholder.

> > Time Value of Money

834-10-55-93 Discount rates that reflect the characteristics of the insurance contract liability may not be directly observable in the market. An entity should maximize the use of current observable market prices of instruments with similar cash flows but should adjust those prices to reflect the characteristics of the insurance contract liability. The guidance in this Topic does not prescribe the method for making those adjustments. An entity should use judgment to determine an approach that is most appropriate under its particular circumstances.

834-10-55-94 In some cases, an entity may decide as a starting point to base the yield curve for the insurance contract liability on a yield curve that reflects current market rates of returns either for the actual portfolio of assets the entity holds or for a reference portfolio of assets with characteristics similar to those of the insurance contract liability. However, the entity also should adjust those rates of return to exclude factors that are not relevant to the insurance contract liability. In that approach, an entity does all of the following:

- a. Start with the yield curve for the actual portfolio or a reference portfolio.
- b. Remove factors that are not relevant to the insurance contract liability, such as market risk premiums for the assets included in the portfolio. Depending on the characteristics of the liability, market risk premiums might include compensation for expected credit risk losses, or unexpected credit risk losses (the risk of losses exceeding the expected value) and other investment risks taken by the entity, unless those risks can reduce the cash flows passed to the policyholder.
- c. Adjust for the differences between the timing of the cash flows of the assets in the portfolio (actual or reference) and the timing of the liability cash flows. That ensures the duration for the discount rates is aligned with the duration of the liability.

An entity need not adjust for any remaining differences between the liquidity characteristics of the insurance contract and the liquidity characteristics of the assets in the portfolio.

834-10-55-95 In other cases, an entity may decide to adjust a risk-free yield curve with the same duration as the insurance contract liability to include additional factors that are relevant to the insurance contract liability. Additional factors that are relevant to the insurance contract liability include differences between the liquidity and risk characteristics of the instruments underlying the rates observed in the market and the liquidity and risk characteristics of the insurance contract. For example, some government bonds are traded in deep and liquid markets, and the holder can typically sell them at any time without incurring significant costs. In contrast, insurance contract liabilities generally cannot be traded, and there may be no contractual provision for the contract to be cancelled before it matures.

834-10-55-96 When observable market variables are not available or do not separately identify the relevant factors, an entity uses estimation techniques to determine the appropriate discount rates taking into account other observable inputs, where available. For example, the entity may need to determine the discount rates applied to cash flows that are expected beyond the period for which observable market data are available using the current, observable market yield curve for shorter durations. Another example would be the estimate of the credit risk premium included in the spread of a debt instrument. Market prices for credit derivatives can include factors that are not relevant to determine the credit risk component of the market rate of return. That means that the entity may need to establish its own method to determine the credit risk component of the overall asset spread. Under either approach, the discount rates should not include a component reflecting the risk that the entity will not perform under the contract.

834-10-55-97 This Topic requires that, to the extent that the amount, timing, or uncertainty of the cash flows arising from an insurance contract depends wholly or partly on the performance of specified assets, the measurement of the insurance contract should reflect that dependence. That is the case regardless of whether that dependence arises as a result of contractual terms or exercise of the entity’s discretion and regardless of whether the specified assets are directly held by the entity.

> > > Example 9: Determining the Discount Rates by Starting with an Expected Asset Portfolio

834-10-55-98 This Example illustrates the types of adjustments that may be needed in an approach that starts with an entity’s actual portfolio of assets. This Example does not imply that this is the only possible approach to determine the appropriate discount rates but, rather, illustrates the points to be considered. It does not address other aspects of the model in this Topic.

834-10-55-99 Assume an entity has net cash outflows of \$100 over each of the next 5 years. The entity has invested the premium in five zero coupon bonds (A, B, C, D, and E) that mature as described.

	Year 1	Year 2	Year 3	Year 4	Year 5
Insurance Contracts Cash Outflow	\$100	\$100	\$100	\$100	\$100
Bond	A	B	C and D	E	
Nominal Cash Inflow	101	101.5	102 102	103	0

	Year 1	Year 2	Year 3	Year 4	Year 5
Expected Cash Inflow (after Expected Defaults)	100	100	100 100	100	0

834-10-55-100 The entity makes an adjustment to transform the asset cash flows to match the term of the liability cash flows. That could be done by substituting the actual Bond D with the data of another Bond F, which matures in Year 5 and has an expected inflow of 100. (However, there might not be an investment available for Year 5; in this case, the insurer would expand the yield curve.) The approach described would result in an appropriate hypothetical portfolio (that is, with the duration of the assets matched to the duration of the liability).

	Year 1	Year 2	Year 3	Year 4	Year 5
Insurance Contracts Cash Outflow	\$100	\$100	\$100	\$100	\$100
Bond	A	B	C	E	F
Nominal Cash Inflow	101	101.5	102	103	104
Expected Cash Inflow (after Expected Defaults)	100	100	100	100	100
Market Yield to Maturity (Based on Nominal Bond Values)	5.00%	5.25%	5.50%	5.75%	6.00%

834-10-55-101 In a second set of adjustments, the entity adjusts the market yields (if based on the nominal bond values) to reflect that the market expects the cash inflows to be only 100, not 101 (that is, expected defaults). The market yield additionally contains a premium for the risk that the expected cash inflows differ from the estimated cash outflows. That market premium should be removed from the market yield (assuming the fulfillment cash flows are not contractually dependent on the performance of the bonds).

834-10-55-102 The resulting rate for each bond will now supply the yield curve to discount the liability.

	Year 1	Year 2	Year 3	Year 4	Year 5
Bond	A	B	C	E	F
Market Yield to Maturity	5.00%	5.25%	5.50%	5.75%	6.00%
Less Market Premium for Credit Risk ^(a)	0.16%	0.22%	0.31%	0.32%	0.37%
Less Risk Premium for Expected Losses ^(b)	1.04%	0.78%	0.69%	0.78%	0.83%
Yield Curve	3.80%	4.25%	4.50%	4.65%	4.80%
Risk-Free Yield	3.75%	4.00%	4.10%	4.15%	4.20%

- (a) The market premium for credit risk assumed for the purposes of this Example was determined on the basis of the entity's methodology using market information.
- (b) This premium is the difference between the market yield and the discount rate used to discount the expected cash flows to the market price of the bond. For Bond A, the market price is \$96.19, and the discount rate to discount the expected cash flows to that market price is 3.96 percent. The premium is the difference between 5.00 percent and 3.96 percent of 1.04 percent.

834-10-55-103 Assume the market conditions change through a 100-basis-points upward parallel shift in the market yield curve for the bonds but the expectation of losses on the bond portfolio (based on a current updated estimate of the entity) does not change. That is, the 100 basis points are attributable to changes in the risk-free rates, the market premium for credit risk, the market premium for illiquidity risk, and an unexplained residual. The market risk premium for the credit risk based on the methodology is based on the market inputs as described below. The resulting spreads include the following.

	Year 1	Year 2	Year 3	Year 4	Year 5
Bond	A	B	C	E	F
Market Yield	6.00%	6.25%	6.50%	6.75%	7.00%
Less Market Premium for Credit Risk ^(a)	0.35%	0.36%	0.40%	0.51%	0.56%
Less Risk Premium for Expected Losses ^(b)	1.05%	0.79%	0.70%	0.79%	0.84%
Yield Curve	4.60%	5.10%	5.40%	5.45%	5.60%
Risk-Free Yield	4.25%	4.50%	4.60%	4.65%	4.70%

(a) The market premium for credit risk assumed for the purposes of this Example was determined on the basis of the entity's methodology using market information.

(b) This premium is the difference between the market yield and the discount rate used to discount the expected cash flows to the market price of the bond. For Bond A, the market price is \$95.28, and the discount rate to discount the expected cash flows to that market price is 4.95 percent. The premium is the difference between 6.00 percent and 4.95 percent of 1.05 percent.

> > Determination of Qualifying Acquisition Costs

834-10-55-104 An entity should include only the following as the costs directly related to the entity's selling efforts that result in obtaining the insurance contracts in the portfolio:

- a. Direct costs of contract acquisition or origination, such as agent or broker commission or bonus, including trailing commissions.
- b. The portion of the employee's total compensation and payroll-related fringe benefits related directly to time spent performing any of the following activities:
 1. Underwriting
 2. Policy issuance and processing
 3. Medical and inspection fees
 4. Sales force contract selling related to that portfolio.
- c. Other costs related directly to the entity's acquisition activities in (b).

834-10-55-105 Payroll-related fringe benefits include any costs incurred for employees as part of the total compensation and benefits program. Examples of those 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.

834-10-55-106 The portion of total compensation of executive employees that relates directly to the time spent approving successful contracts may be deemed qualifying acquisition costs. For example, the amount of compensation allocable to time spent by members of a contract approval committee is a component of acquisition costs.

834-10-55-107 Examples of the other costs described in paragraph 834-10-55-104(c) that would qualify as directly related to the entity's selling efforts that result in obtaining the insurance contracts in the portfolio include:

- 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.

834-10-55-108 This Topic does not specify how costs are to be determined but rather which costs are qualifying acquisition costs. In many instances, standard costing may be used to estimate the qualifying acquisition costs. For certain contracts, the cost of acquisition may be similar across contracts and standard costing may be appropriate for those contracts, while other contracts may be of such a nature that costs must be identified separately. Entities may use any one or a combination of methods that will provide adequate information to report financial results in accordance with this Topic. Development of a standard costing system will require periodic analysis of variances and, if necessary, adjustment of standard costing estimates. Possible standard costing methods that may be used to measure costs applicable to transactions that have occurred include standard costs, actual costs, job process costs (for example, homogeneous policies), or job order costs (for example, specific contracts).

834-10-55-109 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 deemed qualifying acquisition costs and amortized under this Topic. 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 are not deemed as qualifying, of successful and unsuccessful efforts determined for each function.

834-10-55-110 An entity should recognize all costs of acquiring a portfolio of insurance contracts that are not directly related to the successful acquisition of that portfolio in accordance with other Topics. These include, but are not limited to, any of the following costs:

- a. Product development
- b. Software dedicated to contract acquisition
- c. Equipment maintenance and depreciation
- d. Agent and sales staff recruiting and training
- e. Administration, rent, depreciation, and all other occupancy costs
- f. Utilities
- g. Other general overhead
- h. Advertising costs, including soliciting potential customers, direct response advertising costs, and market research costs.

834-10-55-111 Employees' compensation and fringe benefits related to the activities in the preceding paragraph, unsuccessful contract acquisition efforts, and idle time should be charged to expense as incurred.

> Subsequent Measurement

> > Example 10: Use of Other Comprehensive Income for Presenting the Effect of Changes in Discount Rates

834-10-55-112 This Example is intended to show the use of other comprehensive income for presenting the effect of changes in discount rates. It does not address other aspects of the model in this Topic.

834-10-55-113 Assume both of the following:

- a. A portfolio of policies has a 3-year coverage period and claims payments made over 15 years (from inception) in varying amounts, none of which are contractually linked to underlying assets.
- b. There is no change in the expected cash flows other than those resulting from a change in the discount rates. The expected and actual undiscounted cash outflows, each occurring at the end of the year, and the discount rates are as follows.

Year	Cash Outflow	Discount Rate
Inception	-	6.9%
1	\$1,500,000	6.8%
2	2,500,000	6.5%
3	1,500,000	5.7%
4	1,500,000	7.9%
5	500,000	7.5%
6	500,000	6.5%
7	300,000	4.5%
8	200,000	4.0%
9	500,000	4.6%
10	100,000	5.5%
11	100,000	6.1%
12	100,000	4.9%
13	200,000	7.3%
14	200,000	4.9%
15	300,000	5.3%

834-10-55-114 The table in this paragraph and the table in paragraph 834-10-55-116 illustrate the mechanics of how the amounts to be recognized in other comprehensive income and accumulated other comprehensive income might be calculated.

Year	Present Value of Cash Flows			Accumulated Other Comprehensive Income	Other Comprehensive Income
	at Current Rate	at Prior Period Rate	at Interest Accretion Rate		
(1)	(2)	(3)	(4)	(5)	(6)
				(2) – (4)	(5) – (5) _{k-1}
Inception	\$ 7,659,846	-	\$ 7,659,846	-	-
1	6,697,610	\$ 6,687,620	6,687,620	\$ (9,990)	\$ (9,990)
2	4,715,347	4,655,804	4,648,406	(66,941)	(56,951)
3	3,616,842	3,519,619	3,468,688	(148,154)	(81,213)
4	2,118,158	2,321,326	2,207,685	89,527	237,682
5	1,814,428	1,786,485	1,859,798	45,370	(44,158)
6	1,510,511	1,451,148	1,487,940	(22,571)	(67,941)
7	1,412,484	1,308,807	1,290,462	(122,022)	(99,451)
8	1,298,029	1,276,046	1,179,376	(118,652)	3,370
9	830,226	849,950	760,637	(69,589)	49,064
10	745,938	768,416	713,046	(32,893)	36,696
11	676,098	686,965	662,175	(13,922)	18,971
12	632,750	617,340	607,800	(24,950)	(11,028)
13	447,273	463,533	449,679	2,405	27,355
14	286,083	279,713	280,662	(5,421)	(7,826)
15	-	-	-	-	5,421

834-10-55-115 Accumulated other comprehensive income attributable to the insurance contract is calculated as the difference between the insurance contract liability recorded on the statement of financial position (column (2)) and the amount the insurance contract liability would be if it were determined at the interest accretion rates (column (4)). Accordingly, other comprehensive income could be simply calculated as the increase (decrease) in accumulated other comprehensive income (column (5)). For example, in Years 1 and 2 accumulated other comprehensive income decreased by \$9,990 (\$0 at inception to \$(9,990) at the end of Year 1) and \$56,951 (\$(9,990) to \$(66,941) at the end of Year 2), respectively.

834-10-55-116 Alternatively, other comprehensive income could be calculated by separately calculating its components: the effect of discount rate changes on the liability (column (7)) and the reversal of those amounts as interest expense are recognized in net income based on the interest accretion rate (column (10)), as illustrated in the following table.

Year	Effect of Discount Rate Change on Liability	Interest Expense on Cash Flows	Unwind of Discount on Cash Flows	Reduction in Accumulated Other Comprehensive Income Due to Unwind of Discount	Other Comprehensive Income
(1)	(7)	(8)	(9)	(10)	(11)
	(a)	(b)	(c)	(8) – (9)	(10) – (7)
1	\$ 9,990	\$ 527,774	\$ 527,774	-	\$ (9,990)
2	59,543	460,786	458,194	\$ 2,592	(56,951)
3	97,223	320,282	304,272	16,010	(81,213)
4	(203,167)	238,997	204,483	34,514	237,682
5	27,944	152,113	168,327	(16,214)	(44,158)
6	59,363	128,143	136,720	(8,578)	(67,941)
7	103,677	102,521	98,295	4,226	(99,451)
8	21,983	88,915	63,562	25,353	3,370
9	(19,724)	81,261	51,921	29,339	49,064
10	(22,478)	52,409	38,190	14,219	36,696
11	(10,867)	49,130	41,027	8,103	18,971
12	15,411	45,625	41,242	4,383	(11,028)
13	(16,259)	41,878	30,782	11,096	27,355
14	6,370	30,983	32,440	(1,456)	(7,826)
15	-	19,338	13,917	5,421	5,421

- (a) Calculated as the difference between columns (2) and (3) in the table in paragraph 834-10-55-114.
- (b) The interest expense is calculated as the beginning-of-the-year present value of cash flows discounted at the interest accretion rate (column (4) from the table in paragraph 834-10-55-114) multiplied by the 6.9 percent interest accretion rate from the table in paragraph 834-10-55-113.
- (c) The unwind of the discount on the cash flows in this Example is calculated as the beginning-of-the-year insurance contract liability (column (2) in the table included in paragraph 834-10-55-114) multiplied by the current discount rate from the table in paragraph 834-10-55-113 as of the beginning of the year.

834-10-55-117 In Year 1, the liability increases by \$537,764 (offset by a \$1,500,000 cash payment from the table in paragraph 834-10-55-113), which is a function of both the unwind of the discount of \$527,774 (column (9)) because of the passage of time and the effect of changes in the discount rate of \$9,990 (column (7)). In Year 2, the liability increases by \$517,737 (offset by a \$2,500,000 cash payment from the table in paragraph 834-10-55-113), which is a function of both the unwind of the discount of \$458,194 (column (9)) because of the passage of time and the effect of changes in the discount rate of \$59,543 (column (7)). The effect of changes in the discount rate (column (7)) is presented in other comprehensive income. As the discount on the insurance contract liability unwinds through the passage of time, the amounts remaining in accumulated other comprehensive income are recognized into interest expense (that is, the unwind of the discount and the interest expense determined based on the interest accretion rates converge over time). Those positive amounts included in column (10) represent the current-period reclassifications out of accumulated other comprehensive income required by Topic 220 on comprehensive income to be presented on the face of the financial statements or as a separate disclosure in the notes.

> > Example 11: Use of Other Comprehensive Income for Presenting the Effect of Changes in Discount Rates for the Liability for Incurred Claims (for Contracts Measured Using the Premium Allocation Approach)

834-10-55-118 The following Example illustrates the use of other comprehensive income for presenting the effect of changes in discount rates for the **liability for incurred claims** for a portfolio of contracts. It does not address other aspects of the model in this Topic. Assume all of the following:

- a. The premium for 1 year's coverage is \$12,000, which is earned ratably over the year (that is, \$3,000 per quarter).
- b. The entity has elected to recognize all costs of acquiring its portfolio of insurance contracts as an expense when incurred and not to adjust the **liability for remaining coverage** or premiums receivable to reflect the time value of money.
- c. Expected claims are \$9,600 or \$2,400 per quarter (that is, an expected loss ratio of 80 percent), and claims are paid 2 years after they are incurred.
- d. There are no fulfillment cash flows other than premiums and claims.
- e. There is a flat yield curve with a discount rate at the inception of the contract of 4 percent.
- f. The effect for any unwind of the discount on the liability for incurred claims is being ignored.

834-10-55-119 At the end of the first quarter, the entity has reduced the liability for remaining coverage by \$3,000 and recognized that as revenue. Assume that the entity recognizes a liability for incurred claims consistent with its initial

expectations (that is, an 80 percent loss ratio), but the cash flows are discounted at the current discount rate of 5 percent at the date the claims are incurred (that is, based on a 100-basis-point parallel positive shift in the yield curve). There are no changes in yield curve for the remainder of the quarter.

834-10-55-120 Using the yield curve determined at the inception of the contract, an expense for the liability for incurred claims would be recognized in the amount of \$2,219 (\$2,400 discounted at 4 percent for 2 years), and underwriting profit recognized would be \$781 (\$3,000 of revenue less \$2,219 of claims). However, the liability for incurred claims on the statement of financial position would be measured at \$2,177 (\$2,400 discounted at 5 percent for 2 years), and, therefore, a difference of \$42 (\$2,219 – \$2,177) would be recorded to other comprehensive income.

834-10-55-121 At the end of the second quarter, the entity again has reduced the liability for remaining coverage by \$3,000 and recognized that as revenue. Assume that the entity again recognizes a liability for incurred claims consistent with its initial expectations (that is, an 80 percent loss ratio), but the cash flows are discounted at the current discount rate of 3 percent at the date the claims are incurred (that is, based on a 200-basis-point parallel negative shift in the yield curve). There are again no changes in yield curve for the remainder of the quarter.

834-10-55-122 Using the yield curve determined at the inception of the contract, an expense for the liability for incurred claims would again be recognized in the amount of \$2,219 (\$2,400 discounted at 4 percent for 2 years), and underwriting profit recognized would again be \$781 (\$3,000 of revenue less \$2,219 of claims). However, the liability for incurred claims on the statement of financial position for those claims incurred in the second quarter would be measured at \$2,262 (\$2,400 discounted at 3 percent for 2 years), and, therefore, a difference of \$(43) (\$2,219 – \$2,262) would be recorded to other comprehensive income.

834-10-55-123 In addition, the entity would need to update the discount rate for the liability for incurred claims for prior periods as described in the previous example.

> > Example 12: Adjustment to the Interest Accretion Rates

834-10-55-124 The following Example illustrates the use of other comprehensive income for presenting the effect of changes in future interest costs. It illustrates the concepts using a contract that is accounted for using the building block approach, but a similar process would apply to contracts accounted for using the premium allocation approach. It does not address other aspects of the model in this Topic. Assume all of the following for a portfolio of insurance contracts with discretionary participation features and premiums fully paid up front.

Initial estimate of benefits payable	\$1,000
Timing of payment (for purposes of this Example, assume the contracts do not transfer timing risk)	10 years
Initial discount rate	5%
Initial yield on underlying bonds	5.5%
Maturity of initial bonds investment	5 years
Reinvestment plan upon maturity of bonds	Comparable 5-year bonds
Decrease in both the discount rate and the market yield on the bonds at the end of Year 1	100 basis points

834-10-55-125 Further assume that because the entity considers the changes in the market yield to be attributable to short-term movements in interest rates, before the end of Year 2 it did not expect to change the crediting rate. At the end of Year 2, market yields have not recovered and the entity estimates it will need to reinvest the assets at this lower yield and to adjust the interest crediting rate accordingly. The effect of the expected decrease in the interest crediting rate is a revised estimate of benefit payments of \$963.

834-10-55-126 On the basis of the assumptions included in paragraph 834-10-55-124 and the preceding paragraph and assuming no other changes in estimates, the insurance contract liability (ignoring the margin) initially and at the end of Year 1 and Year 2 should be as follows.

	Undiscounted	Discounted
Initially	\$1,000 (from assumptions)	\$614 (present value of \$1,000 at 5% for 10 years)
At the end of Year 1	\$1,000 (from assumptions)	\$703 (present value of \$1,000 at 4% for 9 years)
At the end of Year 2	\$963 (from assumptions)	\$704 (present value of \$963 at 4% for 8 years)

834-10-55-127 At the end of Year 2, upon its change in expectations of the crediting rate, the entity should adjust the interest accretion rate. This rate should be calculated by determining the rate that would result in accretion to the newly

determined cash outflow amount (over the remaining eight years). The adjustment to the rate is determined based on accreting from the amount of the insurance contract liability (before adjusting for the effect of the changes in expected interest crediting) at the measurement date if it were discounted using the immediately preceding interest accretion rate. Thus, the interest accretion rate is calculated as follows.

Estimated undiscounted cash flows (before adjusting for the effect of the changes in expected interest crediting)	\$1,000 (from assumptions)
Immediately preceding interest accretion rate	5% (from assumptions, that is, the initial discount rate)
Insurance contract liability calculated at the immediately preceding interest accretion rate	\$677 (present value of \$1,000 discounted at 5% for 8 years)
Current estimated (undiscounted) cash outflows	\$963 (from assumptions)
New interest accretion rate	4.51% (computed as the rate required to accrete \$677 to \$963 over an 8-year period)

834-10-55-128 The entity would prospectively use the 4.51 percent interest accretion rate to determine interest expense. The interest expense each period is calculated as follows.

	Year 1	Year 2	Year 3 (absent any changes)
Interest accretion rate in effect during the period	5%	5%	4.51%

	Year 1	Year 2	Year 3 (absent any changes)
Amount the insurance contract liability would have been at the beginning of the period if it were calculated at the interest accretion rate	\$614 (present value of \$1,000 at 5% for 10 years)	\$645 (present value of \$1,000 at 5% for 9 years)	\$677 (present value of \$963 at 4.51% for 8 years)
Interest expense	\$31 (5% × \$614)	\$32 (5% × \$645)	\$31 (4.51% × \$677)

834-10-55-129 The accumulated other comprehensive income at the end of each period and the other comprehensive income for each period can be calculated as follows.

	Year 1	Year 2	Year 3 (absent any changes)
Insurance contract liability (end of period)	\$703	\$704	\$732 (present value of \$963 at 4% for 7 years)
Amount the insurance contract liability would be (at the end of the period) if it were calculated at the interest accretion rate	\$645 (present value of \$1,000 at 5% for 9 years)	\$677 (present value of \$963 at 4.51% for 8 years)	\$707 (present value of \$963 at 4.51% for 7 years)
Accumulated other comprehensive income (end of the year)	\$58 ($\$703 - \$645$)	\$27 ($\$704 - \$677$)	\$25 ($\$732 - \$707$)
Accumulated other comprehensive income (beginning of the year)	\$0	\$58	\$27
Other comprehensive income	\$(58) ($\$0 - \$58$)	\$31 ($\$58 - \$27$)	\$2 ($\$27 - \$25$)

> > Liability for Remaining Coverage

> > > Discounting and Accreting Interest

834-10-55-130 In assessing whether a financing component is significant to a contract and results in an entity discounting and accreting the liability for remaining coverage, an entity should consider various factors including, but not limited to, all of the following:

- a. The expected length of time between when the policyholder pays the premium and when the entity transfers the insurance coverage to the policyholder
- b. Whether the amount of consideration would differ substantially if the customer paid in cash promptly in accordance with typical credit terms in the industry and jurisdiction
- c. The interest rates in the contract and prevailing interest rates in the relevant market.

834-10-55-131 As a practical expedient, an entity need not adjust the liability for remaining coverage to reflect the time value of money if the entity expects, at contract inception, that the time period between when the policyholder pays all or substantially all of the premium and when the entity provides the corresponding part of the coverage is one year or less. The following are simplified illustrations of what an entity should consider in determining whether a portfolio of contracts qualifies for the practical expedient.

- a. A three-year surety contract in which the policyholder is expected to pay premiums at the beginning of each of the three years that is commensurate with the service to be provided during the upcoming year. In that situation, the entity would not be required to discount and accrete interest on the liability for remaining coverage.
- b. A three-year surety contract in which the policyholder is expected to pay premiums at the beginning of the first year of coverage. In that situation, the entity would be required to discount and accrete interest on the liability for remaining coverage.

> > > Onerous Contract Test and Subsequent Event Reporting

834-10-55-132 In the precoverage period, the **onerous contract** test is applicable to portfolios measured using both the building block approach and premium allocation approach. The onerous contract test also applies during the coverage period before a claim is incurred for portfolios measured using the premium allocation approach.

834-10-55-133 All of the following are examples of changes in variables that may indicate a contract is onerous:

- a. If the probability of a hurricane or similar catastrophe suddenly increases
- b. If a demand surge after a major hurricane inflates the prices of building materials
- c. If there is an unexpected increase in medical costs that affect specific health insurance contracts.

834-10-55-134 All of the following are facts and circumstances that may indicate that a portfolio of insurance contracts is onerous:

- a. The combined loss ratio (that is, the incurred claims and incurred expenses, including claims adjustment expenses and other underwriting expenses, divided by premiums earned) for the current year in-force business (that is, the portfolio of contracts for which there is an unexpired portion of coverage) exceeds 100 percent. In contrast, if the combined loss ratio for the current year in-force business in the claims period, when the “losses” are determined using the present value of the expected cash flows, is less than 100 percent, it would be a strong indicator that the liability for remaining coverage for that portfolio of contracts is not onerous.
- b. There is a significant increase in the severity or frequency of claims. While the combined loss ratio for the insurance liability in the claims period may be less than 100 percent, an indicator that the ratio may increase for a portfolio of contracts is if the claims being reported are more frequent or severe than originally expected.
- c. There is a change in the characteristics of the risk profile. A company that does not have sufficient historical experience with particular types of insurance may require additional analysis and support to determine that a contract is not onerous if there are other indicators to suggest it is onerous.

834-10-55-135 Entities need to consider infrequent, high-severity events, such as hurricanes, as of the reporting date when determining whether or not a portfolio of contracts is onerous.

> > > **Example 13: Onerous Contract Test**

834-10-55-136 Assume that an entity covers property in Florida against hurricane damage. It prepares financial statements for the period ending September 30, 20X1.

- a. In September, a hurricane is forming in the Atlantic Ocean.
- b. On September 30, the entity estimates that there is a 50 percent probability that the hurricane will strike Florida, which will result in claims estimated at \$1 billion, excluding the impact from discounting for simplicity.

- c. On September 30, the entity's expected probability-weighted estimate of cash outflows is \$0.5 billion for this hurricane, which results in the portfolio of contracts being onerous. Therefore, the entity should record the amount of expected losses in excess of the liability for remaining coverage.
- d. During the first week of October, the hurricane does not strike Florida, and expected cash flows related to the storm are \$0.
- e. In the September 30 financial statements, the entity should include the amount of expected losses in excess of the liability for remaining coverage and disclose the updated assumptions related to the loss (that is, \$0) in its notes in accordance with the guidance in Topic 855 on subsequent events, as a nonadjusting subsequent event.

> > Margin

> > > Recognizing the Margin

834-10-55-137 Determination of the release from risk as evidenced by a reduction in the variability of the cash flows of the portfolio of insurance contracts is a matter of judgment and should be based on facts and circumstances unique to the entity and the nature of its insurance contracts. Different entities may measure a reduction in variability of cash flows in different ways as further information is obtained about the expected cash flows during the life cycle of an insurance portfolio.

834-10-55-138 An entity should consider specific facts and circumstances to qualitatively determine if a reduction in the variability of cash flows of the portfolio of insurance contracts has occurred to determine whether an entity has been released from risk. An entity should consider all of the following facts and circumstances when evaluating the variability of cash flows:

- a. The entity's relative experience with the types of contracts
- b. The entity's past experience in estimating expected cash flows for those types of contracts
- c. Inherent difficulties in estimating expected cash flows
- d. The relative homogeneity of the contracts within the portfolio
- e. The fact that past experience may not be representative of future results.

834-10-55-139 An entity also should consider all of the following minimum points in the life cycle of a contract to provide evidence of a reduction in the variability of cash flows of the portfolio of insurance contracts; at each point, some of the uncertainty in the expectation of cash flows is likely partially resolved:

- a. The dates claims are incurred
- b. The dates claims are reported
- c. When information becomes known about the claims

- d. Settlement of the claims
- e. Payment of the claims.

834-10-55-140 Examples of other factors an entity may consider, if applicable, include the following:

- a. Reduction in the face value of the contracts in force
- b. Reduction in policy counts
- c. Reduction in claim counts
- d. Reduction in **net amount at risk** (that is, the face value of the contracts less the accumulated policyholder account values or premiums received in the current year [depending on type of contract])

834-10-55-141 An entity's methodology used to determine release from risk for each portfolio should be applied consistently throughout the lifecycle of the portfolio.

834-10-55-142 The following simplified Examples show two ways that an entity might recognize the margin as it is released from risk. Those Examples are not intended to preclude an entity from using its judgment to apply the requirements in paragraphs 834-10-35-19 through 35-20 in a manner that best represents its release from risk, nor are they intended to suggest that those measurements of reductions in the variability of cash flows of the portfolio of insurance contracts will be appropriate in all facts and circumstances. The pattern used to release the margin also should be used to recognize expense for qualifying acquisition costs, which is not shown in these Examples. These Examples also do not address other aspects of the model in this Topic.

> > > Example 14: Based on Timing

834-10-55-143 The following assumptions apply in this Example of a portfolio of life insurance contracts for which the variability of the net cash flows is determined to be solely due to timing of insured events and, thus, the entity determines its release from risk on the basis of reduced uncertainty in the timing of the policyholders' deaths. For simplicity of this Example, assume that there is no cash surrender value or other **estimated returnable amounts** associated with these contracts and that all policyholders are expected to die by Year 30. Also for the simplicity of this Example, ignore accretion of interest on the margin.

Margin	\$60,000
Initial Life Expectancy	10% probability of deaths at the portfolio level at end of Year 10 30% probability of deaths at the portfolio level at end of Year 20

Margin	\$60,000
	60% probability of deaths at the portfolio level at end of Year 30

834-10-55-144 After 10 years, 10 percent of the portfolio's policyholders have died (representing benefits equal to 10 percent of the expected benefits for the portfolio), which is in line with initial expectations. Accordingly, and because of the immaterial variability in timing of remaining benefit payments for those policyholders, because there is no uncertainty in the timing of claims payments, all of the variability of cash flows associated with that portion of the portfolio has effectively been eliminated.

834-10-55-145 After considering that experience and both internal and external mortality statistics, the entity concludes that the uncertainty in the timing of the remaining policyholders' deaths has not changed from its initial estimates. Additionally, it concludes that each of the policies had an equivalent amount of timing uncertainty. Therefore, it would have reduced the margin by 10 percent or \$6,000 by the end of Year 10.

834-10-55-146 If the entity had instead concluded, based on new information, that the shape of the probability distribution of the timing of deaths for the remaining policyholders had narrowed, additional amounts of margin also would have been released to reflect a reduction in the variability in cash flows. Conversely, if the shape of the probability distribution of the timing of deaths for the remaining policyholders had widened, the entity would have released less margin.

> > > **Example 15: Based on Timing**

834-10-55-147 Assume the same initial fact pattern as described in Example 14. However, after considering that experience and both internal and external mortality statistics, the entity concludes that the estimated timing of the remaining insured events is consistent with its original estimates (that is, 30 percent of the initial portfolio's policyholders will die in the next decade, and so forth). If the entity concludes that the passage of time has eliminated the initial uncertainty that the remaining policyholder might have died during the first 10 years of its contracts, the shape of the probability distribution curve of the timing of the remaining deaths would narrow. Accordingly, the entity may determine that the reduction in uncertainty in the timing of insured events is best represented by attributing uncertainty to units of time in proportion to the face amount estimated to be **in force** each period. In those circumstances, the entity may calculate its margin release as follows.

	Years 1–10	Years 11–20	Years 21–30	Total
Estimated proportion of death benefits in force (that is, the percentage of contracts in force because the policyholder is still living)	100%	90% (100% – 10% estimated deaths)	60% (90% – 30% estimated deaths)	250%
Initial margin	\$60,000			
Reduction in uncertainty in the timing of insured events	40% (100% / 250%)			
Margin recognized as revenue	\$24,000 ($\$60,000 \times 40\%$)			

834-10-55-148 At each subsequent reporting date the entity should update its assessment as to how much uncertainty in timing remains at that date in comparison to the uncertainty in timing deemed to have existed at the beginning of the period. Accordingly, based on the methodology applied in this Example, if 30 percent of the original policyholders died at the end of Year 20 as estimated at the end of Year 10 and the entity estimates the remaining 60 percent of the policyholders will die at the end of Year 30, the entity would recognize a margin of \$21,600 [$90\% / (90\% + 60\%) \times (\$60,000 - \$24,000)$] in Years 11 through 20 and the remainder in Years 21 through 30.

> > > Example 16: Based on Frequency/Severity

834-10-55-149 The following assumptions apply in this Example to a portfolio of contracts for which the variability of the net cash flows is determined to be due to the frequency and severity of insured events. Thus, the entity determines its release from risk on the basis of reduced variability of cash flows of the portfolio of insurance contracts. Also for the simplicity of this Example, ignore accretion of interest on the margin.

Estimated claims payment date	Five years after contract inception in all scenarios	
Premium	\$1,200 received up front	
		Variance from Mean
Initial estimate of cash outflows distribution	25% probability of claims with present value of \$600	\$(360) (\$600 – \$960)
	50% probability of claims with present value of \$960	\$0 (\$960 – \$960)
	25% probability of claims with present value of \$1,320	\$360 (\$1,320 – \$960)
Mean	\$960 (25% × \$600 + 50% × \$960 + 25% × \$1,320)	
Standard deviation		\$255 ($\sqrt{[(\$360)^2 \times 25\%] + [\$0^2 \times 50\%] + [\$360^2 \times 25\%]}$)

834-10-55-150 The entity concludes that the use of standard deviation will reasonably measure the variability of net cash flows of the portfolio of insurance contracts. Based on the probability distribution, the entity calculates the initial standard deviation to be \$255, as illustrated in the table in the preceding paragraph.

834-10-55-151 After one year, based on new information that has become available related to claims incurred and reported to date, the entity revises its estimates of cash outflows for the portfolio of insurance contracts as follows, reflecting a decrease in the variability of cash flows.

		Variance from Mean
Revised estimate of cash outflows distribution	20% probability of claims with present value of \$780	\$(120) (\$780 – \$900)
	60% probability of claims with present value of	\$0

		Variance from Mean
	\$900	(\$900 – \$900)
	20% probability of claims with present value of \$1,020	\$120 (\$1,020 – \$900)
Mean	\$900 $([20\% \times \$780] + [60\% \times \$900] + [20\% \times \$1,020])$	
Standard deviation		\$76 $(\sqrt{[(\$120)^2 \times 20\%] + [\$0^2 \times 60\%] + [\$120^2 \times 20\%]})$

834-10-55-152 Based on the probability distribution in the preceding paragraph, the entity calculates the revised standard deviation to be \$76, as illustrated in the table in that paragraph. The entity applies the ratio of the reduction in the standard deviation of \$179 (that is, \$255 – \$76) to the original standard deviation of \$255 to measure the reduction in the variability of cash flows as 70 percent (\$179/\$255). Therefore, it would have reduced the initial margin of \$240 by the same 70 percent, or \$168.

> > > Recognizing and Presenting Qualifying Acquisition Costs

> > > > Example 17: Recognizing and Presenting Qualifying Acquisition Costs

834-10-55-153 The following Example shows how an entity would recognize and present qualifying acquisition costs. For simplicity, this Example does not include the effect of the time value of money. Also, it does not address other aspects of the model in this Topic. Assume a portfolio of contracts with the following characteristics:

Future premiums	\$ (200)
Future benefits/claims and contract-related expenses	<u>140</u>
Margin (recognized evenly over the coverage/settlement period of 10 years)	(60)
Total expected acquisition costs (25% incurred before contract recognition [\$5] and trailing commission that is paid evenly over the first 5 years of the contract [\$15])	<u>20</u>
Total expected margin after acquisition costs	<u>\$ (40)</u>

Years	(1)	0	1	2	3	4	5	6	7	8	9	10
Margin before deducting acquisition costs												
Margin, beginning of year	\$ (60)	\$ (60)	\$ (54)	\$ (48)	\$ (42)	\$ (36)	\$ (30)	\$ (24)	\$ (18)	\$ (12)	\$ (6)	
Recognition of margin	-	6	6	6	6	6	6	6	6	6	6	60
Margin, end of year	<u>\$ (60)</u>	<u>\$ (54)</u>	<u>\$ (48)</u>	<u>\$ (42)</u>	<u>\$ (36)</u>	<u>\$ (30)</u>	<u>\$ (24)</u>	<u>\$ (18)</u>	<u>\$ (12)</u>	<u>\$ (6)</u>	<u>\$ (0)</u>	
Acquisition costs												
Expected acquisition costs, beginning of year	\$ (20)	\$ (15)	\$ (15)	\$ (12)	\$ (9)	\$ (6)	\$ (3)	-	-	-	-	-
Expected acquisition costs incurred	5	-	3	3	3	3	3	-	-	-	-	20
Expected acquisition costs, end of year	<u>\$ (15)</u>	<u>\$ (15)</u>	<u>\$ (12)</u>	<u>\$ (9)</u>	<u>\$ (6)</u>	<u>\$ (3)</u>	<u>\$ (0)</u>	<u>\$ (0)</u>	<u>\$ (0)</u>	<u>\$ (0)</u>	<u>\$ (0)</u>	<u>\$ (0)</u>
Acquisition costs not yet recognized, beginning of year	\$ 20	\$ 20	\$ 18	\$ 16	\$ 14	\$ 12	\$ 10	\$ 8	\$ 6	\$ 4	\$ 2	
Acquisition costs recognized as an expense	-	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(20)
Acquisition costs not yet recognized, end of year	<u>\$ 20</u>	<u>\$ 18</u>	<u>\$ 16</u>	<u>\$ 14</u>	<u>\$ 12</u>	<u>\$ 10</u>	<u>\$ 8</u>	<u>\$ 6</u>	<u>\$ 4</u>	<u>\$ 2</u>	<u>\$ (0)</u>	
Margin as recorded on statement of financial position	<u>\$ (55)</u>	<u>\$ (48)</u>	<u>\$ (41)</u>	<u>\$ (34)</u>	<u>\$ (27)</u>	<u>\$ (20)</u>	<u>\$ (16)</u>	<u>\$ (12)</u>	<u>\$ (8)</u>	<u>\$ (4)</u>	<u>\$ (0)</u>	
Effect on net income		\$ 4	\$ 4	\$ 4	\$ 4	\$ 4	\$ 4	\$ 4	\$ 4	\$ 4	\$ 4	40

> > Estimated Returnable Amounts

> > > Example 18: Determination of the Estimated Returnable Amount Excluded from Revenue for a Whole Life Insurance Contract

834-10-55-154 This simplified Example illustrates the initial determination of the estimated returnable amount for a portfolio of whole life contracts. It does not address other aspects of the model in this Topic.

Assumptions:

Lump sum premium paid up front	\$1,200
Death benefit	\$5,000
Discount rate	5%
Cash surrender value:	
After Year 5	\$960
After Year 10	\$1,030
After Year 30	\$3,030

834-10-55-155 Assume that the entity's insurance contract liability is determined based on only the following three scenarios, each with immediate cash distribution: the policyholder cancels the policy after 5 years; the policyholder cancels the policy after 10 years; and the policyholder dies at the 30th anniversary of contract issuance (while the policy is in effect). The following table presents the initial determination of the estimated returnable amount to be excluded from **insurance contract revenue**.

Scenarios	Probability of Scenario	Cash Surrender Value Available	Present Value
Lapses after Year 5	25%	\$960	\$752
Lapses after Year 10	25%	\$1,030	\$632
Death at Year 30 (cash surrender value at death is treated as estimated returnable amount and not part of death benefit)	50%	\$3,030	\$701
Estimated returnable amount		\$2,013 ($25\% \times \$960 + 25\% \times \$1,030 + 50\% \times \$3,030$)	\$697 ($25\% \times \$752 + 25\% \times \$632 + 50\% \times \$701$)
Remaining premium			\$503
Total amount charged			\$1,200

834-10-55-156 Accordingly, the initial expectation of the amount of insurance contract revenue to be presented in net income over the life of the contracts would be based on the remaining premium of \$503 plus accretion of interest on

the revenue to reflect the time value of money for the period between premium receipt and provision of the corresponding coverage. Upon the occurrence of an insured event, claims expense recognized in net income would be calculated as the estimated present value of the claims payment less the cash surrender value of the policy at that date. In this Example, if \$2,500 (\$5,000 aggregate death benefit $\times$ 50 percent of the portfolio) of claims is incurred and immediately paid in Year 30, the cash surrender value of \$1,515 (\$3,030 $\times$ 50 percent) that those policyholders were entitled to immediately before the insured event would be deducted from the \$2,500, and a claims expense of \$985 would be recognized in net income.

834-10-55-157 As the entity updates its assumptions as part of the measurement of the insurance contract liability, any changes in the estimated returnable amount should be evaluated to determine the effect on the amount of insurance contract revenue to be prospectively recognized. Assume in Year 5 that for the same portfolio of whole life contracts, the entity updates its assumptions to reflect its revised expectation that there will be no lapses in Year 10 as originally expected. Also assume that actual experience was consistent with those revised expectations and that there were no other changes in assumptions. The following table presents the updated determination of the estimated returnable amount to be excluded from insurance contract revenue and claims.

Scenarios	Probability of Scenario	Cash Surrender Value Available	Present Value (at Inception) ^(a)
Lapses after Year 5	25%	\$960	\$752
Lapses after Year 10	0%	1,030	632
Death at Year 30 (cash surrender value at death is treated as estimated returnable amount and not part of death benefit)	75%	3,030	701
Estimated returnable amount		2,513 (25% $\times$ \$960 + 75% $\times$ \$3,030)	714 (25% $\times$ \$752 + 75% $\times$ \$701)
Remaining premium			486
Total amount charged			1,200

- (a) The present value at inception rather than the current present value was used in this calculation as a means to eliminate the effect of changes in the estimated returnable amount due solely to the passage of time (that is, to facilitate comparison to the initial estimate of the estimated returnable amount, which was determined at inception of the contract).

834-10-55-158 Accordingly, the revised expectation of the amount of insurance contracts revenue to be presented in net income over the life of the contracts would be based on the remaining premium of \$486 plus accretion of interest on the revenue.

834-10-55-159 The resulting change in insurance contracts revenue of \$17 (\$503 – \$486), plus or minus any effect due to the accretion of interest will be recognized prospectively from the beginning of the period in which the related change is recognized in the measurement of the insurance contract liability. Accordingly, this effect on revenue will be recognized over the period commencing with the change in the estimated returnable amount (Year 5) up through the end of the portfolio of contracts (Year 30).

> > > Example 19: Determination of the Estimated Returnable Amount Excluded from Revenue for a Portfolio of Property-Casualty Reinsurance Contracts

834-10-55-160 This simplified Example illustrates the initial determination of the estimated returnable amount for a portfolio of property and casualty reinsurance contracts with a bonus paid to the cedant if there are no claims (that is, a no-claims bonus). In addition to providing a \$15,000 bonus for not incurring any claims, the terms of those contracts stipulate that to the extent claims are incurred in an amount of less than \$15,000, the contracts will pay a bonus equal to the excess of the \$15,000 maximum bonus above the value of the actual claims incurred. It does not address other aspects of the model in this Topic.

Portfolio of Contracts with No-Claims Bonuses

Number of contracts	1,000
Contractual premium	\$25,000
No-claims bonus, per contract (paid at the end of Year 2)	\$15,000
Percentage of contracts with no claims	90%

834-10-55-161 The amount excluded from revenue and claims is the maximum bonus of \$15,000,000 (1,000 contracts × \$15,000 bonus per contract) (or the present value of that amount if discounting is applied to measure the time value of money). For this Example, assume that for the 10 percent of contracts with claims each had claims in excess of \$15,000 and, therefore, \$1,500,000 of

\$15,000,000 is paid to policyholders in the form of claim payments (that is, rather than as no claims bonuses). Even though the \$1,500,000 is paid to policyholders in the form of claims payments, it is still considered estimated returnable amounts because, absent the claim payments, the amount would still be returnable (that is, as a no-claims bonus).

> > **Example 20: Building Block Approach—Determination of Insurance Contract Revenue Recognized in a Reporting Period**

834-10-55-162 The following Example represents a group of 25-year term life contracts sold to 40-year-old males with all premiums paid at contract inception and with none of the premium refundable to the policyholder or its beneficiary (that is, there is no estimated returnable amount). The mortality assumptions used to estimate the claims pattern are those used in the measurement of the fulfillment cash flows. This Example is intended to show the determination of revenue recognized in a reporting period and does not address other aspects of the model in this Topic. In addition, assume all of the following:

- a. Actual experience is equal to the initial expectations for premiums, incurred claims, and expenses.
- b. Time value of money is excluded and, therefore, there is no discounting.
- c. The margin is released as follows, in proportion to the reduction in the variability of cash outflows:
 - 1. 18 percent in Years 1–5
 - 2. 20 percent in Years 6–10
 - 3. 21 percent in Years 11–15
 - 4. 21 percent in Years 16–20
 - 5. 20 percent in Years 21–25.
- d. The premiums and what they are deemed attributable to is as follows.

Total premiums received	\$ 15,000
Attributable to:	
Maintenance and benefit expense ^(a)	(900)
Death benefits ^(b)	<u>(10,000)</u>
Margin gross of acquisition costs	<u>\$ 4,100</u>

(a) Based on the assumption of \$36 per year.

(b) The expected cash outflows upon death.

834-10-55-163 Paragraph 834-10-35-12 requires that insurance contract revenue for premiums attributable to the fulfillment cash flows be recognized over the coverage period in proportion to the value of coverage and any other services that the entity has provided. An entity should determine which techniques and

methods most accurately portray the value of coverage and other services provided each period. Although other methods might be appropriate to meet that objective, in this Example, the entity has determined that the value of coverage provided each period in this case is best depicted by the expected mortality costs for that period and that the value of the other services is best depicted by the cost of maintenance and benefits expenses. Therefore, the entity calculates the revenue attributable to death benefits to be allocated to each period as follows.

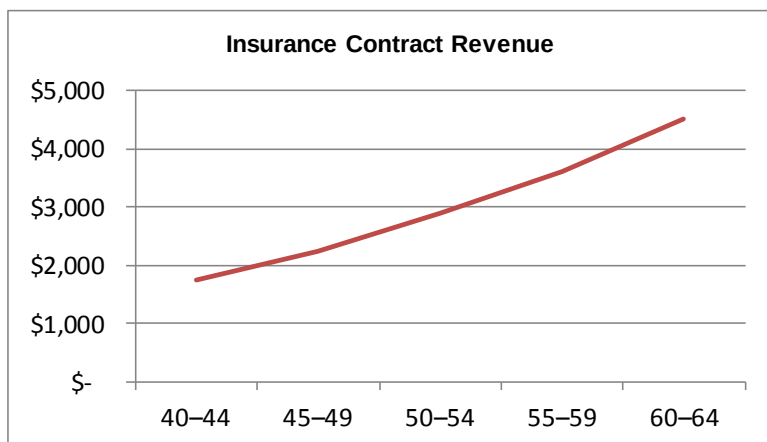
Ages	Revenue and	
	Original Mortality Rates	Estimated Claims ^(a)
40–44	1.266%	\$ 819
45–49	1.907%	1,234
50–54	2.874%	1,860
55–59	3.972%	2,570
60–64	5.435%	3,517
	15.454%	\$ 10,000

- (a) The amount of revenue attributable to death benefits recognized each period is based on the expected claims for the period. This amount is determined by dividing the original mortality rates for the period by the total mortality rates for all periods and multiplying that amount by the expected death benefits of \$10,000.

834-10-55-164 Because the entity expects to incur its \$900 in maintenance and benefit expenses evenly throughout the 25-year period, it has allocated the revenue attributable to those other services on a straight-line basis over the coverage period. The entity calculates its release of the margin for each 5-year period of time by taking the \$4,100 of initial margin, gross of acquisition costs, and allocating it across each period of time according to the allocation rates included in the assumptions in paragraph 834-10-55-162(c) (for example, \$4,100 multiplied by 18 percent for Years 1–5, that is, the policyholders’ age of 40–44). The resulting insurance contract revenue and corresponding expenses recognized are as follows.

	<u>Policyholder Age</u>					
	<u>40-44</u>	<u>45-49</u>	<u>50-54</u>	<u>55-59</u>	<u>60-64</u>	<u>Aggregate</u>
Revenue, consisting of:						
Death benefits	\$ 819	\$ 1,234	\$ 1,860	\$ 2,570	\$ 3,517	\$ 10,000
Maintenance expense	180	180	180	180	180	900
Margin release	738	820	861	861	820	4,100
Insurance contracts revenue	\$ 1,737	\$ 2,234	\$ 2,901	\$ 3,611	\$ 4,517	\$ 15,000
Claims	\$ 819	\$ 1,234	\$ 1,860	\$ 2,570	\$ 3,517	\$ 10,000
Maintenance and benefit expense	180	180	180	180	180	900
Underwriting income	\$ 738	\$ 820	\$ 861	\$ 861	\$ 820	\$ 4,100

834-10-55-165 The following reflects the amount of insurance contracts revenue being earned in each five-year increment throughout the policy duration.



834-10-55-166 At the end of Year 11 (that is, policyholders' age of 50), the entity updates its assumptions to reflect its expectations that an additional 1 percent of policyholders will die at the end of Year 20 resulting in an additional \$647 of claims; however, the entity did not change its assumptions about expected cash inflows or other cash outflows. Therefore, the entity recalculates the revenue attributable to death benefits as shown in the following table.

Ages	Adjusted Mortality		Estimated	
	Rates	Claims ^(a)	Revenue ^(b)	
40–44	1.266%	\$ 819	\$ 819	
45–49	1.907%	1,234	1,234	
50–54	2.874%	1,860	1,720	
55–59	4.972%	3,217	2,975	
60–64	5.435%	3,517	3,252	
	16.454%	\$ 10,647	\$ 10,000	

- (a) The amount of estimated claims for each period after the assumption change is determined by dividing the adjusted mortality rates for the period by the adjusted total mortality rates for all periods and multiplying that amount by the adjusted expected death benefits of \$10,647.
- (b) The amount of revenue attributable to death benefits in each of the last 15 years of the contract is calculated by multiplying the ratio of estimated claims for the period over the total remaining estimated claims by the \$7,947 of remaining unearned revenue attributable to death benefits (\$10,000 less \$2,053 recognized in the first 10 years). Had the amount of expected cash inflows changed, the remaining unearned revenue to be recognized would have been adjusted accordingly.

834-10-55-167 Additionally, the change in estimated claims resulted in the entity decreasing its estimate of the variability of cash outflows, such that the margin release was 30 percent in Years 11–15, 20 percent in Years 16–20, and 12 percent in Years 21–25.

834-10-55-168 Given the change in assumptions described in the preceding paragraphs, the resulting insurance revenue is as follows.

	Policyholder Age					
	40–44	45–49	50–54	55–59	60–64	Aggregate
Revenue, consisting of:						
Death benefits	\$ 819	\$ 1,234	\$ 1,720	\$ 2,975	\$ 3,252	\$ 10,000
Maintenance and benefit expense	180	180	180	180	180	900
Margin release	738	820	1,230	820	492	4,100
Insurance contracts revenue	\$ 1,737	\$ 2,234	\$ 3,130	\$ 3,975	\$ 3,924	\$ 15,000
Claims	\$ 819	\$ 1,234	\$ 1,860	\$ 3,217	\$ 3,517	\$ 10,647
Maintenance and benefit expense	180	180	180	180	180	900
Change in estimates of future incurred claims	-	-	647	-	-	647
Reversal of changes in estimates ^(a)	-	-	(140)	(242)	(265)	(647)
Underwriting income	\$ 738	\$ 820	\$ 583	\$ 820	\$ 492	\$ 3,453

- (a) The timing of revenue recognition is dependent on the proportion of coverage and other services provided during the period in accordance with paragraph 834-10-35-12, and the timing of the recognition of claims expense is dependent on the timing (and estimated cost) of insured events in accordance with paragraph 834-10-35-13. However, changes in estimates of future cash flows are recognized immediately as an adjustment to the insurance contract liability and within net income in accordance with paragraph 834-10-35-3. Thus, as claims are incurred for which the entity had previously adjusted its estimates, the entity must adjust the expenses presented in net income to avoid double counting the claims expense. That adjustment is included within the "reversal of changes in estimates" line in this table. However, because changes in estimates of future incurred claims generally also affect the amount of remaining unearned revenue to be recognized each period, any difference between the original estimates of revenue expected to be recognized for the period and the actual revenue recognized for the period also may require an adjustment in net income. That might be the case if those adjustments to the revenue recognition pattern are not accompanied by a change in the measurement of the insurance contract liability (that is, the changes are not attributable to changes in the amount of estimated consideration to be received). Those adjustments are presented in this table within the same "reversal of changes in estimates" line. For example, for Years 16–20 (age 55–59), the \$242 is calculated as \$647 (\$3,217 – \$2,570), which is the reversal of changes in estimated claims recognized in Years 11–15 less \$405 (\$2,975 – \$2,570), which is the difference between revenue estimates.

834-10-55-169 As shown in the preceding paragraph, as an entity updates its assumptions used in measurement of the insurance contract liability, it should redetermine the pattern for recognizing revenue prospectively for any revenue not yet earned.

> Derecognition

> > Contract Modification

834-10-55-170 A modification is substantial if any of the following criteria exist:

- a. At inception, a contract equivalent to the modified contract would have been excluded from the scope of this Topic.
- b. The entity applied the premium allocation approach to the original contract, but the modified contract no longer meets the criteria to apply the premium allocation approach (or, alternatively, the entity applied the building block approach to the original contract and the modified contract now meets the criteria to apply the premium allocation approach).
- c. The insured event, risk, or period of coverage of the contract has changed, as noted by significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.
- d. The nature of the investment return rights (for example, amounts determined by formulas specified by the contract, pass through of actual performance of referenced investments, or returns at the discretion of

- the entity) accounted for as part of the insurance contract, if any, between the insurance enterprise and the policyholder has changed.
- e. Any additional 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 premiums or charges are not reduced by an amount at least equal to the corresponding reduction in benefits or coverage.
 - f. There is a net reduction in the policyholder's account value or the cash surrender value, if any exists, other than resulting from distributions to the policyholder or contract designee or charges related to newly purchased or elected benefits or coverages.
 - g. There is a change in the participation or dividend features of the contract, if any such features exist.

> Presentation

834-10-55-171 The following is an example of a statement of financial position of an entity whose primary business is insurance and is not intended to represent all possible line items that could be presented. An entity need not use the labels below on the statement of financial position.

Assets		Liabilities and Shareholders' Equity	
Cash	XX	Liability for remaining coverage (premium allocation approach)	XX
Investments	XX	Liability for incurred claims (premium allocation approach)	XX
Premiums receivable (premium allocation approach)	XX	Insurance contract liability (building block approach)	XX
Unconditional premium receivable (building block approach)	XX	Margin (building block approach)	<u>XX</u>
Insurance contract asset (building block approach)	XX	Total liabilities	XX
Reinsurance contract asset (premium allocation approach)	XX	Accumulated other comprehensive income	XX
Reinsurance contract asset (building block approach)	<u>XX</u>	Retained earnings	<u>XX</u>
Total assets	<u>XX</u>	Total liabilities and shareholders' equity	<u>XX</u>

834-10-55-172 The following is an example of a single statement of comprehensive income of an entity whose primary business is insurance and is not intended to represent all possible line items that could be presented. An entity need not use the labels below on the statement of comprehensive income.

Statement of Comprehensive Income

Insurance contract revenue (building block approach)	XX
Insurance contract revenue (premium allocation approach)	XX
Ceded reinsurance consideration (building block approach)	(XX)
Ceded reinsurance consideration (premium allocation approach)	(XX)
Claims/benefits incurred (building block approach)	(XX)
Claims/benefits incurred (premium allocation approach)	(XX)
Reinsurance recoverable for claims/benefits incurred (building block approach)	XX
Reinsurance recoverable for claims/benefits incurred (premium allocation approach)	XX
Adjustment for changes in estimates of future benefits/claims and reversals of those changes	XX
Amortization of qualifying acquisition costs	<u>(XX)</u>
Underwriting margin	<u>XX</u>
Other income	XX
Other expenses	<u>(XX)</u>
Investment income	XX
Interest expense	<u>(XX)</u>
Net income	XX
Components of other comprehensive income	<u>XX</u>
Total comprehensive income	<u>XX</u>

834-10-55-173 In principle, the insurance contract revenue (building block approach) recognized over the life of the portfolio of contracts is the sum of the following:

- a. Premiums or other consideration attributable to the fulfillment cash flows, excluding any amounts attributable to estimated returnable amounts
- b. The margin
- c. Accretion of interest on those amounts.

> Disclosure

834-10-55-174 Examples of line items that may be disclosed, depending on materiality, as part of the reconciliation of the opening and closing balance of the insurance contract liability measured using the building block approach could be any of the following:

- a. Expected premiums for contracts written.
- b. Premiums received.
- c. Future benefits for contracts written in the period.
- d. Adjustments to contracts written in the prior period due to changes in assumptions.
- e. Examples of additional disaggregation include changes in:
 1. Mortality/morbidity/longevity
 2. Expenses
 3. Lapse and surrender
 4. Discount rates
 5. Utilization rates
 6. Annuitization rates.
- f. Cash paid.
- g. Surrenders.
- h. Accretion of interest.
- i. Other amounts that may affect a balance depending on materiality and other facts and circumstances, such as:
 1. The effects of business combinations
 2. Assumption reinsurance
 3. Foreign exchange adjustments.

834-10-55-175 Examples of line items that may be disclosed as part of the reconciliation of the opening and closing balance of the liability for incurred claims could be any of the following:

- a. Insurable events incurred in the current period.
- b. Adjustments to amounts incurred in prior periods for changes in assumptions. Examples of further disaggregation include changes in:
 1. Claim costs
 2. Number of claims
 3. **Settlement period**
 4. Change in discount rates.
- c. Cash paid.
- d. Accretion of interest.
- e. Other amounts that may affect a balance, such as:
 1. The effects of business combinations
 2. **Portfolio transfers**
 3. Foreign exchange adjustments.

834-10-55-176 Examples of line items that may be disclosed as part of the reconciliation of the opening and closing balance of the margin could be any of the following:

- a. New margin with amounts attributable to expected acquisition costs separately identified
- b. Margin released
- c. Balance and/or line items attributable to expected acquisition costs to be paid.

834-10-55-177 Examples of significant transactions and events for which there are no specific disclosure requirements in other Topics that an entity should disclose information about may include both of the following:

- a. The restructuring of the entity (for example, **demutualization** or redomiciliation to another jurisdiction)
- b. Ceasing the writing of new business (for example, exiting a line of business or creating a **closed block** of business).

> Transition

> > Use of Objective Information in Determination of the Margin

834-10-55-178 Objective information that is reasonably available should be used to determine the margin at transition. An entity could look to historical documentation of conditions at the time the contract was issued, such as any of the following:

- a. Original pricing documentation to provide details on the assumed claims experience, expense levels, and expected investment income and profitability at the time contracts were originally issued.
- b. Reinsurance agreements, if entered into with the direct sale of a policy, to assess the market value of the business and to estimate the margin at transition.
- c. Original U.S. GAAP valuation assumptions. Those assumptions typically include details on assumed claims experience and related items at the time of issuance, for example, acquisition costs and the amortization pattern of those costs.
- d. The economic conditions present at the date of issuance of the portfolio of contracts.
- e. For contracts with discretionary participation features, the basis on which nonguaranteed payments or credits were anticipated to be made or have been made. Those payments are typically determined by retaining a margin and returning the excess to the policyholder. If the amount that was retained was documented, an entity could look to that documentation for objective information. If the amount retained was not

documented but can be determined, an entity could use that as the basis for estimating the margin.

834-10-55-179 Historical data from the time near the issuance of the original contract also could be considered objective information. That data could be used to understand what was expected at the time and to reconstruct pricing documentation as follows:

- a. If original documentation is not reasonably available, it may be reconstructed by assuming that experience in the early years of the contract reflected the experience assumed in pricing. Those experience records, along with economic conditions and documented premium rates, could be used to carry out a pricing exercise in which the premium is already set to back into the margin that would have been included.
- b. Historical record of profits could be used to estimate the amount of the margin that has been released so far. If an entity has a basis for amortizing the margin, the entity could infer the amount of the original margin that would have been released so far and the amount that is expected to be released in the future. Together, those two estimates could be used to estimate the margin at transition.

834-10-55-180 Entities also could use the margins determined as far back as practicable and make adjustments for changes in the entities' strategies and economic conditions present at the date the portfolio of contracts was issued.

834-10-55-181 An entity may need to consider a combination of the items listed in paragraphs 834-10-55-178 through 55-180 to estimate the margin at transition.

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 201X-XX, *Insurance Contracts (Topic 834)*

834-10-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 201X-XX, *Insurance Contracts (Topic 834)*:

- a. The pending content that links to this paragraph shall be effective for fiscal years, and interim periods within those fiscal years, beginning on or after [date to be inserted after exposure].
- b. An entity shall apply the pending content that links to this paragraph by means of retrospective application to all prior periods. At the beginning of the earliest period presented (that is, the transition date), an entity shall:
 1. For contracts measured using the building block approach:

- i. Measure the present value of the **fulfillment cash flows** in accordance with the guidance in this Topic using current assumptions at the date of transition
 - ii. Determine the **margin**.
- 2. For contracts measured using the premium allocation approach:
 - i. Measure the **liability for remaining coverage** in accordance with the guidance in this Topic at the date of transition, including determining and measuring an **onerous contract**
 - ii. Measure the **liability for incurred claims** in accordance with the guidance in this Topic using current assumptions at the date of transition.
- c. An entity shall derecognize any existing balances of deferred acquisition costs related to **insurance contracts** and account for the acquisition costs in accordance with the guidance in this Topic.
- d. When determining the margin at transition, an entity can elect to use its determination of the portfolio immediately before the transition. That may result in contracts written before the transition date that are being grouped into separate portfolios from contracts written or substantially modified after the transition date if the entity's determination of the portfolio differs from what the portfolio would be under the guidance in this Topic.
- e. An entity shall determine the margin through retrospective application of the pending content that links to this paragraph to all prior periods, unless it is impracticable to do so.
- f. If it is impracticable to determine the margin in applying the pending content that links to this paragraph retrospectively to all prior periods, an entity shall:
 - 1. Apply this Topic to all contracts issued after the start of the earliest period for which retrospective application is practicable. That is, an entity shall apply this Topic retrospectively for as many previous periods as is practicable for each portfolio.
 - 2. For contracts issued in earlier periods for which retrospective application is considered to be impracticable, an entity shall estimate what the margin would have been using objective information had the entity been able to apply the pending content that links to this paragraph retrospectively. In those cases, an entity need not undertake exhaustive efforts to obtain objective information but should take into account all objective information that is reasonably available. The margin shall be adjusted using the guidance in this Topic through the transition date.
 - 3. If it is impracticable to apply the pending content that links to this paragraph retrospectively for other reasons or there is not objective information that is reasonably available, an entity shall apply the general requirements of Subtopic 250-10 on accounting changes and error corrections for the determination of the margin, which are relevant to situations in which there are limitations on retrospective

application. That is, Topic 944 before the effective date of this Topic shall be applied; because Topic 944 before the effective date does not address accounting for the margin, the margin recorded shall be zero.

- g. For portfolios of contracts written before the transition date for which it would be impracticable to determine the discount rates as of the initial recognition of the portfolio of contracts, an entity shall use the following discount rates to determine the margin at transition for contracts measured using the building block approach and as the interest accretion rates for all contracts, as follows:
 - 1. Observable rates, at the initial recognition date, that approximate the calculated discount rates in accordance with the guidance in this Topic for a minimum of three consecutive years before the effective date (for example, if an entity determines that its discount rates for three years is equivalent to the A corporate bond rates, then an entity shall use the A corporate bond rates for the years in which the portfolio was initially recognized).
 - 2. If there are no observable rates that approximate the calculated rates, an entity shall determine the initial discount rates by applying a spread between the calculated rates and the observable rates (averaged over at least three consecutive years before the effective date) that most closely approximates the yield curve.
 - 3. If applicable, for portfolios of contracts for which the initially determined interest accretion rates shall be adjusted in accordance with paragraph 834-10-35-25, the interest accretion rates shall be determined by applying a ratio between the calculated interest accretion rates in accordance with the guidance in this Topic and the observable rates averaged over a minimum of 3 consecutive years before the effective date (for example, if an entity determines changes in its interest accretion rates for 3 years approximates 75 percent of the movement in the A corporate bond curve or 75 percent of the movement of the rolling average of A corporate bond curve rates for a 3-year period, then an entity shall use 75 percent of the movement in the A corporate bond curve or 75 percent of the movement of the rolling average of A corporate bond curve rates for a 3-year period, respectively, to adjust the interest accretion rates for the years before transition).
- h. An entity shall recognize in accumulated other comprehensive income the cumulative effect of the difference between the current discount rates applied to the fulfillment cash flows at the transition date and the interest accretion rates.
- i. For portfolios of contracts measured using the building block approach that are written before the date of transition, an entity shall determine the amount of revenue to be recognized after the transition date as follows:

1. For portfolios of contracts in which the margin is determined through retrospective application, the **insurance contract revenue** remaining to be earned as of the date of transition shall be determined retrospectively by using the assumptions applied in the retrospective determination of the margin.
2. For portfolios of contracts for which retrospective application is not practicable to determine the margin, the insurance contract revenue remaining to be earned shall be presumed to equal the portion of the **insurance contract liability** for which an **insured event** has not occurred (that is, analogous to the amount of the liability for remaining coverage), excluding any estimated returnable amounts, recognized at the date of transition (plus accretion of interest). The liability for remaining coverage for those contracts at the date of transition shall be presumed not to consist of any losses on initial recognition or of changes in estimates of future cash flows recognized in net income after the inception of the contracts and before the transition date. The amount of revenue to be recognized after the transition date shall not exceed the total expected cumulative consideration for in-force policies in the portfolio less receipts for the estimated returnable amounts.

Prior business combinations

- j. For business combinations that occurred before the effective date of the pending content that links to this paragraph, an entity shall:
 1. Derecognize any existing intangible assets that arise from insurance contracts that were assumed in previously recognized business combinations and that do not meet the definition of an intangible asset (sometimes referred to as value of business acquired or present value of future profits).
 2. Reallocate the purchase price attributed to the insurance liabilities assumed and insurance assets acquired in the business combination to determine the margin on the acquired business. Using the **fair value** determined at the acquisition date, an entity shall recognize the following components:
 - i. Expected net cash flows measured in accordance with the guidance in this Topic using assumptions as of the acquisition date
 - ii. A margin if the fair value attributed to the insurance liabilities assumed and insurance assets acquired exceeds the expected net cash flows determined in (1). If the expected net cash flows determined in (1) exceed the fair value attributed to the insurance liabilities assumed and insurance assets acquired, an entity shall recognize an immediate loss in net income.

Both the expected net cash flows and the margin shall be adjusted using the guidance in this Topic through the transition date.

- k. The acquisition date shall be considered the contract inception date for purposes of determining the interest accretion rates for the portfolio of contracts acquired unless the interest accretion rates are subsequently adjusted in accordance with paragraph 834-10-35-25.

Redesignation of financial assets

- l. Upon adoption of the pending content that links to this paragraph, an entity shall redesignate and reclassify its financial assets that are identified as relating to its insurance contracts either by legal entity or internal designation or relating to funding of insurance contracts that are newly determined to be insurance, as if the entity had adopted on the transition date of this Topic the applicable classification and measurement guidance for financial instruments.
- m. The effect of that designation of financial assets shall be reported as a change in accounting principle.

Transition disclosures

- n. An entity shall provide the following transitional disclosure requirements in Subtopic 250-10 on accounting changes and error corrections:
 - 1. Those in paragraph 250-10-50-1(b)(1) and (3) through (4) (the method of applying the change, including a description of prior-period information that has been retrospectively adjusted, the cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the earliest period presented, and, if retrospective application is impracticable, the reasons why and the alternative methods used)
 - 2. Those in paragraph 250-10-50-1(c) (a description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per share amounts, attributable to each prior period presented)
 - 3. Those in paragraph 250-10-50-2 (disclosures of the change in the interim period of the change, if issuing interim financial statements, and the annual period of the change).
- o. In applying paragraph 834-10-50-31(c), an entity need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the first financial reporting year in which the entity first applies the pending content that links to this paragraph. If it is impracticable from when an entity first

applies the guidance in this Topic to prepare information about claims development that occurred before the beginning of the earliest period for which the entity presents full comparative information that complies with the guidance in this Topic, the entity shall disclose that fact.

Amendments to the FASB Accounting Standards Codification®

Note: These proposed amendments are based on the Accounting Standards Codification as of the date of this proposal and do not include, for example, potential amendments from the proposed FASB Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, or the proposed FASB Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*, which is expected to be issued final as Topic 606. Where applicable, the staff has noted those potential amendments and the resulting consequential amendments from this proposed Update. These proposed amendments do not replace or affect guidance issued by the Securities and Exchange Commission (SEC) or its staff for public companies in their filings with the SEC.

Summary of Proposed Amendments to the Accounting Standards Codification

1. This proposed Accounting Standards Update describes the principles that an entity should apply in the recognition, measurement, presentation, and disclosures of insurance contracts issued and reinsurance contracts held in an entity's financial statements. Consequently, the Board proposes to supersede or amend various Subtopics of the Accounting Standards Codification. Those proposed amendments are summarized below.

Codification Topics and Subtopics	Description of Changes
Master Glossary	Added the following terms: <i>Commutation, Estimated Returnable Amount, Financial Risk, Frequency, Fulfillment Cash Flows, Insurance Contract Asset, Insurance Contract Liability, Insurance Contract Premium, Insurance Contract Revenue, Insured Event, Investment Component, Liability for Remaining Coverage, Loss-Sensitive Feature, Margin, Onerous Contract, Performance Obligation, Policyholder, Portfolio of Insurance Contracts, Portfolio Transfer, Qualifying Acquisition Costs, Reinsurance Asset (Reinsurance</i>

Codification Topics and Subtopics	Description of Changes
	<i>Recoverable), Segregated Account, Segregated Fund Arrangement, and Severity</i> • Amended the following terms: <i>Acquisition Costs, Annual Policyholder Dividends, Annuitization, Ceding Entity, Claim Adjustment Expenses, Closed Block, Coverage, Coverage Period, Incurred-but-Not-Reported Claims, In Force, Insurance Contract, Insurance Risk, Lapse Rate, Liability for Unpaid Claims, Mortality, Mortality Risk, Net Amount at Risk (Relating to Variable Annuity Contracts), Participating Insurance, Persistency, Prospective Reinsurance, Reinsurance, Retroactive Reinsurance, Salvage, Settlement Period, Statutory Accounting Practices, Subrogation, and Underwriting Risk</i> • For the list of terms that were superseded, see paragraph 5
220-10 Comprehensive Income—Overall	Added guidance to paragraph 220-10-45-10A to include the effect of changes in discount rates as an item required to be reported in other comprehensive income
270-10 Interim Reporting—Overall	Added paragraph 270-10-50-8 to reflect interim reporting requirements for insurance contract liabilities (and assets) as required by paragraph 834-10-50-35
275-10 Risks and Uncertainties—Overall	Removed guidance in Section 275-10-50 on disclosures related to deferred policy acquisition costs of insurance entities
350-30 Intangibles—Goodwill and Other—General Intangibles Other Than Goodwill	Removed guidance in paragraph 350-30-15-4(d) on intangible assets recognized for acquired insurance contracts under Subtopic 944-805

Codification Topics and Subtopics	Description of Changes
360-30 Property, Plant, and Equipment—Real Estate Acquired in Settling Insurance Claims	• Added Subtopic 360-30 to reflect content moved from Subtopic 944-360, Financial Services—Insurance—Property, Plant, and Equipment • Amended content to reflect that the Subtopic applies to real estate acquired in settling insurance claims • Amended content to reflect that the Subtopic applies to contracts within the scope of Topic 834
360-40 Property, Plant, and Equipment—Real Estate Investments of Insurance Entities	• Added Subtopic 360-40 to reflect content moved from Subtopic 944-360 • Amended content to reflect that the Subtopic applies to real estate investments of insurance entities
405-30 Liabilities—Insurance-Related Assessments	• Updated paragraph references in paragraphs 405-30-15-2 through 15-3 • Superseded paragraph 405-30-30-9 that references current practice that has been changed in this proposed Update • Amended paragraph 405-30-30-10 to reflect guidance removed from paragraph 405-30-30-9 • Updated paragraph reference in paragraph 405-30-55-9
410-30 Asset Retirement and Environmental Obligations—Environmental Obligations	• Amended paragraph 410-30-15-3(d) to remove reference to unpaid claim liabilities of insurance entities

Codification Topics and Subtopics	Description of Changes
450-10 Contingencies—Overall	• Amended content in paragraphs 450-10-60-9 through 60-10 to remove reference to insurance entity and reinsurance entity • Updated paragraph references in paragraphs 450-10-60-9 through 60-10 • Superseded paragraph 450-10-60-11 that referenced superseded guidance in Topic 944
450-20 Contingencies—Loss Contingencies	• Amended paragraph 450-20-05-3 to remove reference to risk of loss from catastrophes assumed by insurance entities, which would be accounted for in accordance with Topic 834 • Updated paragraph references in paragraph 450-20-15-2(d) and amended the paragraph to replace reference to insurance entities with reference to insurance contracts issued and reinsurance contracts held in accordance with Topic 834 • Amended paragraph 450-20-60-14 to reflect amendments made to paragraph 720-20-25-1 • Superseded paragraph 450-20-60-19 to remove reference to risk of loss from catastrophes assumed by insurance entities, which would be accounted for in accordance with Topic 834
460-10 Guarantees—Overall	• Amended paragraph 460-10-15-4 to include in the scope exception of Topic 460 guarantee contracts that are not within the scope of Topic 834 • Updated paragraph reference in paragraph 460-10-15-7(d) and amended the paragraph to include guarantees accounted for in accordance with Topic 834
470-70 Debt—Surplus Notes	• Added Subtopic 470-70 by moving content from Subtopic 944-470, Financial Services—Insurance—Debt, on surplus notes

Codification Topics and Subtopics	Description of Changes
605 Revenue Recognition	- Updated paragraph references in paragraph 605-20-15-3 and removed reference to financial guarantee insurance contracts to expand to all contracts accounted for in accordance with Topic 834 - Updated paragraph references and amended paragraph 605-20-25-2 to replace reference to accounting for short-duration insurance contracts with accounting for contracts measured using the premium allocation approach - Amended paragraph 605-20-25-3 to align with the scope exceptions in Topic 834
715-30 Compensation— Retirement Benefits—Defined Benefit Plans— Pension	Amended various paragraphs throughout Section 715-30-35 to replace reference to insurance entities with insurer
715-60 Compensation— Retirement Benefits—Defined Benefit Plans—Other Postretirement	- Amended paragraphs 715-60-35-109 through 35-120 to replace references to insurance entity and investment contracts with insurer and contracts accounted for in accordance with Topic 834 - Updated paragraph references in paragraphs 715-60-35-112 through 35-113 - Amended paragraph 715-60-35-120 to reflect the definition of an insurance contract
720-15 Other Expenses— Start-Up Costs	Amended paragraph 720-15-15-4(a) to include as a scope exception qualifying acquisition costs related to obtaining a portfolio of insurance contracts and updated reference
720-20 Other Expenses—	- Updated paragraph references throughout the Subtopic - Amended paragraphs throughout the Subtopic

Codification Topics and Subtopics	Description of Changes
Insurance Costs	to remove references to insurance entity • Amended paragraph 720-20-25-1 to remove the guidance on reinsurance contracts • Amended paragraph 720-20-25-3 to specify that Topic 834 does not apply to policyholder accounting • Amended paragraphs 720-20-25-8 through 25-9 and 720-20-25-12 to remove references to policy
720-50 Other Expenses— Fees Paid to the Federal Government by Pharmaceutical Manufacturers and Health Insurers	Amended paragraph 720-50-25-1 to reflect that the annual fee imposed on health insurers does not represent a qualifying acquisition cost as discussed in Topic 834 and it does not represent cash flows that are included in the measurement of fulfillment cash flows as discussed in Topic 834
740-10 Income Taxes— Overall	• Removed reference to Subtopic 944-740, Financial Services—Insurance—Income Taxes, from paragraph 740-10-05-4(i) as an incremental Income Taxes Subtopic • Amended paragraph 740-10-25-3(a)(4) to reflect content moved from paragraphs 944-740-25-2 through 25-3 about income taxes likely to be paid because of a known or expected reduction in policyholders' surplus • Added paragraph 740-10-25-20(b)(i) (moved content from paragraph 944-740-25-1) and amended content to include previously referenced content about expected dividends being considered a planned contractual benefit in computing liabilities under U.S. GAAP that should be considered in timing differences for tax purposes • Added paragraph 740-10-50-22 (moved content from paragraph 944-740-50-1)
805-20 Business Combinations—	• Updated references in paragraphs 805-20-25-8 and 805-20-35-7 • Amended paragraph 805-20-25-8(b) to remove

Codification Topics and Subtopics	Description of Changes
Identifiable Assets and Liabilities, and Any Noncontrolling Interest	reference to entity and deposit contract
810-10 Consolidation—Overall	• Amended paragraph 810-10-15-17(b) to remove reference to separate accounts of life insurance entities and replace with reference to segregated fund arrangements as described in Topic 834 • Added paragraphs 810-10-25-15A through 25-15B (moved content from paragraphs 944-80-25-3(d) through (f) and 944-80-25-12) and amended to replace references to separate accounts with references to segregated funds and to remove guidance on the accounting for certain aspects of a separate account that is superseded by Topic 834
815-10 Derivatives and Hedging—Overall	• Amended paragraph 815-10-05-11 to replace reference to insurance entity with issuer of contracts within the scope of Topic 834 • Amended paragraphs 815-10-15-53 through 15-54 to replace reference to insurance entities with insurance contracts within the scope of Topic 834 and to remove reference to traditional insurance contracts • Amended paragraphs 815-10-55-32 through 55-39 to replace reference to insurance entities with insurance contracts within the scope of Topic 834 and to remove reference to traditional insurance contracts • Amended paragraph 815-10-55-33 to reflect description of a dual trigger contract • Updated reference in paragraph 815-10-55-40 • Amended paragraph 815-10-55-132 to reflect amendments made to paragraph 815-10-55-40
815-15 Derivatives and Hedging—Embedded	• Updated paragraph references throughout the Subtopic • Added paragraphs 815-15-25-55 through 25-60 (moved content from paragraphs 944-815-25-1

Codification Topics and Subtopics	Description of Changes
Derivatives	through 25-6) and amended paragraphs to reference segregated fund arrangements in place of separate accounts and deleted superseded criteria to be deemed a segregated fund arrangement • Superseded paragraph 815-15-55-3 that refers to foreign currency denominated liabilities • Amended paragraphs throughout Section 815-15-55 to replace contracts issued by insurance entities and investment contracts accounted for in accordance with Topic 944 with contracts that are accounted for in accordance with Topic 834 to replace investment components with participation features that wholly depend on the performance of an underlying item or customer's account value, and to include assets that are in a segregated fund arrangement • Updated paragraph references within Section 815-15-55 • Amended paragraphs 815-15-55-58 through 55-61 to remove references to different accounting for phases of the insurance contract (that is, accumulation phase and pay-out phase) and replace with analysis that reflects the insurance contract as a whole • Superseded note in paragraph 815-15-55-75 that refers to fair value election to hybrid financial instruments • Amended paragraphs 815-15-55-204 through 55-206 to reflect that an investment in a disaster bond may be the issuance of an insurance contract that would be accounted for in accordance with Topic 834 • Superseded paragraphs 815-15-55-227 through 55-238 to remove examples that reflected different components of an insurance contract that is not relevant on the basis of the guidance in this proposed Update

Codification Topics and Subtopics	Description of Changes
815-20 Derivatives and Hedging—Hedging—General	Added paragraphs 815-20-25-47 through 25-49B (moved content from paragraphs 944-815-55-1 through 55-5) and amended to remove references to insurance entity
815-45 Derivatives and Hedging—Weather Derivatives	Amended paragraph 815-45-15-2 to include reference that weather derivatives could be within the scope of Topic 834
825-10 Financial Instruments—Overall	- Amended paragraph 825-10-15-4 to remove the fair value option for the rights and obligations under an insurance contract with certain characteristics - Amended paragraph 825-10-15-5 to include financial assets and financial liabilities recognized as insurance contracts in accordance with Topic 834 as contracts for which the fair value option cannot be elected - Superseded paragraph 825-10-25-7(c) through (d) to remove reference to insurance contracts for which the fair value option is elected - Superseded paragraph 825-10-50-8 to remove requirement to disclose fair value information for insurance contracts - Amended paragraph 825-10-50-22 to remove the exception for reinsurance receivables and prepaid reinsurance premiums
830-10 Foreign Currency Matters—Overall	- Amended paragraph 830-10-45-18 to remove the exception for policy acquisition costs for life insurance companies from the guidance related to common nonmonetary balance sheet items - Added paragraph 830-10-45-20 to provide guidance on foreign currency presentation for items related to insurance contracts

Codification Topics and Subtopics	Description of Changes
942-605 Financial Services— Depository and Lending—Revenue Recognition	Superseded paragraphs 942-605-25-1 through 25-2 that apply to accounting for insurance commissions
944 Financial Services— Insurance	Superseded Topic 944, other than Subtopics 944-310, 944-320, and 944-325, which are being moved to the applicable Topic and superseded by the proposed Update on financial instruments
954-450 Health Care Entities— Contingencies	Updated paragraph references in paragraph 954-450-25-2
954-720 Health Care Entities—Other Expenses	Updated paragraph reference in paragraph 954-720-25-4A
958-325 Not-for-Profit Entities— Investments—Other	Superseded paragraph 958-325-60-2 to remove reference to accounting for equity securities for not-for-profit entities that conduct insurance activities
962-325 Plan Accounting— Defined Contribution Pension Plans— Investments—Other	Updated paragraph references in paragraphs 962-325-35-7 through 35-8 and amended to remove references to long-duration contracts and investment contracts
965-325 Plan Accounting— Health and Welfare	Updated paragraph references in paragraphs 965-325-35-3 through 35-5 to guidance on the scope of insurance transactions and the

Codification Topics and Subtopics	Description of Changes
Benefit Plans— Investments—Other	definition of an insurance contract in Topic 834 Removed guidance in paragraph 965-325-35-5 on certain types of insurance contracts

Introduction

2. The Accounting Standards Codification is amended as described in paragraphs 3–68. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Master Glossary

3. Add the following new terms to the Master Glossary, with a link to transition paragraph 834-10-65-1, as follows:

Commutation

An agreement between two parties, such as a cedant and a reinsurer, that terminates all rights and obligations between the parties under a particular insurance or reinsurance contract.

Estimated Returnable Amount

The estimate of the component of an insurance contract that an entity is required to repay the **policyholder** or the beneficiary that does not depend on whether an insured event occurs.

Financial Risk

The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable.

Frequency

The number of insured events that occur.

Fulfillment Cash Flows

The present value of the unbiased, probability-weighted estimate of the future cash flows that will arise as an entity fulfills the insurance contract.

Insurance Contract Asset

An entity's net expected contractual rights less obligations under an insurance contract, if the rights exceed the obligations as of the reporting date.

Insurance Contract Liability

An entity's net expected contractual obligations less rights under an insurance contract, if the obligations exceed the rights as of the reporting date.

Insurance Contract Premium

The amount charged to a policyholder for an insurance contract (that is, the total consideration provided by the policyholder under the terms of the contract).

Insurance Contract Revenue

Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from providing insurance coverage. This excludes from insurance contract premium any estimated returnable amounts.

Insured Event

An uncertain future event that is covered by an insurance contract and creates insurance risk.

Investment Component

A component included in an insurance contract that contains financial risk and no significant insurance risk.

Liability for Remaining Coverage

In the premium allocation approach, an entity's stand-ready obligation to provide coverage for future insured events that arise under existing contracts (that is, the obligation that relates to the unexpired portion of coverage).

Loss-Sensitive Feature

A provision within a contract that causes the premium, insured loss or benefit, or commission to vary based on the loss experience of that contract. Examples include reinstatement premium provisions, retrospective premium adjustments, profit commissions, and sliding scale commissions, all of which limit the risk for an entity and reward the policyholder based on favorable loss experience and/or penalize the policyholder for unfavorable loss experience.

Margin

The excess of the expected present value of the cash inflows over the expected present value of the cash outflows to fulfill an insurance contract at the initial recognition of a portfolio of insurance contracts, less any amounts recognized in net income over time.

Onerous Contract

A contract in which the present value of the future costs of fulfilling the unexpired portion of coverage (that is, the **liability for remaining coverage**) and the expected qualifying acquisition costs are expected to exceed the **carrying amount** of the liability related to the unexpired portion of coverage.

Performance Obligation

A promise in a contract with a customer to transfer a distinct good or service to the customer.

Policyholder

A party that has a right to compensation under an insurance contract if an insured event occurs. The policyholder may elect that a beneficiary receive claim or benefit payments under the contract.

Portfolio of Insurance Contracts

A group of insurance contracts that both:

- a. Are subject to similar risks and priced similarly relative to the risk assumed
- b. Have similar duration and similar expected patterns of release from risk, that is, reduction in variability in cash flows.

Portfolio Transfer

The transfer of an entity's entire liability for in-force insurance contracts or outstanding losses, or both, of a portfolio or portfolios of the entity's business to another entity.

Qualifying Acquisition Costs

Costs that are related directly to the successful acquisition of new or renewal insurance contracts.

Reinsurance Asset (Reinsurance Recoverable)

A ceding entity's net contractual rights under a **reinsurance** contract, including amounts recoverable from a reinsurer for paid and unpaid claims and/or benefits and claim settlement expenses, including claims incurred but not reported.

Segregated Account

A separate investment account (that is, portfolio of assets) established and maintained by an entity to which funds have been allocated for certain contracts of the entity.

Segregated Fund Arrangement

A participation feature within an insurance contract that is contractually linked to a **segregated account** and meets both of the following conditions as a result of contractual, statutory, or regulatory requirements:

- a. The entity must invest the policyholder's funds directed by the policyholder in designated investment alternatives or in accordance with specific investment objectives or policies.
- b. All investment performance, net of contract fees and assessments, must be passed through to the individual policyholder.

Severity

The amount of the claim to be paid under an insurance contract.

4. Amend the following Master Glossary terms, with a link to transition paragraph 834-10-65-1, as follows:

Acquisition Costs

Costs that are related ~~directly~~ to the ~~successful~~ acquisition of new or renewal ~~{add glossary link}~~ insurance contracts ~~{add glossary link}~~.

Annual Policyholder Dividends

Amount of dividends to policyholders ~~calculated and paid each year~~, representing the policyholders' share of divisible surplus.

Annuitization

~~Annuitization refers to the policyholder receiving periodic payments under various payment options, including their remaining life or for a term certain period. The process of converting an annuity into a series of periodic payments.~~

Ceding Entity (Cedant) (second definition)

The party ~~in a reinsurance contract that pays a reinsurance premium in a reinsurance transaction.~~ that acquires insurance coverage on its underlying insurance contracts. The ceding entity compensates the reinsurer for insurance risk transferred to the reinsurer. The ceding entity receives the right to reimbursement from the ~~assuming entity~~ reinsurer under the terms of the reinsurance contract.

Claim Adjustment Expenses

~~Expenses incurred in the course of investigating and settling claims. The amount to provide for the estimated cost required to investigate and settle claims relating to insured events.~~

Closed Block

~~A mechanism to preserve, over time, the reasonable dividend expectations of individual policyholders with individual life, health, or annuity policies for which dividends are currently being paid or are expected to be paid under the current dividend scale. A closed block comprises aA defined, limited group of policies and a defined set of assets, and is that are governed by a set of operating rules.~~

Coverage

An insurance entity's exposure to loss. The concept of coverage would typically include policy limits, deductible, insured, and covered property or insured event.

Coverage Period

~~See **Contract Period**.The period over which insured events that occur are covered by an insurance contract. It is defined by the contract boundary. Commonly referred to as the period that a contract is in force.~~

Incurred-but-Not-Reported Claims

Claims relating to insured events that have occurred but have not yet been reported to the ~~insurer or reinsurer entity~~ as of the date of the financial statements.

In Force

~~Policies and Insurance contracts written and recorded~~recognized on the books of an ~~insurance carrier entity~~ that are unexpired as of a given date.

Insurance Contract

~~A contract under in which one party (the issuing entity) accepts significant—an insurance entity unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium. An insurance contract is irrevocable and involves the transfer of significant risk~~**insurance risk** from the employer (or the plan) another party (the policyholder) by agreeing to the insurance entity, compensate the policyholder or its designated beneficiary if a specified uncertain future event (the **insured event**) adversely affects the policyholder.

Insurance Risk

The risk arising from uncertainties about ~~both underwriting risk as opposed to financial 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.

Lapse Rate

The rate at which insurance contracts terminate through failure of the ~~insureds~~ policyholders to continue required premium payments. The lapse rate also may also be considered a rate of nonpersistence. ~~It is usually expressed as a ratio of the number of contracts that terminated by reason of failure of insureds to make premium payments during a given period, to the total number of contracts at the beginning of the period from which those lapses occurred.~~

Liability for ~~Unpaid~~ Incurred Claims

In the premium allocation approach, the ~~The~~ amount needed to provide for the estimated ~~ultimate~~ cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the ~~balance sheet~~ reporting date). Includes the liability for incurred-but-not-reported claims and claim adjustment expenses.

Mortality

The relative incidence of death in a given time ~~or place~~.

Mortality Risk

The risk arising from uncertainties about the ~~The~~ obligation to make payments that are contingent upon the death or continued survival of a specific individual or group.

Net Amount at Risk ~~(Relating to Variable Annuity Contracts)~~

~~The guaranteed benefit in excess of the current account balance. For guarantees in the event of death, the net amount at risk is the minimum guaranteed amount available to the contract holder upon death in excess of the contract holder's account balance at the balance sheet date. For guarantees of amounts at annuitization, the net amount at risk is defined as the present value of the~~

~~minimum guaranteed annuity payments available to the contract holder determined in accordance with the terms of the contract in excess of the current account balance. That portion of the amount insured that exceeds the amount retained by an entity for the policyholder. Sometimes referred to as the face value of a contract less the accumulated policyholder account value or premiums received.~~

Participating Insurance

Insurance in which the policyholder is entitled to participate in ~~the~~either of the following:

- a. ~~The earnings or surplus of the insurance entity. The participation occurs through the distribution of dividends to policyholders.~~
- b. The performance of an underlying item.

Persistency (second definition)

~~As the~~The complement of the ~~termination rate~~lapse rate, persistency is ~~the renewal quality of insurance contracts, that is, refers to the number of insured policyholders that keep their insurance coverage in force during a period. Persistency varies by plan of insurance, age at issue, year of issue, frequency of premium payment, and other factors.~~

Prospective Reinsurance

Reinsurance in which an assuming entity agrees to reimburse a ceding entity (cedant) 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.~~

Reinsurance

A transaction in which a reinsurer (assuming entity), ~~for a consideration (premium),~~ assumes all or part of insurance risk undertaken originally by another ~~insurer~~entity (ceding entity or cedant) in exchange for compensation. For indemnity reinsurance, the legal rights of the ~~insured policyholder~~ are not affected by the reinsurance transaction and the ~~insurance~~ entity issuing the underlying insurance contract remains liable to the ~~insured policyholder~~ 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.~~

Retroactive Reinsurance

Reinsurance in which an assuming entity agrees to reimburse a ceding entity (cedant) 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.~~

Salvage

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

Settlement Period

The estimated period over which claims or benefits are paid. For reinsurance contracts, the estimated period over which a ceding entity (cedant) expects to recover substantially all amounts due from the reinsurer under the terms of the reinsurance contract.

Statutory Accounting Practices

Accounting principles required by statute, regulation, or rule, or permitted by specific approval, that an insurance entity ~~is required to~~ must follow when submitting its financial statements to state insurance departments, reporting to an insurance regulator.

Subrogation

The right of an ~~insurer entity~~ 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 entity~~.

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.

5. Supersede the following Master Glossary terms, with a link to transition paragraph 834-10-65-1, as follows:

- Accumulation Phase
- Actuarial Calculation
- Actuarial Calculation Date
- Annuitization Phase
- Annuity Contract (second definition)
- Base Contract
- Benefit Period
- Binder Date
- Block of New Insurance Contracts
- Contract Exchange
- Contract Rate
- Cost of Insurance
- Cost Recovery Method (second definition)
- Credit Life Insurance
- Date of Demutualization
- Day-One Bonus
- Deposit Method (third definition)
- Distribution-Form Demutualization
- Dividend Fund
- Dividend Fund Interest Rate
- Dividend Scales
- Earnings Protection Benefit
- Endowment Contract
- Enhanced-Yield Bonus
- Existing Contract
- Financial Guarantee Insurance Contract
- Financial Guarantee Reinsurance Contract
- Front-End Fees
- Fronting Arrangements
- GMAB
- GMIB
- GMWB
- Gross Premium
- Group Insurance
- Group Participating Pension Contracts
- Guaranteed Investment Option
- Guaranteed Minimum Accumulation Benefit
- Guaranteed Minimum Income Benefit
- Guaranteed Minimum Withdrawal Benefit
- Immediate Bonus
- Incremental Direct Cost of Contract Acquisition
- Initiation or Front-End Fees
- Integrated Contract Feature

- Internal Replacement
- Investment Contracts
- Investment Yield
- Involuntary Termination
- Liability for Claim Adjustment Expenses
- Liability for Future Policy Benefits
- Life-Contingent Payments
- Limited-Payment Contracts
- Lock-In Concept
- Long-Term Care Benefit
- Market Value Annuity (second definition)
- MGDB
- Minimum Guaranteed Death Benefit
- MVA
- Net Closed Block Liability
- Net Level Premium Reserve
- Net Premiums
- Nonforfeiture Benefits
- Nonintegrated Contract Feature
- Nonparticipating Insurance Contract (second definition)
- Open Year Method
- Original Contract
- Participating Contract
- Participating Insurance Contract
- Payout Phase
- Persistency Bonus
- Plan of Demutualization
- Policy Credits
- Prepaid Reinsurance Premiums
- Ratchet Death Benefit
- Reinsurance Receivable
- Replacement Contract
- Reset Date
- Retrocession
- Return of Premium Death Benefit
- Reunderwriting
- Risk Load
- Risk of Adverse Deviation
- Risk of Antiselection
- Roll-Up Death Benefit
- Sales Inducements
- Seed Money
- Separate Account Arrangement

- Single Premium Deferred Annuity
- Subscription-Form Demutualization
- Terminal Dividends
- Termination
- Term Life Insurance
- Two-Tier Annuity
- Voluntary Termination
- Whole-Life Contract
- Wrap

Amendments to Subtopic 220-10

6. Amend paragraph 220-10-45-10A, with a link to transition paragraph 834-10-65-1, as follows:

Comprehensive Income—Overall

Other Presentation Matters

> > Items within Other Comprehensive Income

220-10-45-10A Items of other comprehensive income include the following:

- Foreign currency translation adjustments (see paragraph 830-30-45-12)
- Gains and losses on foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date (see paragraph 830-20-35-3(a))
- Gains and losses on intra-entity foreign currency transactions that are of a long-term-investment nature (that is, settlement is not planned or anticipated in the foreseeable future), when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting entity's financial statements (see paragraph 830-20-35-3(b))
- Gains and losses (effective portion) on derivative instruments that are designated as, and qualify as, cash flow hedges (see paragraph 815-20-35-1(c))
- Unrealized holding gains and losses on available-for-sale securities (see paragraph 320-10-45-1)
- Unrealized holding gains and losses that result from a debt security being transferred into the available-for-sale category from the held-to-maturity category (see paragraph 320-10-35-10(c))
- Amounts recognized in other comprehensive income for debt securities classified as available-for-sale and held-to-maturity related to an other-

- than-temporary impairment recognized in accordance with Section 320-10-35 if a portion of the impairment was not recognized in earnings
- h. Subsequent decreases (if not an other-than-temporary impairment) or increases in the fair value of available-for-sale securities previously written down as impaired (see paragraph 320-10-35-18)
- i. Gains or losses associated with pension or other postretirement benefits (that are not recognized immediately as a component of net periodic benefit cost) (see paragraph 715-20-50-1(j))
- j. Prior service costs or credits associated with pension or other postretirement benefits (see paragraph 715-20-50-1(j))
- k. Transition assets or obligations associated with pension or other postretirement benefits (that are not recognized immediately as a component of net periodic benefit cost) (see paragraph 715-20-50-1(j)).
- l. The effect of changes in the discount rates used to measure insurance contracts, where applicable (see Section 834-10-35).

Additional classifications or additional items within current classifications may result from future accounting standards.

Amendments to Subtopic 270-10

7. Add paragraph 270-10-50-8, with a link to transition paragraph 834-10-65-1, as follows:

Interim Reporting—Overall

Disclosure

> Guidance Related to Disclosure of Other Topics at Interim Dates

270-10-50-8 An entity shall provide a reconciliation of opening and closing balances of insurance contract liabilities (or assets) as required by Topic 834 on insurance contracts when it reports interim results (see paragraph 834-10-50-36).

Amendments to Subtopic 275-10

8. Amend paragraph 275-10-50-15, with a link to transition paragraph 834-10-65-1, as follows:

Risks and Uncertainties—Overall

Disclosure

> Certain Significant Estimates

275-10-50-15 The following are examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

- a. Inventory subject to rapid technological obsolescence
- b. Specialized equipment subject to technological obsolescence
- c. Valuation allowances for deferred tax assets based on future taxable income
- d. Capitalized motion picture film production costs
- e. Capitalized computer software costs
- f. Subparagraph superseded by Accounting Standards Update 201X-XX, ~~Deferred policy acquisition costs of insurance entities~~
- g. Valuation allowances for commercial and real estate loans
- h. Environmental remediation-related obligations
- i. Litigation-related obligations
- j. Contingent liabilities for obligations of other entities
- k. Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- l. Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- m. Amounts reported for long-term contracts.

The above list is not intended to be all-inclusive. See Section 275-10-60 for links to illustrations of the disclosure requirements that are contained in other Topics.

Amendments to Subtopic 350-30

9. Amend paragraph 350-30-15-4, with a link to transition paragraph 834-10-65-1, as follows:

Intangibles—Goodwill and Other—General Intangibles Other Than Goodwill

Scope and Scope Exceptions

> Transactions

350-30-15-4 The guidance in this Subtopic does not apply to the following:

- a. Subparagraph not used
- b. Subparagraph superseded by Accounting Standards Update No. 2010-07
- c. Except for certain disclosure requirements as noted in the preceding paragraph, capitalized software costs
- d. Subparagraph superseded by Accounting Standards Update 201X-XX. Intangible assets recognized for acquired insurance contracts under the requirements of Subtopic 944-805.

Addition of Subtopic 360-30

10. Add Subtopic 360-30, with a link to transition paragraph 834-10-65-1, as follows:

Property, Plant, and Equipment—Real Estate Acquired in Settling Insurance Claims

Overview and Background

General

360-30-05-1 This Subtopic provides guidance to insurance entities on accounting for and financial reporting of real estate acquired in settling insurance claims. [Content amended as shown and moved from paragraph 944-360-05-1]

Scope and Scope Exceptions

General

> Overall Guidance

360-30-15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 944-10-15 Subtopic 834-10 on insurance contracts. [Content amended as shown and moved from paragraph 944-360-15-1]

Initial Measurement

General

> Real Estate Acquired in Settling Certain Claims

360-30-30-1 Real estate acquired in settling mortgage guaranty and title insurance claims shall be measured initially at **fair value**. [Content moved from paragraph 944-360-30-1]

Subsequent Measurement

General

> Real Estate Acquired in Settling Certain Claims

360-30-35-1 Real estate acquired in settling mortgage guaranty and title insurance claims shall be reported subsequently at **fair value**. [Content moved from paragraph 944-360-35-1]

360-30-35-2 Paragraph ~~944-40-35-4~~ requires that subsequentSubsequent reductions in the reported amount of real estate acquired in settling claims shall be recognized as an adjustment to ~~claim costs~~**claims** or ~~benefits~~ incurred. [Content amended as shown and moved from paragraph 944-360-35-2]

> Potential Ownership Interest in Real Estate

360-30-35-3 As discussed in paragraph ~~944-40-30-2~~, ~~estimated~~**Estimated** recoveries on unsettled claims, such as **salvage, subrogation**, or a potential ownership interest in real estate, shall be evaluated in terms of their estimated realizable value and deducted from the ~~fulfillment cash flows and/or the liability for unpaid~~**incurred claims**. [Content amended as shown and moved from paragraph 944-40-35-2]

Derecognition

General

> Real Estate Acquired in Settling Certain Claims

360-30-40-1 Paragraph ~~944-40-35-4~~ requires that realized**Realized** gains and losses on the sale of real estate acquired in settling claims shall be recognized as an adjustment to ~~claim costs~~**claims** or ~~benefits~~ incurred. [Content amended as shown and moved from paragraph 944-360-40-1]

Other Presentation Matters

General

> Balance Sheet—Real Estate Acquired in Settling Certain Claims

360-30-45-1 Real estate acquired in settling claims shall be separately reported in the balance sheet and shall not be classified as an investment. **[Content moved from paragraph 944-360-45-1]**

> Income Statement

> > Real Estate Operating Costs

360-30-45-2 Depreciation and other real estate operating costs shall be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. **[Content amended as shown and moved from paragraph 944-360-45-2]**

> > Real Estate Investments

360-30-45-3 ~~Paragraph 944-325-45-3 states that realized~~ Realized gains and losses on all investments (except those that are accounted for as either hedges of net investments in foreign operations [see Subtopic 815-35] or cash flow hedges [see Subtopic 815-30]) shall be reported in the statement of earnings as a component of other income, on a pretax basis. **[Content amended as shown and moved from paragraph 944-360-45-3]**

360-30-45-4 ~~Paragraph 944-325-45-4 states that realized~~ Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to financial statements ~~(see paragraph 944-310-50-4).~~ **[Content amended as shown and moved from paragraph 944-360-45-4]**

> Other-Than-Temporary Impairment

360-30-45-5 Losses arising from an other-than-temporary impairment shall be presented in accordance with Subtopic 320-10. **[Content moved from paragraph 944-360-45-5]**

Disclosure

General

360-30-50-1 ~~Paragraph 944-325-50-1 states that, if~~ realized gains and losses are not presented as a separate item in the statement of earnings ~~(see~~

~~paragraph 944-360-45-4~~), they shall be disclosed in the notes to financial statements. **[Content amended as shown and moved from paragraph 944-360-50-1]**

Addition of Subtopic 360-40

11. Add Subtopic 360-40, with a link to transition paragraph 834-10-65-1, as follows:

Property, Plant, and Equipment—Real Estate Investments of Insurance Entities

Overview and Background

General

360-40-05-1 This Subtopic provides guidance to insurance entities on accounting for and financial reporting of real estate as an investment. **[Content amended as shown and moved from paragraph 944-360-05-1]**

Scope and Scope Exceptions

General

> Overall Guidance

360-40-15-1 The guidance in ~~the Financial Services Insurance Topic~~ this Subtopic applies to all of the following entities:

- a. Life and health insurance entities, including both:
 1. Stock life insurance entities
 2. Mutual life insurance entities.
- b. **Property and liability insurance entities** (also known as property and casualty insurance entities), which include all of the following entities:
 1. Stock entities
 2. Mutual entities.
 - ~~3. Paragraph not used.~~
- c. **Title insurance entities**
- d. **Assessment entities**
- e. **{add glossary link}** Fraternal benefit societies **{add glossary link}**
- f. **Mortgage guaranty insurance entities**

- g. Financial guaranty insurance entities
- h. Pools other than public-entity risk pools
- i. Syndicates
- j. Captive insurance entities
- k. **Reinsurance** entities
- l. **Reciprocal exchange** or **interinsurance exchange**.

[Content amended as shown and moved from paragraph 944-10-15-2]

Recognition

General

360-40-25-1 Real estate shall be classified either as an investment (real estate investments) or as real estate used in the insurance entity's operations (real estate used in the business), depending on its predominant use. [Content moved from paragraph 944-360-25-1]

Initial Measurement

General

> Real Estate Investments

360-40-30-1 Real estate investments shall be measured initially at cost. [Content moved from paragraph 944-360-30-2]

Subsequent Measurement

General

> Real Estate Investments

360-40-35-1 Real estate investments shall be measured subsequently at cost less accumulated depreciation. [Content moved from paragraph 944-360-35-4]

360-40-35-2 Depreciation and other related charges or credits shall be charged or credited to investment income. [Content moved from paragraph 944-360-35-5]

360-40-35-3 Reductions in the **carrying amount** of real estate investments resulting from the application of the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10 shall be included in realized gains and losses. [Content moved from paragraph 944-360-35-6]

> Real Estate Used in the Business

360-40-35-4 Imputed investment income and rental expense shall not be recognized for real estate used in the business. [Content moved from paragraph 944-360-35-7]

Derecognition

General

> Real Estate Investments

360-40-40-1 ~~As stated in paragraph 944-325-40-1, realized~~Realized gains and losses (including those on sales of real estate investments) shall not be deferred, either directly or indirectly. [Content amended as shown and moved from paragraph 944-360-40-2]

> Real Estate Used in the Business

360-40-40-2 Realized gains and losses on the sale of assets other than investments, such as real estate used in the business, shall be reported in accordance with Subtopic 225-20. [Content moved from paragraph 944-360-40-3]

Other Presentation Matters

General

> Income Statement

> > Real Estate Operating Costs

360-40-45-1 Depreciation and other real estate operating costs shall be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. [Content moved from paragraph 944-360-45-2]

> > Real Estate Investments

360-40-45-2 ~~Paragraph 944-325-45-3 states that realized~~Realized gains and losses on all investments (except those that are accounted for as either hedges of net investments in foreign operations [see Subtopic 815-35] or cash flow hedges [see Subtopic 815-30]) shall be reported in the statement of earnings as

a component of other income, on a pretax basis. **[Content amended as shown and moved from paragraph 944-360-45-3]**

360-40-45-3 ~~Paragraph 944-325-45-4 states that realized~~Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to financial statements ~~(see paragraph 944-310-50-4).~~**[Content amended as shown and moved from paragraph 944-360-45-4]**

> Other-Than-Temporary Impairment

360-40-45-4 Losses arising from an other-than-temporary impairment shall be presented in accordance with Subtopic 320-10. **[Content moved from paragraph 944-360-45-5]**

Disclosure

General

360-40-50-1 ~~Paragraph 944-325-50-1 states that, if~~Realized gains and losses are not presented as a separate item in the statement of earnings ~~(see paragraph 944-360-45-4),~~ they shall be disclosed in the notes to financial statements. **[Content amended as shown and moved from paragraph 944-360-50-1]**

Amendments to Subtopic 405-30

12. Amend paragraph 405-30-15-3, with a link to transition paragraph 834-10-65-1, as follows:

Liabilities—Insurance-Related Assessments

Scope and Scope Exceptions

> Transactions

405-30-15-2 The guidance in this Subtopic applies to assessments mandated by statute or regulatory authority that are related directly or indirectly to underwriting activities (including self insurance), except for income taxes and premium taxes.

405-30-15-3 The guidance in this Subtopic does not apply to the following transactions and activities:

- a. Amounts payable or paid as a result of reinsurance contracts or arrangements that are in substance reinsurance, including assumed reinsurance activities and certain **involuntary pools** that are covered by ~~Topic 944~~ Topic 834 on insurance contracts.
- b. Assessments of depository institutions related to bank insurance and similar funds.
- c. The annual fee imposed on health insurers by the Patient Protection and Affordable Care Act as amended by the Health Care and Education Reconciliation Act (the Acts). The accounting for the Acts' fee is addressed in Subtopic 720-50.

13. Supersede paragraph 405-30-30-9 and amend paragraph 405-30-30-10, with a link to transition paragraph 834-10-65-1, as follows:

Initial Measurement

> Present Value Measurement of the Obligation

405-30-30-9 Paragraph superseded by Accounting Standards Update 201X-XX. ~~Current practice in the insurance industry is to allow, but not require (with limited exceptions, such as pensions and postretirement benefits), the discounting of liabilities to reflect the time value of money when the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for a particular liability.~~

405-30-30-10 ~~Similarly, for assessments that meet those criteria,~~ When the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for a particular liability, the liability for the assessment may be, but is not required to be, recorded at its present value by discounting the estimated future cash flows at an appropriate interest rate.

14. Amend paragraph 405-30-55-9, with a link to transition paragraph 834-10-65-1, as follows:

Implementation Guidance and Illustrations

> Illustrations

> > Example 2: Retrospective-Premium-Based Assessment

405-30-55-9 The resulting recognized liability and asset are as follows (shown on both a discounted and undiscounted basis, based on paragraphs ~~405-30-30-~~

9405-30-30-10 through 30-12, discounting is optional), assuming average annual subject premiums of \$100,000 for the 3 years before the insolvency.

Assessments	Recorded at	Cash Payments									
	12/31/19X0	19X1	19X2	19X3	19X4	19X5	19X6	19X7	19X8	19X9	20X0
Assessments											
19X3 Assessment				1,000							
19X4 Assessment					1,000						
19X5 Assessment						1,000					
Total	3,000			1,000	1,000	1,000					
Premium tax offset											
19X3 Assessment ^(a)					200	200	200	200	200		
19X4 Assessment ^(a)						200	200	200	200	200	
19X5 Assessment ^(a)							200	200	200	200	200
Total	3,000				200	400	600	600	600	400	200
Present value of assessments											
At 12/31/19X0 ^(b)	2,470										
Present value of premium											
Tax offset at 12/31/19X0 ^(b)	2,139										

(a) Assumed that, based upon anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset.

(b) Discounted at 5 percent, assuming all assessments are paid and offsets realized at the end of each year.

Amendments to Subtopic 410-30

15. Amend paragraph 410-30-15-3, with a link to transition paragraph 834-10-65-1, as follows:

Asset Retirement and Environmental Obligations— Environmental Obligations

Scope and Scope Exceptions

> Transactions

410-30-15-3 The guidance in this Subtopic does not apply to the following transactions and activities:

- a. Environmental contamination incurred in the normal operation of a long-lived asset (see Subtopic 410-20 for guidance that will apply if the entity is legally obligated to treat the contamination). Paragraph 410-20-15-3(b) explains that the obligation to clean up the spillage resulting from the normal operation of the fuel storage facility is within the scope of Subtopic 410-20. Additionally, that Subtopic applies if a **legal obligation** to treat environmental contamination is incurred or assumed as a result of the acquisition, construction, or development of a long-lived asset.
- b. Pollution control costs with respect to current operations or on accounting for costs of future site restoration or **closure** that are required upon the cessation of operations or sale of facilities, as such

- current and future costs and obligations represent a class of accounting issues different from environmental remediation liabilities.
- c. Environmental remediation actions that are undertaken at the sole discretion of management and that are not induced by the threat, by governments or other parties, of litigation or of assertion of a claim or an assessment.
 - d. Recognizing liabilities of insurance ~~contracts—entities for unpaid claims.~~
 - e. Natural resource damages and toxic torts (see paragraphs 450-20-55-10 through 55-21).
 - f. Asset impairment issues.

Amendments to Subtopic 450-10

16. Amend paragraphs 450-10-60-9 through 60-10, with a link to transition paragraph 834-10-65-1, as follows:

Contingencies—Overall

Relationships

> Financial Services—Insurance

450-10-60-9 For contingencies that arise when an ~~insurance entity or a reinsurance entity~~ issues an insurance contract, see ~~Subtopic 944-40.~~Section 834-10-15 on insurance contracts.

450-10-60-10 For contingencies associated with a reinsurance contract ~~between insurance entities~~ (including retrocession), see Section ~~944-20-15~~834-10-15.

17. Supersede paragraph 450-10-60-11, with a link to transition paragraph 834-10-65-1, as follows:

450-10-60-11 ~~Paragraph superseded by Accounting Standards Update 201X-XX. For contingencies associated with multiple-year retrospectively rated contracts, see Subtopic 944-20.~~

Amendments to Subtopic 450-20

18. Amend paragraph 450-20-05-3, with a link to transition paragraph 834-10-65-1, as follows:

Contingencies—Loss Contingencies

Overview and Background

450-20-05-3 The following are examples of loss contingencies for which links are provided in Section 450-20-60:

- a. Collectibility of receivables
- b. Obligations related to product warranties and product defects
- c. Subparagraph superseded by Accounting Standards Update 201X-XX.~~Risk of loss from catastrophes assumed by property and casualty insurance entities including reinsurance entities~~
- d. Guarantees of indebtedness of others
- e. Obligations of commercial banks under standby letters of credit
- f. Agreements to repurchase receivables (or to repurchase the related property) that have been sold.

19. Amend paragraph 450-20-15-2, with a link to transition paragraph 834-10-65-1, as follows:

Scope and Scope Exceptions

> Transactions

450-20-15-2 The following transactions are excluded from the scope of this Subtopic because they are addressed elsewhere in the Codification:

- a. Stock issued to employees, which is discussed in Topic 718.
- b. Employment-related costs, including deferred compensation contracts, which are discussed in Topics 710, 712, and 715. However, certain postemployment benefits are included in the scope of this Subtopic through application of paragraphs 712-10-25-4 through 25-5.
- c. Uncertainty in income taxes, which is discussed in Section 740-10-25.
- d. Accounting and reporting by insurance entities, for insurance contracts issued and reinsurance contracts held, which is ~~are~~ discussed in Topic 944834 on insurance contracts.

20. Amend paragraph 450-20-60-14 and supersede paragraph 450-20-60-19 and its related heading, with a link to transition paragraph 834-10-65-1, as follows:

Relationships

> Other Expenses

450-20-60-14 For contingencies related to an insurance contract or reinsurance contract that does not, despite its form, provide for indemnification compensation of the insured or the ceding company entity by the insurer or reinsurer against loss or liability, see paragraph 720-20-25-1.

> ~~Financial Services—Insurance~~

450-20-60-19 ~~Paragraph superseded by Accounting Standards Update 201X-XX. For contingencies related to the risk of loss that is assumed by a property and casualty insurance entity or reinsurance entity when it issues an insurance policy covering risk of loss from catastrophes, see Subtopic 944-40.~~

Amendments to Subtopic 460-10

21. Amend paragraphs 460-10-15-4 and 460-10-15-7, with a link to transition paragraph 834-10-65-1, as follows:

Guarantees—Overall

Scope and Scope Exceptions

> Transactions

> > Transactions That Are within the Scope of This Topic

460-10-15-4 Except as provided in Topic 834 on insurance contracts and paragraph 460-10-15-7, the provisions of this Topic apply to the following types of guarantee contracts:

- a. Contracts that contingently require a guarantor to make payments (as described in the following paragraph) to a guaranteed party based on changes in an **underlying** that is related to an asset, a liability, or an equity security of the guaranteed party. For related implementation guidance, see paragraph 460-10-55-2.
- b. Contracts that contingently require a guarantor to make payments (as described in the following paragraph) to a guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees). For related implementation guidance, see paragraph 460-10-55-12.

- c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party.
- d. **Indirect guarantees of the indebtedness** of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

> > Transactions That Are Excluded from the Scope of This Topic

460-10-15-7 The guidance in this Topic does not apply to the following types of guarantee contracts:

- a. A guarantee or an indemnification that is excluded from the scope of Topic 450 (see paragraph 450-20-15-2—primarily employment-related guarantees)
- b. A lessee's guarantee of the residual value of the leased property at the expiration of the **lease term**, if the lessee (guarantor) accounts for the lease as a capital lease under Subtopic 840-30
- c. A contract that meets the characteristics in paragraph 460-10-15-4(a) but is accounted for as contingent rent under Subtopic 840-30
- d. A guarantee (or an indemnification) that is ~~issued by either an insurance entity or a reinsurance entity and~~ accounted for under Topic ~~944~~834 ~~(including guarantees embedded in either insurance contracts or investment contracts)~~
- e. A contract that meets the characteristics in paragraph 460-10-15-4(a) but provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party
- f. A contract that provides for payments that constitute a vendor rebate (by the guarantor) based on the volume of purchases by the buyer (because the underlying relates to an asset of the seller, not the buyer who receives the rebates)
- g. A guarantee or an indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction
- h. A registration payment arrangement within the scope of Subtopic 825-20 (see Section 825-20-15)
- i. A guarantee or an indemnification of an entity's own future performance (for example, a guarantee that the guarantor will not take a certain future action)

- j. A guarantee that is accounted for as a **credit derivative** at fair value under Topic 815.

For related implementation guidance, see Section 460-10-55.

Addition of Subtopic 470-70

22. Add Subtopic 470-70, with a link to transition paragraph 834-10-65-1, as follows:

Debt—Surplus Notes

Overview and Background

General

470-70-05-1 This Subtopic provides guidance on accounting, financial statement presentation, and disclosure by the issuers of **surplus notes**. The term surplus notes is the most common term applied to these financial instruments. Some jurisdictions refer to these financial instruments as certificates of contribution, surplus debentures, or capital notes. The following are some general characteristics of surplus notes:

- a. Approval of the issuance by the domiciliary state insurance commissioner
- b. Stated maturity date in most but not all cases
- c. Scheduled interest payments
- d. Approval of the payment of principal and interest by the domiciliary state insurance commissioner
- e. Nonvoting
- f. Subordinate to all claims except those of shareholders for stock entities
- g. Subordinate to all claims except policyholder residuals for mutual entities (after policyholder liabilities are settled)
- h. No or limited acceleration rights other than for rehabilitation, liquidation, or reorganization of the insurer by a governmental agency
- i. Proceeds from issuance in the form of cash, cash equivalent, or some other asset with a **readily determinable fair value** satisfactory to the domiciliary state insurance commissioner. **[Content moved from paragraph 944-470-05-1]**

Recognition

General

> Surplus Notes

470-70-25-1 **Surplus notes** shall be accounted for as debt instruments in accordance with Subtopic 825-10 on financial instruments; equity treatment for surplus notes is inappropriate. **[Content amended as shown and moved from paragraph 944-470-25-1]**

Subsequent Measurement

General

> Surplus Notes

470-70-35-1 Interest shall be accrued over the life of the {add glossary link}surplus note{add glossary link}, irrespective of the approval of interest and principal payments by the domiciliary state insurance commissioner, and shall be recognized as an expense in the same manner as other debt. **[Content amended as shown and moved from paragraph 944-470-35-1]**

Other Presentation Matters

General

> Surplus Notes

470-70-45-1 **Surplus notes** shall be presented as liabilities in the financial statements of the issuer in accordance with Subtopic 825-10 on financial instruments; equity treatment for surplus notes is inappropriate. **[Content amended as shown and moved from paragraph 944-470-45-1]**

Disclosure

General

> Surplus Notes

470-70-50-1 An entity shall disclose the domiciliary state insurance commissioner's role and ability to approve or disapprove any interest and principal payments. **[Content moved from paragraph 944-470-50-1]**

470-70-50-2 **Surplus notes** are subject to the disclosure requirements in Subtopic 825-10 on financial instruments.

Amendments to Subtopic 605-20

[Note: Topic 605 is being superseded by proposed FASB Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from*

Contracts with Customers. However, because that guidance is not final, this proposed Update is amending the current content.]

23. Amend paragraph 605-20-15-3, with a link to transition paragraph 834-10-65-1, as follows:

Revenue Recognition—Services

Scope and Scope Exceptions

605-20-15-3 The guidance in this Subtopic does not apply to the following service activities and arrangements:

- a. Guarantees accounted for as derivatives in accordance with Section 815-10-15
- b. Product warranties, except that paragraph 605-20-25-3 provides guidance on revenue recognition by sellers of manufacturers, dealers, or retailers selling extended warranty or product maintenance contracts
- c. Guarantees required to be accounted for as financial guarantee insurance contracts in accordance with Topic 944-834 on insurance contracts.

24. Amend paragraphs 605-20-25-2 through 25-3, with a link to transition paragraph 834-10-65-1, as follows:

Recognition

605-20-25-2 Accounting for extended warranty and product maintenance contracts follows an approach similar to that described in ~~the Short-Duration Contracts Subsection of~~ Section ~~944-605-25~~834-10-30 for ~~short-duration insurance contracts~~ accounted for using the premium allocation approach. Like ~~short-duration~~ insurance contracts, extended warranty and product maintenance contracts provide coverage against the risk of certain specified claim costs for a specified period. Those claim costs may take the form of repair costs if the product requires repair or service costs if the customer requests that a covered service be performed on the product. Paragraph ~~944-605-25~~1834-10-35-27 indicates that premiums from ~~short-duration~~ insurance contracts measured using the premium allocation approach should be recognized as revenue ~~over the period of the contract~~ in proportion to the value of coverage that the insurer has provided, which shall be based on the passage of time or on the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time~~amount of insurance protection provided~~. That generally results in premiums being recognized as revenue evenly over the contract period.

605-20-25-3 ~~Sellers of Manufacturers, dealers, or retailers selling extended warranty or product maintenance contracts have an obligation to the buyer to perform services throughout the period of the contract and, therefore, revenue shall be recognized in income over the period in which the seller is obligated to perform. That is, revenue from separately priced extended warranty and product maintenance contracts shall be deferred and recognized in income on a straight-line basis over the contract period except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue shall be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.~~

Amendments to Subtopic 715-30

25. Amend paragraph 715-30-35-46, with a link to transition paragraph 834-10-65-1, as follows:

Compensation—Retirement Benefits—Defined Benefit Plans—Pension

Subsequent Measurement

> Assumptions

> > Discount Rates

715-30-35-46 ~~An insurance entity/insurer~~ deciding on the price of an annuity contract will consider the rates of return available to it for investing the premium received and the rates of return expected to be available to it for reinvestment of future cash flows from the initial investment during the period until benefits are payable. That consideration is indicative of a relationship between rates inherent in the prices of annuity contracts and rates available in investment markets. Therefore, it is appropriate for employers to consider that relationship and information about investment rates in estimating the discount rates required for application of this Subtopic. Thus a current settlement rate best meets that objective and is consistent with measurement of plan assets at fair value for purposes of recognizing as a net asset or a net liability, and disclosing the plan's funded status. Each year the discount rates shall be reevaluated to determine whether they reflect the best estimate of the current effective settlement rates. As established in paragraph 715-30-35-44, if interest rates generally decline or rise, the assumed discount rates shall change.

26. Amend paragraphs 715-30-35-54, 715-30-35-57, and 715-30-35-59 through 35-60, with a link to transition paragraph 834-10-65-1, as follows:

> **Annuity and Other Contracts**

715-30-35-54 If the ~~insurance entity insurer~~ obligated under an annuity contract is a **captive insurer**, or if there is any reasonable doubt that the ~~insurance~~ entity will meet its obligations under the contract, the contract is not an annuity contract for purposes of this Subsection.

715-30-35-57 Participating annuity contracts provide that the purchaser (either the plan or the employer) may participate in the experience of the ~~insurance entity insurer~~. Under those contracts, the ~~insurance entity insurer~~ ordinarily pays dividends to the purchaser, the effect of which is to reduce the cost of the plan. The purchase price of a **participating annuity contract** ordinarily is higher than the price of an equivalent contract without participation rights. The difference is the cost of the participation right.

715-30-35-59 If the substance of a participating contract is such that the employer remains subject to all or most of the risks and rewards associated with the benefit obligation covered and the assets transferred to the ~~insurance entity insurer~~, that contract is not an annuity contract for purposes of this Subtopic.

715-30-35-60 Insurance contracts that are in substance equivalent to the purchase of annuities shall be accounted for as such. Other contracts with ~~insurance entities insurers~~ shall be accounted for as investments and measured at fair value. For some contracts, the best available evidence of fair value may be contract value. If a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value.

27. Amend paragraph 715-30-55-31, with a link to transition paragraph 834-10-65-1, as follows:

Implementation Guidance and Illustrations

> **Implementation Guidance**

> > **Selection of Discount Rates**

715-30-55-31 Ordinarily, an employer would not want to purchase annuities for that portion of the pension benefit obligation related to future compensation levels and an ~~insurance entity insurer~~ would be unwilling to undertake an unconditional obligation based on future compensation levels without charging

increased premiums for the additional risk. Even though a current settlement of the portion of the projected benefit obligation that relates to future compensation levels is unlikely, an employer shall not use those interest rates implicit in current prices of annuity contracts to determine the accumulated benefit obligation, and use interest rates expected to be implicit in future prices of annuity contracts to determine the pension obligation in excess of the accumulated benefit obligation. The use of rates implicit in future annuity prices is not consistent with the requirements of paragraph 715-30-35-46 to use current settlement rates.

Amendments to Subtopic 715-60

28. Amend paragraphs 715-60-35-110 through 35-115, 715-60-35-117, and 715-60-35-120, with a link to transition paragraph 834-10-65-1, as follows:

Compensation—Retirement Benefits—Defined Benefit Plans—Other Postretirement

Subsequent Measurement

General

> Insurance Contracts

715-60-35-109 Benefits covered by insurance contracts shall be excluded from the accumulated postretirement benefit obligation. Insurance contracts shall be excluded from plan assets, except as provided in paragraphs 715-60-25-3 and 715-60-35-115 through 35-116 for the cost of participation rights.

715-60-35-110 If the ~~insurance entity~~ insurer providing the contract does business primarily with the employer and related parties (a **captive insurer**) or if there is any reasonable doubt that the ~~insurance entity~~ insurer will meet its obligations under the contract, the contract is not an **insurance contract** for purposes of this Subtopic.

715-60-35-111 An insurance contract with a captive insurer generally does not qualify as a **plan asset** unless it meets the criteria in the definition of the term plan assets. To qualify as a plan asset, ~~an investment~~ a contract with a captive insurer shall be segregated and restricted for the payment of postretirement benefits. Note that whether a funding vehicle can be restricted solely for the payment of retirees' benefits is subject to legal, not accounting, interpretation.

715-60-35-112 In addition, because a plan's ~~investment~~ insurance contract (or contract that is not within the scope of Topic 834 on insurance contracts) with a

~~captive insurance entity insurer~~ represents an obligation of the employer to pay cash to be used to pay benefits and because amounts accrued by the employer to pay benefits are not plan assets, that contract shall be considered an employer **debt security** for purposes of this Subtopic and, therefore, must be currently transferable to be included in plan assets. (See paragraphs 715-60-55-26 through 55-28 for guidance on employer entities.)

715-60-35-113 See paragraphs ~~944-20-15-16 through 15-19~~ for a description of ~~investment contracts~~. 834-10-15-1 through 15-5 for the scope of insurance contracts.

715-60-35-114 Some insurance contracts (participating insurance contracts) provide that the purchaser (either the plan or the employer) may participate in the experience of the ~~insurance entity insurer~~. Under those contracts, if the ~~insurance entity insurer~~ has favorable experience, the ~~insurance entity insurer~~ will pay dividends to the purchaser, the effect of which is to reduce the cost of the plan. For example, if the ~~insurance entity's investment return of the insurer~~ is better than anticipated, or perhaps if actual experience related to mortality or other assumptions is favorable, the purchaser will receive dividends that reduce the cost of the contract.

715-60-35-115 The purchase price of a **participating insurance contract** ~~contract~~ ordinarily is higher than the price of an equivalent contract without a **participation right**. The difference is the cost of the participation right.

715-60-35-116 In subsequent periods, the participation right shall be measured at its fair value if the contract is such that fair value is reasonably estimable. Otherwise the participation right shall be measured at its amortized cost (not in excess of its net realizable value), and the cost shall be amortized systematically over the expected dividend period under the contract.

715-60-35-117 If the participating insurance contract causes the employer to remain subject to all or most of the risks and rewards associated with the benefit obligation covered or the assets transferred to the ~~insurance entity insurer~~, that contract is not an insurance contract for purposes of this Subtopic, and the purchase of that contract does not constitute a settlement pursuant to paragraphs 715-60-35-150 through 35-155 and 715-60-35-157 through 159.

715-60-35-118 To the extent that insurance contracts are purchased during the period to cover postretirement benefits attributed to service in the current period (such as life insurance benefits), the cost of those benefits shall be the cost of purchasing the coverage under the contracts, except as provided in paragraphs 715-60-25-3 and 715-60-35-115 through 35-116 for the cost of a participation right. If all the postretirement benefits attributed to service in the current period are covered by **nonparticipating insurance contracts** purchased during that

period, the cost of the contracts determines the service cost component of net postretirement benefit cost for that period.

715-60-35-119 Benefits attributed to current service in excess of benefits provided by nonparticipating insurance contracts purchased during the current period shall be accounted for according to the provisions of this Subtopic applicable to plans not involving insurance contracts.

715-60-35-120 Other contracts ~~with insurance entities~~ may not meet the definition of an insurance contract because the ~~insurance entity~~insurer does not accept significant insurance risk from the policyholder by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder~~unconditionally undertake a legal obligation to provide specified benefits to specified individuals~~. Those contracts shall be accounted for as investments and measured at fair value. If a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value. For some contracts, the best available estimate of fair value may be contract value.

Amendments to Subtopic 720-15

29. Amend paragraph 720-15-15-4, with a link to transition paragraph 834-10-65-1, as follows:

Other Expenses—Start-Up Costs

Scope and Scope Exceptions

General

> Transactions

720-15-15-4 Certain costs that may be incurred in conjunction with start-up activities are outside the scope of this Subtopic. Such costs should be accounted for in accordance with other existing authoritative accounting literature. The guidance in this Subtopic does not apply to the following transactions and activities:

- a. ~~Ongoing customer acquisition costs, such as policy acquisition costs~~
Qualifying acquisition costs related to insurance contracts (see Subtopic ~~944-30-Section 834-10-30~~).
- b. Loan origination costs (see Subtopic 310-20)

- c. Activities related to routine, ongoing efforts to refine, enrich, or otherwise improve upon the qualities of an existing product, service, process, or facility
- d. Activities related to mergers or acquisitions
- e. Business process reengineering and information technology transformation costs addressed in Subtopic 720-45
- f. Costs of acquiring or constructing long-lived assets and getting them ready for their intended uses (however, the costs of using long-lived assets that are allocated to start-up activities [for example, depreciation of computers] are within the scope of this Subtopic)
- g. Costs of acquiring or producing inventory
- h. Costs of acquiring intangible assets (however, the costs of using intangible assets that are allocated to start-up activities [for example, amortization of a purchased patent] are within the scope of this Subtopic)
- i. Costs related to internally developed assets (for example, internal-use computer software costs) (however, the costs of using those assets that are allocated to start-up activities are within the scope of this Subtopic)
- j. Research and development costs that are within the scope of Section 730-10-15
- k. Regulatory costs that are within the scope of Section 980-10-15
- l. Costs of fundraising incurred by NFPs
- m. Costs of raising capital
- n. Costs of advertising
- o. Costs incurred in connection with existing contracts as stated in paragraph 605-35-25-41(d).

Amendments to Subtopic 720-20

30. Amend paragraph 720-20-05-3, with a link to transition paragraph 834-10-65-1, as follows:

Other Expenses—Insurance Costs

Overview and Background

Retroactive Contracts

720-20-05-3 The Retroactive Contracts Subsections provide guidance on how an insured entity, ~~including an insurance entity purchasing insurance unrelated to its core insurance operations (for example, manufacturers, retailers, service entities, and financial institutions),~~ should account for a purchased retroactive insurance policy and whether the transaction results in gain recognition (excluding reinsurance transactions). For example, an entity records a liability of \$100

million incurred as a result of a past event in accordance with Subtopic 450-20. The entity then buys an insurance policy for \$60 million to cover that liability.

31. Amend paragraphs 720-20-15-6 and 720-20-15-8, with a link to transition paragraph 834-10-65-1, as follows:

Other Expenses—Insurance Costs

Scope and Scope Exceptions

Retroactive Contracts

> Transactions

720-20-15-6 The guidance in the Retroactive Contracts Subsections does not apply to the following transactions and activities:

- a. Those that legally extinguish the entity's liability
- b. Reinsurance transactions (see ~~Subtopic 944-20-~~Topic 834 on insurance contracts for guidance on the accounting by ~~insurance~~ entities for reinsurance contracts).

Claims-Made Contracts

> Transactions

720-20-15-8 The guidance in the Claims-Made Contracts Subsections does not apply to reinsurance transactions (see ~~the Reinsurance Subsections of Topic 944-~~834 for guidance on the accounting by ~~insurance~~ entities for reinsurance contracts).

32. Amend paragraphs 720-20-25-1 through 25-3, 720-20-25-6, 720-20-25-8 through 25-9, 720-20-25-12, and 720-20-25-14 through 25-15, with a link to transition paragraph 834-10-65-1, as follows:

Recognition

General

720-20-25-1 To the extent that an insurance contract ~~or reinsurance contract~~ does not, despite its form, provide ~~for indemnification~~compensation 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.

720-20-25-2 See Subtopic 340-30 for guidance on deposit accounting. In addition, the preceding paragraph requires that an entity determine whether insurance risk has been transferred through an insurance contract; entities may find the conditions guidance in Section 944-20-15 paragraphs 834-10-55-3 through 55-17 useful in assessing whether an insurance contract transfers risk.

[Note: Subtopic 340-30 is being superseded by proposed FASB Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. However, because that guidance is not final, this proposed Update is not amending that reference.]

Retroactive Contracts

> Purchase of a Retroactive Insurance Policy

720-20-25-3 Notwithstanding that Topic 944834 on insurance contracts applies only to insurance entities, does not apply to policyholder accounting (unless the contract compensates the entity for losses on one or more direct insurance contracts issued by that entity, such as reinsurance), purchased retroactive insurance contracts that indemnify the insured shall be accounted for in a manner similar to the manner in which retroactive reinsurance contracts are accounted for under Subtopic 944-605 Topic 834. The guidance in that Subtopic That guidance shall be applied, as appropriate, based on the facts and circumstances of the particular transaction. That is, amounts paid for retroactive insurance shall be expensed immediately. Simultaneously, a receivable shall be established for the expected recoveries related to the underlying insured event.

720-20-25-4 If the receivable established exceeds the amounts paid for the insurance, the resulting gain is deferred. Immediate gain recognition and liability derecognition are not appropriate because the liability has not been extinguished (the entity is not entirely relieved of its obligation). Additionally, the liability incurred as a result of a past insurable event and amounts receivable under the insurance contract do not meet the criteria for offsetting under paragraph 210-20-45-1.

Claims-Made Contracts

> Claims-Made Insurance Policies That Represent Purchased Retroactive Insurance Contracts

720-20-25-6 A claims-made insurance policy contains a retroactive provision if it provides coverage for specific known claims that were reportable prior to the policy period. Regardless of whether the insured has recognized a loss contingency for those claims, specific known claims that were reportable (by the insured entity to the insurance entity) would encompass:

- a. Asserted claims
- b. Known unasserted claims
- c. Any known previous event or circumstance that might result in a specific claim (whether asserted or unasserted).

Such claims include those that were not reported by the insured to the ~~insurance entity~~ insurer, but would have been reportable to the ~~insurance entity~~ insurer had a claims-made policy been in place in a prior period.

720-20-25-7 If a claims-made insurance policy contains a retroactive provision, the retroactive and prospective provisions of the policy shall be accounted for separately, if practicable.

720-20-25-8 If it is not practicable to separate the retroactive and prospective provisions, the claims-made insurance policy shall be accounted for entirely as a retroactive contract ~~in accordance with Subtopic 944-605~~. A claims-made insurance ~~policy~~ contract that contains no retroactive provisions should be accounted for on a prospective basis as described in the Claims-Made Contracts Subsection of Section 720-20-35 and in Examples 4–5 (see paragraphs 720-20-55-13 through 55-20).

720-20-25-9 ~~Paragraph 944-20-15-34B states that in~~ In claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the ~~policy~~ contract, of a claim for a loss covered by the insurance contract. Accordingly, a prospective claims-made insurance ~~policy~~ contract only covers claims for losses reportable to the insurer during the ~~policy~~ contract term. A retroactive provision provides coverage for known claims, for which the underlying event had occurred and the incident would have been reportable prior to the effective date of the claims-made ~~policy~~ contract. A recognized liability for **incurred but not reported** claims generally would not be determinative in concluding that a claims-made insurance ~~policy~~ contract either does or does not contain a retroactive provision.

720-20-25-12 An insured entity may, for various reasons, contemporaneously enter into multiple claims-made insurance ~~policy~~—contracts. In those circumstances, an entity should consider whether those insurance contracts should be combined in order to determine the appropriate accounting treatment. The guidance contained in Section ~~944-20-15~~834-10-15 and paragraphs 834-10-55-26 through 55-43 on insurance contracts is helpful in those instances.

> Recognizing a Liability for Incurred but Not Reported Claims

720-20-25-14 Paragraph 450-20-25-2 requires that insured entities (except ~~as discussed in Section 944-20-15~~ if the transaction is in the scope of Topic 834, which includes transactions that compensate an entity for losses on one or more direct insurance contracts issued by that entity, such as reinsurance), including those that use a claims-made approach for insuring certain risks, recognize a liability for the probable losses from incurred but not reported claims and incidents if the loss is both probable and reasonably estimable. Paragraphs 450-20-55-10 through 55-17 provide implementation guidance about litigation, claims, and assessments.

Multiple-Year Retrospectively Rated Contracts

720-20-25-15 For a multiple-year retrospectively rated insurance contract accounted for as insurance, the insured shall recognize either of the following:

- a. ~~As indicated in paragraph 944-20-25-2, a~~ liability to the extent that the insured has an obligation to pay cash (or other consideration) to the insurer that would not have been required absent experience under the contract
- b. ~~As indicated in paragraph 944-20-25-2, an~~ asset to the extent that any cash (or other consideration) would be payable by the insurer to the insured based on experience to date under the contract.

33. Amend paragraph 720-20-35-13, with a link to transition paragraph 834-10-65-1, as follows:

Subsequent Measurement

Multiple-Year Retrospectively Rated Contracts

720-20-35-13 The insured shall account for changes in coverage in the same manner as changes in other contract costs, ~~as indicated in paragraph 944-20-35-2~~. For example, the effects of decreases in coverage without a commensurate reduction in premium shall be recognized as a loss by the insured when the event causing the decrease in coverage takes place.

Amendments to Subtopic 720-50

34. Amend paragraph 720-50-25-1, with a link to transition paragraph 834-10-65-1, as follows:

Other Expenses—Fees Paid to the Federal Government by Pharmaceutical Manufacturers and Health Insurers

Recognition

720-50-25-1 The liability related to the annual fee described in paragraphs 720-50-05-1 through 05-4 shall be estimated and recorded in full upon the first qualifying sale for pharmaceutical manufacturers or once the entity provides qualifying health insurance for health insurers in the applicable calendar year in which the fee is payable with a corresponding deferred cost that is amortized to expense using a straight-line method of allocation unless another method better allocates the fee over the calendar year that it is payable. The annual fee imposed on health insurers does not represent a cost related to the acquisition of policies that is consistent with the definition of an *qualifying acquisition cost* as discussed in Subtopic 944-30-paragraphs 834-10-30-14 and 834-10-55-101 through 55-108 and does not represent cash flows that are included in the measurement of fulfillment cash flows as discussed in paragraphs 834-10-30-1 through 30-7 and 834-10-55-75 through 55-78.

Amendments to Subtopic 740-10

35. Amend paragraph 740-10-05-4, with a link to transition paragraph 834-10-65-1, as follows:

Income Taxes—Overall

Overview and Background

740-10-05-4 Other Topics, including industry-specific Topics, may also have Income Taxes Subtopics that address the Topic-specific requirements for income taxes. Guidance in those Subtopics is intended to be incremental to the guidance otherwise established in the Income Taxes Topic. Topics with incremental Income Taxes Subtopics are:

- a. Investments—Equity Method and Joint Ventures, Subtopic 323-740
- b. Compensation—Stock Compensation, Subtopic 718-740
- c. Business Combinations, Subtopic 805-740

- d. Foreign Currency Matters, Subtopic 830-740
- e. Reorganizations, Subtopic 852-740
- f. Entertainment—Casinos, Subtopic 924-740
- g. Extractive Activities—Oil and Gas, Subtopic 932-740
- h. Financial Services—Depository and Lending, Subtopic 942-740
- i. ~~Subparagraph superseded by Accounting Standards Update 201X-XX, Financial Services—Insurance, Subtopic 944-740~~
- j. Health Care Entities, Subtopic 954-740
- k. Real Estate—Common Interest Realty Associations, Subtopic 972-740
- l. Regulated Operations, Subtopic 980-740
- m. U.S. Steamship Entities, Subtopic 995-740.

36. Amend paragraphs 740-10-25-3(a)(4) and 740-10-25-20(b), with a link to transition paragraph 834-10-65-1, as follows:

Recognition

740-10-25-3 The only exceptions in applying those basic requirements are:

- a. Certain exceptions to the requirements for recognition of deferred taxes whereby a deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:
 - 4. Policyholders' surplus of stock life insurance entities that arose in fiscal years beginning on or before December 15, 1992. ~~See paragraph 944-740-25-2 for the specific requirements related to this exception. As described in Topic 740, a life insurance entity shall not provide deferred taxes on taxable temporary differences related to policyholders' surplus that arose in fiscal years beginning on or before December 15, 1992. However, if circumstances indicate that the~~ **{add glossary link}**life insurance entity**{add glossary link}** is likely to pay income taxes, either currently or in later years, because of a known or expected reduction in policyholders' surplus, income taxes attributable to that reduction shall be accrued as a tax expense of the current period; the accrual of those income taxes shall not be accounted for as an extraordinary item. **[Content amended as shown and moved from paragraph 944-740-25-3]**

740-10-25-20 An assumption inherent in an entity's statement of financial position prepared in accordance with generally accepted accounting principles (GAAP) is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Based on that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future

year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Examples include the following:

- b. Expenses or losses that are deductible after they are recognized in financial income. A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.

- 1. Although payment is not required, a participation feature such as a policyholder dividend recognized in accordance with the guidance in Topic 834 on insurance contracts under paragraph 944-50-25-3 is considered a planned contractual benefit in computing liabilities under ~~generally accepted accounting principles (GAAP)~~GAAP. However, it may be necessary to identify the amount of this dividend to calculate deferred income taxes in those cases in which there is a question as to whether the dividend provision in the liabilities, together with the dividends paid or declared, may exceed the amount of dividends otherwise deductible for federal income tax purposes. **[Content amended as shown and moved from paragraph 944-740-25-1]**

37. Add paragraph 740-10-50-22 and its related heading, with a link to transition paragraph 834-10-65-1, as follows:

Disclosure

> Disclosures Related to Deferred Tax Liabilities That Are Not Recognized

740-10-50-22 The following information shall be disclosed if a life insurance entity has a deferred tax liability that is not recognized because of the exceptions to comprehensive recognition of deferred taxes for any of the areas addressed by Section 740-10-25:

- a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable
- b. The cumulative amount of each type of temporary difference
- c. The amount of the deferred tax liability for temporary differences other than the policyholders' surplus of a {remove glossary link}life insurance entity{remove glossary link} that is not recognized in accordance with the provisions of paragraph 740-10-25-3. **[Content amended as shown and moved from paragraph 944-740-50-1]**

Amendments to Subtopic 805-20

38. Amend paragraph 805-20-25-8, with a link to transition paragraph 834-10-65-1, as follows:

Business Combinations—Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

> > Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in a Business Combination

805-20-25-6 At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date.

805-20-25-7 In some situations, GAAP provides for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to the following:

- a. Classification of particular investments in securities as trading, available for sale, or held to maturity in accordance with Section 320-10-25
- b. Designation of a derivative instrument as a hedging instrument in accordance with paragraph 815-10-05-4
- c. Assessment of whether an embedded derivative should be separated from the host contract in accordance with Section 815-15-25 (which is a matter of classification as this Subtopic uses that term).

805-20-25-8 This Section provides the following two exceptions to the principle in paragraph 805-20-25-6:

- a. Classification of a lease contract as either an operating lease or a capital lease in accordance with the guidance in paragraph 840-10-25-27
- b. Classification of a contract ~~written by an entity~~ that is in the scope of ~~Subtopic 944-10~~ Section 834-10-15 on insurance contracts as an insurance or reinsurance contract ~~or a deposit contract~~.

The acquirer shall classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

39. Amend paragraph 805-20-35-7, with a link to transition paragraph 834-10-65-1, as follows:

Subsequent Measurement

> Additional Guidance on Subsequent Measurement of Assets Acquired, Liabilities Assumed or Incurred, and Any Noncontrolling Interests in a Business Combination

805-20-35-7 ~~Topic 944~~834 on insurance contracts provides ~~and Subtopic 605-20 provide~~ guidance on the subsequent accounting for an insurance or reinsurance contract acquired in a business combination.

Amendments to Subtopic 810-10

40. Amend paragraph 810-10-15-17(b), with a link to transition paragraph 834-10-65-1, as follows:

Consolidation—Overall

Scope and Scope Exceptions

Variable Interest Entities

> Entities

810-10-15-17 The following exceptions to the Variable Interest Entities Subsections apply to all legal entities in addition to the exceptions listed in paragraph 810-10-15-12:

- b. ~~Separate accounts of life insurance entities as described in Topic 944~~Segregated fund arrangements as described in Topic 834 on insurance contracts are not subject to consolidation according to the requirements of the Variable Interest Entities Subsections.

41. Add paragraphs 810-10-25-15A through 25-15B and the related heading, with a link to transition paragraph 834-10-65-1, as follows:

Recognition

General

> Retention of Specialized Accounting for Investments in Consolidation

810-10-25-15 For the purposes of consolidating a subsidiary subject to guidance in an industry-specific Topic, an entity shall retain the industry-specific guidance applied by that subsidiary.

~~**810-10-25-15A** All of the following guidance applies if a separate account arrangement meets all of the conditions in the preceding paragraph:~~

- ~~a. The portion of separate account assets representing contract holder funds shall be reported in the insurance entity's financial statements as a summary total, with an equivalent summary total reported for related liabilities.~~
- ~~b. Any liabilities related to minimum guarantees and insurance benefit liabilities under the contracts in excess of the fair value of separate account assets representing contract holder funds shall be recognized as general account liabilities.~~
- ~~c. Contract fees and assessments shall be reported in accordance with paragraph 944-605-25-5.~~

~~d. For the purpose of evaluating the retention of specialized accounting for investments in consolidation as described in paragraph 810-10-25-15, a separate account segregated fund arrangement, as described in Topic 834 on insurance contracts, shall be considered a subsidiary. An insurer is not required to consolidate an investment in which a separate account segregated fund holds a controlling financial interest if the investment is not or would not be consolidated in the standalone financial statements of the separate account segregated funds, if prepared.~~

- ~~a. e.~~ Except as described in paragraph ~~(a)~~(b), the insurer shall not do either of the following when assessing whether the insurer is required to consolidate an investment held by a separate account segregated fund arrangement:
 - 1. Consider any separate account segregated fund interests held for the benefit of policy holders to be the insurer's interests
 - 2. Combine any separate account segregated fund interests held for the benefit of policy holders with the insurer's **{add glossary link to second definition}** general account **{add glossary link to second definition}** interest in the same investment.
- ~~b. f.~~ Separate account Segregated fund interests held for the benefit of a related party policy holder shall be combined with the insurer's general account interest when the Variable Interest Entities Subsections of Subtopic 810-10 require the consideration of related parties. For this purpose, a related party includes any party identified in paragraph 810-10-25-43 other than:

1. An employee of the decision maker or service provider (and its other related parties), except if the employee is used in an effort to circumvent the provisions of Subtopic 810-10
 2. An employee benefit plan of the decision maker or service provider (and its other related parties), except if the employee benefit plan is used in an effort to circumvent the provisions of Subtopic 810-10.
- [Content amended as shown and moved from paragraph 944-80-25-3]**

> Consolidation of an Investment Fund When ~~Separate Accounts~~ Segregated Funds Are Involved

810-10-25-15B If an insurer concludes that an investment fund should be consolidated and a portion of the fund is owned by the insurer's ~~separate accounts~~ segregated fund arrangements, the insurer should consolidate the investment fund in accordance with ~~in the following manner: Subtopic 825-10 on financial instruments.~~

- a. ~~The portion of the fund assets representing the contract holder's interests shall be included as separate account assets and liabilities in accordance with paragraph 944-80-25-3.~~
- b. ~~The remaining portion of the fund assets (including the portion owned by any other investors) shall be included in the general account of the insurer on a line by line basis. For example, if the consolidated fund held debt and equity securities, those amounts would be included in the debt and securities lines.~~
- c. ~~Noncontrolling interests should not be included in the separate account liability but rather be classified as a liability or equity based on other applicable guidance.~~ **[Content amended as shown and moved from paragraph 944-80-25-12]**

Amendments to Subtopic 815-10

42. Amend paragraph 815-10-05-11(c), with a link to transition paragraph 834-10-65-1, as follows:

Derivatives and Hedging—Overall

Overview and Background

General

815-10-05-11 A synthetic guaranteed investment contract is a contract that simulates the performance of a traditional guaranteed investment contract through the use of **financial instruments**. As with other types of guaranteed investment contracts, the specific terms and conditions of synthetic guaranteed investment contracts are negotiated on a case-by-case basis. However, those contracts fall into several broad structural categories, as follows:

- c. Fixed-rate, fixed-maturity. This contract is essentially the same as a traditional general account guaranteed investment contract. The synthetic guaranteed investment contract issuer guarantees a fixed rate for a fixed and certain term and assumes the investment risks and rewards of the assets. If the assets earn less than the guaranteed return, the ~~insurance entity~~issuer absorbs the loss. If the assets earn more than was assumed in pricing, the income recognized by the ~~insurer~~issuer will be greater than the wrap fee assumed in the pricing. Typically, the ~~insurer~~issuer also will be the investment manager because of the assumption of investment risk. Note that participant-initiated withdrawals and transfers of fixed-rate, fixed-maturity contracts are permitted at book value but are expected to occur infrequently. Withdrawals initiated by the customer generally are permitted only at the value of the assets and the guarantee is not activated.

43. Amend paragraphs 815-10-15-53 through 15-54 and add paragraph 815-10-15-53A, with a link to transition paragraph 834-10-65-1, as follows:

Scope and Scope Exceptions

815-10-15-53 The following types of insurance contracts written by ~~insurance~~ entities or held by the insureds are not subject to the requirements of this Subtopic for the reasons given:

- a. ~~Traditional life~~Life insurance contracts. The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.
- b. ~~Traditional property~~Property and casualty contracts. The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.

815-10-15-53A In evaluating whether a contractual feature shall be separated from the host contract and accounted for as a derivative instrument in accordance with paragraph 815-15-25-1, multiple features within an insurance contract, for example, a death benefit and a life contingent benefit, shall each be evaluated individually for the scope exception, which may apply to more than one feature.

815-10-15-54 In addition, some contracts with insurance or other entities combine derivative instruments with other insurance products or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts, and property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 815-15-25-1. However, insurance entities that issue insurance contracts that are within the scope of Topic 834 on insurance contracts enter into other types of contracts that may be subject to the provisions of this Subtopic.

44. Amend paragraphs 815-10-55-32 through 55-36, 815-10-55-38 through 55-39, 815-10-55-40(g), and 815-10-55-132, with a link to transition paragraph 834-10-65-1, as follows:

Implementation Guidance and Illustrations

> > > Dual-Trigger Financial Guarantee Contracts

815-10-55-32 Entity ABC extends credit to consumers through credit cards and personal loans of various sorts. Entity ABC is exposed to credit losses from its managed asset portfolio, including owned and securitized receivables. Entity ABC would like to purchase an insurance ~~policy~~contract to protect itself against high levels of consumer default.

815-10-55-33 The proposed insurance ~~policy~~contract will entitle Entity ABC to collect claims to the extent that its credit losses exceed a specified minimum level but limited to the amount by which the credit losses on a customized pool or index of consumer loans exceed that same specified minimum level (that is, a dual trigger contract because the payment of a claim is triggered by the occurrence of two events). Thus, Entity ABC will collect claims based on the lesser of the following:

- a. Entity ABC's actual credit losses
- b. The credit losses on a customized pool or index of consumer loans.

815-10-55-34 Although the insurer's payment to Entity ABC may be affected by credit losses on a customized pool, the payment nevertheless represents compensation for actual credit losses Entity ABC incurred. Entity ABC purchases this ~~insurance~~contract to obtain a lower premium because claims are limited by

external charge-off rates and the insurer is not exposed to Entity ABC's underwriting performance.

815-10-55-35 This type of control may also exist in property and casualty reinsurance policies. For example, an ~~insurance~~ entity may purchase reinsurance that covers actual hurricane losses in excess of a specified level in their block of business, but the coverage does not apply to losses in excess of a geographically diversified index of hurricane losses.

815-10-55-36 Financial guarantee ~~insurance~~ contracts are not subject to this Subtopic only if all of the conditions in paragraph 815-10-15-58 are met. The description of the financial guarantee insurance contract in paragraph 815-10-55-32 is insufficient for determining whether those conditions are met. The following provisions of that contract represent a type of deductible and do not affect the application of the conditions in paragraph 815-10-15-58:

- a. The provision that limits any claims to the extent that Entity ABC's actual credit losses exceed a specified minimum level
- b. The provision that limits any payments for those claims to the amount by which the credit losses on a customized pool or index of consumer loans exceed that same specified minimum level.

> > > Certain Insurance Contracts—Dual-Trigger Property and Casualty Insurance Contracts

815-10-55-37 A common characteristic of dual-trigger policies is that the payment of a claim is triggered by the occurrence of two events (that is, the occurrence of both 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. The policyholder is often purchasing the policy to provide for coverage against a catastrophe because if both events occur, the combined impact may be disastrous to its business.

815-10-55-38 Paragraph 815-10-55-40 addresses seven contracts that illustrate the characteristics of dual-trigger policies offered to different types of policyholders that have different risk management needs. All seven contracts qualify for either the exception in paragraph 815-10-15-53(b) for ~~traditional~~ property and casualty contracts or the exception in paragraph 815-10-15-59(b) for non-exchange-traded contracts involving nonfinancial assets. Therefore, the dual-trigger variable in those contracts is not separated and accounted for separately as a derivative instrument.

815-10-55-39 In contrast, paragraph 815-15-55-12 states that, if ~~an insurance contract issued by an insurance entity~~ involves essentially assured amounts of

cash flows based on insurable events that are highly probable of occurrence (as discussed in paragraph 815-10-15-55(c)), an embedded derivative related to changes in the separate pre-identified variable for that portion of the contract would be required to be separately accounted for as a derivative instrument.

815-10-55-40 Following are descriptions of seven contracts:

- g. Contract G—property-casualty reinsurance contract. Reinsurance contracts, which ~~indemnify~~compensate the holder of the contract (the reinsured) against loss or liability relating to insurance risk, are accounted for under the provisions of Topic ~~944~~834 on insurance contracts. Reinsurance contract provisions often adjust the amount at risk or the price of the amount at risk for a number of events or circumstances, such as loss experience or premium volume, while continuing to provide indemnification related to insurance risk. One type of reinsurance contract, an excess contract, provides the reinsured with indemnification against a finite amount of insured losses in excess of a defined level of insured losses retained by the reinsured. Example 11 (see paragraph 815-10-55-132) illustrates a reinsurance contract with a provision that adjusts the retention amount downward based on the performance of a specified equity index.

> > Example 11: Certain Insurance Contracts—Dual-Trigger Property-Casualty Reinsurance Contract

815-10-55-132 This Example illustrates a reinsurance contract with a provision that adjusts the retention amount downward based on the performance of a specified equity index as discussed in paragraph 815-10-55-40(g). Reinsurer enters into a reinsurance contract with Reinsured to ~~indemnify~~compensate Reinsured for certain insured losses in excess of a defined retention. The intent of the coverage is to protect Reinsured from significant or catastrophic property-casualty losses. The coverage would include a retention amount that would be adjusted downward according to a scale tied to the Dow Jones Industrial Average. If a catastrophic loss occurs, Reinsured would likely have to liquidate some of its investment holdings (bonds or equities) to pay its losses, which exposes Reinsured to significant investment risk in a down market. The adjustment feature provides protection against investment risk by allowing Reinsured to recover more losses in a declining investment market. Reinsured has no ability to receive appreciation in the Dow Jones Industrial Average.

- a. Parties: Reinsurer and Reinsured
- b. Coverage: Property losses
- c. Period: January 1, X1, through December 31, X1
- d. Retention: \$20 million per occurrence, adjusted downward in the same percentage as period-to-date (from January 1, X1, to measurement

- date) decreases in the Dow Jones Industrial Average, not to exceed 50%
- e. Limit: \$15 million per occurrence, \$15 million per annum
- f. Premium: \$1.4 million per annum.

Amendments to Subtopic 815-15

45. Add paragraphs 815-15-25-55 through 25-60 and their related headings, with a link to transition paragraph 834-10-65-1, as follows:

Derivatives and Hedging—Embedded Derivatives

Recognition

> Traditional Variable Annuity Product Structures and Other Segregated Fund Arrangements

815-15-25-55 In concluding that certain **traditional variable annuity** product structures and other segregated fund arrangements~~(see paragraph 944-20-05-18)~~ do not contain embedded derivatives, paragraph 815-15-55-55(b) through (c) does not refer to ownership of the assets specifically resting with either the policyholder or the insurer. While the policyholder is entitled to direct the investment of premiums into various approved funds, the ~~insurance entity~~insurer actually owns the investments. The guidance in (b) and (c) in that paragraph that a traditional ~~{add glossary link}~~variable annuity contract~~{add glossary link}~~ contains no embedded derivatives that warrant separate accounting under Subtopic 815-15 remains valid even though the insurer, rather than the policyholder, actually owns the assets. **[Content amended as shown and moved from paragraph 944-815-25-1]**

815-15-25-56 The following indicators provide the basis for concluding that a traditional variable annuity contract is not a hybrid instrument to be accounted for under paragraph 815-15-25-1:

- a. ~~The variable annuity contract is established, approved, and regulated under special rules applicable to variable annuities, such as state insurance laws, securities laws, and tax laws.~~
- b. ~~The assets underlying the contract are insulated from the general account liabilities of the insurance entity; that is, the policyholder is not subject to insurer default risk to the extent of the assets held in the separate account.~~
- a. ~~c.~~ The policyholder's premium is invested in contract-approved ~~separate accounts~~segregated funds (for example, ~~{add glossary link to second definition}~~separate accounts~~{add glossary link to second definition}~~) at the policyholder's direction.
- b. ~~d.~~ The insurer must invest in the assets on which the account values are based.

- c. ~~e.~~—The policyholder may redirect its investment among the contract-approved investment options.
- d. ~~f.~~—The account values are based entirely on the performance of those directed investments.
- e. ~~g.~~—All investment returns are passed through to the policyholder, including dividends, interest, gains, and losses.
- f. ~~h.~~—The policyholder may redeem its interests at any time; however, it may be subject to **{add glossary link to second definition}surrender charges{add glossary link to second definition}**.
- g. ~~i.~~—The policyholder has voting rights in certain ~~separate account structures~~segregated fund arrangements.

In addition, although the liability to policyholders is not specifically required by ~~the Financial Services Insurance Topic 834 on insurance contracts~~ to be remeasured at **fair value** with changes reported in earnings, paragraphs ~~944-80-25-3, 944-80-30-1, and 944-80-35-2~~ 834-10-35-6 through 35-10 require that the portion of cash flows that are related directly to the segregated fund assets included in the probability weighted measurement of the liability an entity record a liability for traditional variable annuity contracts equal to the summary total of the fair value of the assets held in the separate account for the policyholders. shall reflect the measurement of the fair value of the underlying assets. **[Content amended as shown and moved from paragraph 944-815-25-2]**

815-15-25-57 The accounting in the preceding paragraph shall be applied to all structures that are considered a segregated fund arrangement in accordance with Topic 834. In determining the accounting for other seemingly similar structures, an entity shall not analogize to the guidance in the preceding paragraph due to the unique attributes of traditional variable annuity contracts segregated fund arrangements and the fact that the guidance in that paragraph can be viewed as an exception for traditional variable annuity contracts issued by insurance entities segregated fund arrangements that are in the scope of Topic 834. **[Content amended as shown and moved from paragraph 944-815-25-3]**

815-15-25-58 Paragraph 815-15-55-55(a) states why a minimum death benefit component during the accumulation period is not an embedded derivative that warrants separate accounting under paragraph 815-15-25-1. **[Content amended as shown and moved from paragraph 944-815-25-4]**

> Nontraditional Variable Annuity Contracts and Other Segregated Fund Arrangements

815-15-25-59 The host contract in a nontraditional variable annuity contract would be considered the traditional variable annuity that, as described in paragraph 944-815-25-1815-15-25-55, does not contain an embedded derivative that warrants separate accounting. Nontraditional features, such as a guaranteed

investment return through a minimum accumulation benefit or a guaranteed account value floor, would be considered embedded derivatives subject to the requirements of Subtopic 815-15. The economic characteristics and risks of the investment guarantee and those of the traditional variable annuity contract typically would not be considered to be clearly and closely related. **[Content amended as shown and moved from paragraph 944-815-25-5]**

815-15-25-60 The accounting in the preceding paragraph shall be applied to all structures that are considered a segregated fund arrangement in accordance with Topic 834. In determining the accounting for other seemingly similar structures, an entity shall not analogize to the guidance in the preceding paragraph due to the unique attributes of ~~nontraditional variable annuity contracts~~ segregated fund arrangements and the fact that the guidance in that paragraph can be viewed as an exception for ~~nontraditional variable annuity contracts issued by insurance entities~~ segregated fund arrangements that are in the scope of Topic 834. **[Content amended as shown and moved from paragraph 944-815-25-6]**

46. Supersede paragraph 815-15-55-3, with a link to transition paragraph 834-10-65-1, as follows:

Implementation Guidance and Illustrations

815-15-55-3 Paragraph superseded by Accounting Standards Update 201X-XX. ~~Because the insurance entity does not record a claim liability in accordance with Subtopic 944-40 until losses are incurred, no foreign-currency-denominated liability exists (that would otherwise be subject to Subtopic 830-20, as contemplated by paragraph 815-15-15-10) during the period between the inception of the insurance contract and the loss occurrence date.~~

47. Amend paragraph 815-15-55-12, with a link to transition paragraph 834-10-65-1, as follows:

> > > Certain Insurance Contracts: Dual-Trigger Insurance Contracts

815-15-55-12 Paragraphs 815-10-55-37 through 55-39 provide guidance on dual-trigger insurance contracts and whether such a contract, in its entirety, is a derivative instrument subject to the requirements of Subtopic 815-10. If a contract that is within the scope of Topic 834 ~~issued by an insurance entity~~ involves essentially assured amounts of cash flows based on insurable events that are highly probable of occurrence (as discussed in paragraph 815-10-15-55(c)), an embedded derivative related to changes in the separate pre-identified variable for that portion of the contract would be required to be separately accounted for as a derivative instrument.

48. Amend paragraphs 815-15-55-54 through 55-62, with a link to transition paragraph 834-10-65-1, as follows:

> > > Variable Annuity Products in General

~~815-15-55-54 Variable annuity products are investment contracts as discussed in Subtopic 944-20. Similar to variable life insurance products, in variable annuity products, policyholders direct their investment account asset mix among a variety of mutual funds composed of equities, bonds, or both, and assume the risks and rewards of investment performance. The funds are generally maintained in separate accounts segregated fund arrangements by the insurance issuing entity. Contract terms provide that if the policyholder dies, the greater of the account market value or a minimum death benefit guarantee will be paid. The minimum death benefit guarantee is generally limited to a return of premium plus a minimum return (such as 3 or 4 percent); this life insurance feature represents the fundamental difference from the life insurance contracts that include significant (rather than minimal) levels of life insurance. The investment account may have various payment alternatives at the end of the accumulation period. One alternative is the right to purchase a life annuity at a fixed price determined at the initiation of the contract.~~

~~815-15-55-55 Variable annuity product structures as discussed in Topic 944 are generally not subject to the scope of this Subtopic (except for payment options at the end of the accumulation period), as follows:~~

- a. ~~Death benefit component. Paragraph 815-10-15-53(a) excludes a death benefit from the scope of Subtopic 815-10 because the payment of the death benefit is the result of an identifiable insurable event instead of changes in an underlying. The death benefit in this example is limited to the floor guarantee of the investment account, calculated as the premiums paid into the investment account plus a guaranteed rate of return, less the account fair value. Topic 944 834 remains the applicable guidance for the insurance-related liability accounting.~~
- b. ~~Investment component. Participation feature that wholly depends on the performance of an underlying item. The policyholder directs certain premium investments in the investment account that includes equities, bonds, or both, which are held in separate accounts segregated fund arrangements that are distinct from the insurer's general account assets. This component is not considered a derivative instrument because of the unique attributes of traditional variable annuity contracts issued by insurance entities insurers. Furthermore, any embedded derivatives within those investments shall not be separated from the host contract by the insurer because the separate account assets that are in a segregated fund arrangement are already marked to fair value under Topic 944 834. In contrast, if the product were an equity-index-~~

based interest annuity (rather than a traditional variable annuity), the investment component would contain an embedded derivative (the equity index-based derivative instrument) that meets all the requirements of paragraph 815-15-25-1 for separate accounting.

- c. Investment account surrender right at fair value. Because this right is exercised only at the fund fair value (without the insurer's floor guarantee) and relates to a traditional variable annuity contract ~~issued by an insurance entity~~, this right is not within the scope of Subtopic 815-10.
- d. Payment alternatives at the end of the accumulation period. Payment alternatives are options subject to the requirements of Subtopic 815-10 if interest rates or other underlying variables affect the fair value.

815-15-55-56 The guidance in (b) and (c) in the preceding paragraph is an exception for traditional variable annuity contracts issued by ~~insurance entities~~ insurers. In determining the accounting for other seemingly similar structures, it would be inappropriate to analogize to that guidance due to the unique attributes of traditional variable annuity contracts.

> > > **Payment Alternatives for Variable Annuity Contracts**

815-15-55-57 There are various types of annuity payment options offered by ~~insurance entities~~ insurers to policyholders. This guidance addresses four common payment alternatives. The first three are payment alternatives offered during the accumulation phase of the contract, while the fourth involves guaranteed minimum periodic annuity payments in the contract's payout phase.

815-15-55-58 ~~During the accumulation phase of~~ For a deferred annuity contract, a guarantee of a minimum interest rate to be used in computing periodic annuity payments if and when a policyholder elects to annuitize generally does not require separate accounting under paragraph 815-15-25-1 because the criterion in paragraph 815-15-25-1(c) generally is not met. Absent a market mechanism allowing net settlement or the payout annuity contract being readily convertible to cash, the ~~The~~ embedded option does not meet the definition of a derivative instrument because it does not meet the net settlement criteria as discussed beginning in paragraph 815-10-15-99. Settlement of the option can be achieved only by an investment of the account balance in a payout annuity contract in lieu of electing an immediate payment of the account value. If an additional provision existed whereby the policyholder could withdraw all or a portion of its account balance during the payout phase, an embedded derivative would still not exist because the economic benefit of the guaranteed minimum interest rate would be obtainable only if an entity were to maintain the annuity contract through its specified maturity date. Additionally, if the option is for life-contingent annuity payments, it may not be subject to the requirements of this Subtopic because it meets the criteria as discussed beginning in paragraph 815-10-15-52 for the insurance contracts scope exception.

815-15-55-59 A provision that guarantees a minimum account value that is available to annuitize if and when a policyholder elects to annuitize generally fails to meet the definition of a derivative instrument during the accumulation phase because it cannot be net settled absent a market mechanism allowing net settlement or the payout annuity contract being readily convertible to cash. The benefit of the minimum account value is realized by the policyholder by annuitizing and receiving the economic benefit over the payout term, similar to the analysis of the guarantee of a minimum interest rate. However, if the policyholder is able to withdraw all or a portion of the guaranteed account balance during the payout **(annuitization)** period, or the payout (annuitization) period is set to an unrealistically short period such as one year, this is equivalent to net settlement, and the guarantee (or the portion of the guarantee that is withdrawable, if applicable) is an embedded derivative ~~only during the accumulation period.~~

815-15-55-60 ~~During the accumulation phase~~For a deferred variable annuity contract, a provision that guarantees a minimum level of periodic annuity payments ~~during the payout phase if and when a policyholder elects to annuitize into a variable payout annuity~~generally does not require separate accounting as an embedded derivative under paragraph 815-15-25-1. Absent a market mechanism allowing net settlement or the payout annuity contract being readily convertible to cash, an embedded derivative does not exist ~~during the accumulation phase of~~ a deferred variable annuity contract because the policyholder cannot net settle the provisioncontract. The only way the policyholder can obtain the benefit of the floor payment guarantee is over the life of the variable-payout annuity. This guidance assumes that the contract is annuitized at its contract value without any floor account value guarantee specified in the preceding paragraph.

815-15-55-61 ~~During the payout phase of a variable payout annuity, the contract may include a provision that guarantees a minimum level of periodic payments. (This type of provision may be found in contracts referred to as standalone immediate payout annuities or in the payout phase of an existing annuity.)~~The accounting treatment for a contractual provision for guaranteed minimum periodic payments ~~is that meet the definition of a derivative instrument may be dependent upon the payout option in the variable-payout annuity contract. For the period-certain variable-payout annuity, the guaranteed minimum periodic payments are, during the payout phase, an embedded derivative that is required to be separated under paragraph 815-15-25-1. This conclusion is based on the assessment that the guaranteed payment floor is not clearly and closely related to the host contract—a traditional variable-payout annuity contract. This is consistent with Section 944-20-25.~~ However, a solely life-contingent variable-payout annuity contract with such features that meets the definition of an insurance contract under ~~paragraph 944-20-15-18 through 15-19~~Topic 834 would not be subject to the requirements of Subtopic 815-10 provided there are no

withdrawal features. For a period-certain-plus-life-contingent variable-payout annuity contract, the embedded derivative related only to the period-certain guaranteed minimum periodic payments would be required to be separated under paragraph 815-15-25-1 (if it meets the net settlement criteria as discussed beginning in paragraph 815-10-15-99), whereas the embedded derivative related to the life-contingent guaranteed minimum periodic payments would not be separated under that paragraph. Separate accounting for the embedded derivative related only to the period-certain guaranteed minimum periodic payments would be required even if the period-certain-plus-life-contingent annuity, in its entirety, meets the definition of an insurance contract under ~~paragraph 944-20-15-18 through 15-19~~ Topic 834 and has no withdrawal features.

> > > **Equity-Indexed Annuity Contracts**

815-15-55-62 This Subtopic defines an **equity-indexed annuity** as a deferred fixed annuity contract with a guaranteed minimum interest rate plus a contingent return based on some internal or external equity index, such as the Standard & Poor's S&P 500 Index. The guaranteed contract value is generally designed to meet certain regulatory requirements such that the contract holder receives no less than 90 percent of the initial deposit, compounded annually at 3 percent, which establishes a floor value for the contract. ~~Equity-indexed annuities typically have minimal mortality risk and are therefore classified as investment contracts under Topic 944.~~ Equity-indexed annuities often do not have specified maturity dates; therefore, the contracts remain in the deferral (accumulation) phase until the customer either surrenders the contract or elects annuitization. Customers typically can surrender the contract at any point in time, at which time they receive their account value, as specified in the contract, less any applicable surrender charges. The account value is defined in the policy as generally the greater of the policyholder's initial investment plus the equity-indexed return or a guaranteed floor amount (calculated as the policyholder's initial investment plus a specified annual percentage return).

49. Amend paragraphs 815-15-55-67 and 815-15-55-69, with a link to transition paragraph 834-10-65-1, as follows:

[Note: Paragraphs 815-15-55-67 and 815-15-55-69 are being superseded by the proposed FASB Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. However, because that guidance is not final, this proposed Update is amending the current content.]

815-15-55-67 From an insurer's perspective, the option component of an equity-indexed annuity that specifies a point-to-point design meets the definition of a derivative instrument and requires separate accounting under paragraph 815-15-

~~25-1 unless a fair value election is made pursuant to paragraph 815-15-25-4.~~
(Note that Section 815-15-25 allows for a fair value election for hybrid financial instruments that otherwise would require bifurcation. However, Section 815-15-25 does not apply to hybrid financial instruments that are described in paragraph 825-10-50-8, which include insurance contracts as discussed in Subtopic 944-20 Topic 834, other than financial guarantees and investment contracts.)

815-15-55-68 This guidance also applies to the policyholder because the policyholder does not qualify for a scope exclusion.

815-15-55-69 For the periodic ratchet design product, the insurer has committed to issue a series of options on the index over the duration of the contract. All of those forward-starting options meet the definition of a derivative instrument and require separate accounting under paragraph 815-15-25-1 from the perspective of the insurer ~~unless a fair value election is made pursuant to paragraph 815-15-25-4.~~ Paragraph 815-15-25-7 requires that the embedded feature with multiple components be separately accounted for as one compound embedded derivative.

50. Amend paragraphs 815-15-55-73 through 55-75, with a link to transition paragraph 834-10-65-1, as follows:

[Note: Paragraph 815-15-55-75 is being superseded by the proposed Update on financial instruments. However, because that guidance is not final, this proposed Update is amending the current content.]

> > > Equity-Indexed Life Insurance Contracts

815-15-55-73 Equity-indexed life insurance contracts combine term life insurance coverage with an investment feature, similar to universal life contracts. Death benefit amounts are based on the amount selected by the policyholder plus the account value. Charges for the cost of insurance and administrative costs are assessed periodically against the account. The policyholder's account value, maintained in the ~~insurance entity's insurer's~~ general account (not a separate account), is based on the cumulative deposits credited with positive returns based on the S&P 500 Index or some other equity index. An essential component of the contract is that the cash surrender value is also linked to the index. Accordingly, the policy's cash surrender value is also linked to an equity index. The death benefit amount may also be dependent on the cumulative return on the index.

815-15-55-74 Equity-indexed life insurance contracts are accounted for as ~~universal life insurance contracts~~ under Topic ~~944-834~~. For those contracts, the customer's account value ~~(the investment component of a universal life contract)~~ is credited with a return indexed to an equity index (for example, the S&P 500)

rather than an interest rate established by the insurer, as is done with typical universal life contracts. The existence of the death benefit provision does not exclude the entire equity-indexed life insurance contract from being subject to Subtopic 815-10 for either the issuer or the policyholder because the policyholder can obtain an equity-linked return by exercising the surrender option before death.

815-15-55-75 The investment component customer's account value of the equity-indexed life insurance contract would contain an embedded derivative (the equity index-based derivative) that meets all of the requirements of paragraph 815-15-25-1 for separate accounting. ~~(Note that Section 815-15-25 allows for a fair value election for hybrid financial instruments that otherwise would require bifurcation. However, Section 815-15-25 does not apply to hybrid instruments that are described in paragraph 825-10-50-8, which include insurance contracts as discussed in Subtopic 944-20, other than financial guarantees and investment contracts.)~~

51. Amend paragraph 815-15-55-105, with a link to transition paragraph 834-10-65-1, as follows:

[Note: Paragraph 815-15-55-105 is being superseded by the proposed Update on financial instruments. However, because that guidance is not final, this proposed Update is amending the current content.]

> > Case A: Credit-Linked Note

815-15-55-105 Paragraph 815-15-25-6 explains that the fair value election for hybrid financial instruments that otherwise would require bifurcation does not apply to hybrid financial instruments that are described in paragraph 825-10-50-8, which include insurance contracts as discussed in ~~Section 944-20-15, other than financial guarantees and investment contracts.~~Topic 834.

52. Amend paragraphs 815-15-55-120 and 815-15-55-125, with a link to transition paragraph 834-10-65-1, as follows:

> > Example 9: Clearly and Closely Related Criterion—Market-Adjusted Value Prepayment Options

815-15-55-120 This Example illustrates the application of the clearly and closely related criterion in paragraph 815-15-25-1(a) to a **market value annuity** accounted for as an ~~investment contract under Topic 944.~~insurance contract under Topic 834.

815-15-55-125 There is no substantial premium or discount present in these contracts at inception, and the put option is exercisable at any time by the

contract holder (that is, the put option is not contingently exercisable). Because the investor always has the option to hold the market value annuity to maturity and receive the fixed rate and the ~~insurance-entity insurer~~ cannot force the investor to surrender, the condition in paragraph 815-15-25-26(a) would not be met (that is, the ~~insurance-entity insurer~~ does not have the contractual right to demand surrender and put the investor in a situation of not recovering substantially all of its initial recorded investment).

53. Amend paragraphs 815-15-55-204 through 55-205 and supersede paragraph 815-15-55-206, with a link to transition paragraph 834-10-65-1, as follows:

[Note: Paragraph 815-15-55-205 is being amended by the proposed Update on financial instruments. However, because that guidance is not final, this proposed Update is amending the current content.]

> > > Case O: Disaster Bond

815-15-55-204 A disaster bond pays a coupon above that of an otherwise comparable traditional bond; however, all or a substantial portion of the principal amount is subject to loss if a specified disaster experience occurs. Disaster bonds (sometimes referred to as catastrophe or cat bonds) are many times issued by entities that are exposed to loss from the referenced adverse insurable event. In those cases, the investor may be providing insurance or reinsurance coverage to the issuer. If the disaster bond is insurance in accordance with Section 834-10-15, the investor should account for the disaster bond in accordance with Topic 834. If the investor's principal is subject to loss as a result of losses on one or more of the bond issuer's insurance contracts that are within the scope of Topic 834, the bond issuer should account for the disaster bond in accordance with Topic 834.

815-15-55-205 However, if the disaster bond is not accounted for in accordance with Topic 834, it A disaster bond can be viewed as a fixed-rate bond combined with a conditional exchange contract (an option contract). The investor receives an additional coupon interest payment in return for giving the issuer an option indexed to industry loss experience on a specified disaster. Because the option contract is indexed to the specified disaster experience, it cannot be viewed as being clearly and closely related to an investment in a fixed-rate bond. Therefore, the embedded derivative should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Subtopic.

815-15-55-206 Paragraph superseded by Accounting Standards Update 201X-XX. However, if the embedded derivative entitles the holder of the option (that is, the issuer of the disaster bond) to be compensated only for changes in the value of specified assets or liabilities for which the holder is at risk (including the liability for insurance claims payable due to the specified disaster) as a result of an

~~identified insurable event (see paragraphs 815-10-15-53 through 15-54), a separate instrument with the same terms as the embedded derivative would not meet the definition of a derivative instrument in Section 815-10-15. In that circumstance, because the criterion in paragraph 815-15-25-1(c) would not be met, there is no embedded derivative to be separated from the host contract, and the disaster bond would not be subject to the requirements of this Subtopic. The investor is essentially providing a form of insurance or reinsurance coverage to the issuer.~~

54. Supersede paragraphs 815-15-55-227 through 55-238 and their related headings, with a link to transition paragraph 834-10-65-1, as follows:

>> Example 14: Purchases of Life Insurance

815-15-55-227 ~~Paragraph superseded by Accounting Standards Update 201X-XX. To illustrate the host contract and embedded derivative valuation issues in this Subtopic, consider the following equity-indexed annuity point to point design example, which includes a minimum account value stated as a return on the principal amount of the annuity.~~

Initial premium	\$ _____ 100,000
Participation rate	100% participation in the equity returns, credited at the end of the contract term
Contract term	3 years
Minimum account value at the end of the contract term	\$103,030 (\$100,000 compounded annually at the minimum accumulation rate of 1% per year)
Implied option strike price	Current S&P 500 X 1.0303
Embedded option valuation	Monte Carlo Option model calculated value at \$20,000 at inception

815-15-55-228 ~~Paragraph superseded by Accounting Standards Update 201X-XX. At inception, the insurer has received \$100,000, recorded as follows.~~

Cash	\$ 100,000	
Embedded derivative		\$ 20,000
Host zero-coupon debt obligation		— 80,000

815-15-55-229 ~~Paragraph superseded by Accounting Standards Update 201X-XX. In the preceding journal entry, paragraphs 815-15-30-2 and 815-15-35-3 are followed: the embedded derivative is recorded at fair value, and the carrying value assigned to the host contract is the difference between the proceeds~~

received from the issuance of the hybrid instrument and the fair value of the embedded derivative.

815-15-55-230 Paragraph superseded by Accounting Standards Update 201X-XX. Accordingly, in this Example, the host contract would be accreted annually to the minimum account value at the end of the contract (\$103,030) using an effective yield method (in this Example, the implicit interest rate underlying the host is 8.8 percent).

815-15-55-231 Paragraph superseded by Accounting Standards Update 201X-XX. From the issuer's (insurer's) perspective, an equity-indexed annuity liability comprises a fixed annuity host and an embedded written equity option. The embedded equity option should be accounted for under the provisions of Subtopic 815-10. The fixed annuity component should be accounted for under the provisions of Topic 944 that require debt instrument accounting. In this Example, the host contract is a discounted debt instrument that should be accreted using the effective yield method to its minimum account value at the projected maturity or termination date.

815-15-55-232 Paragraph superseded by Accounting Standards Update 201X-XX. Upon receipt of consideration for an equity-indexed annuity, the issuing entity should allocate a portion of the consideration to the embedded written option, as described in paragraphs 815-15-30-2 and 815-15-35-3, that is, the fair value of the option is assigned to the embedded derivative. The remainder of the consideration should be assigned to a fixed annuity host contract. Both credited interest and changes in the fair value of the embedded equity option would be recognized in earnings. Accordingly, in this Example, the host contract would be accreted annually to the minimum account value at the end of the contract (\$103,030) using an effective yield method (in this example, the implicit interest rate underlying the host is 8.8 percent).

815-15-55-233 Paragraph superseded by Accounting Standards Update 201X-XX. The following Cases illustrate valuation of the components under the following scenarios at the end of Year 1:

- a. Standard and Poor's Index increases (Case A).
- b. Standard and Poor's Index decreases (Case B).

>>> Case A: Standard and Poor's Index Increases

815-15-55-234 Paragraph superseded by Accounting Standards Update 201X-XX. The components are valued as follows.

Embedded derivative	\$—28,968	(Assumed)
Accreted value of host contract	<u>—87,032</u>	(\$80,000 × 1.088)
Value of hybrid instrument	<u><u>\$—116,000</u></u>	

Value under Topic 944 (in absence of this Subtopic): \$115,000 (\$100,000 at 15% return)

815-15-55-235 Paragraph superseded by Accounting Standards Update 201X-XX. Note that because of the market's implicit valuation of future volatility in the Standard and Poor's Index, as reflected in the fair value of the embedded derivative, the combined value of the embedded derivative and the host contract is greater than that which would be calculated for the contract as a whole under Topic 944. The proper accounting in this Case is to record a total liability of \$116,000, the hybrid contract value under this Subtopic.

>>> **Case B: Standard and Poor's Index Decreases**

815-15-55-236 Paragraph superseded by Accounting Standards Update 201X-XX. The components are valued as follows.

Embedded derivative	\$—7,968
Accreted value of host contract	<u>—87,032</u>
Value of hybrid instrument	<u><u>\$—95,000</u></u>

Value under Topic 944 (in absence of this Subtopic): \$101,000 (\$100,000 at 1% return)

815-15-55-237 Paragraph superseded by Accounting Standards Update 201X-XX. The components already reflect the application of paragraph 815-15-25-1 (the derivative instrument is measured at fair value) and paragraph 815-15-25-4 (the host contract is accreted like a debt instrument).

815-15-55-238 Paragraph superseded by Accounting Standards Update 201X-XX. As a result, the equity indexed annuity liability would be recorded at \$95,000 at the end of Year 1. A separate Topic 944 calculation of account value is no longer required because the derivative instrument is carried at fair value in accordance with this Subtopic and the host contract is recorded following the GAAP accounting guidance for an investment contract under that Topic. Therefore, the insurer should ignore any minimum liability that exceeds the sum of the embedded derivative separately accounted for and the host debt instrument that is accounted for applying the debt model.

Amendments to Subtopic 815-20

55. Add paragraphs 815-20-25-47 through 25-49B and their related headings, with a link to transition paragraph 834-10-65-1, as follows:

Derivatives and Hedging—Hedging—General

Recognition

> > Cash Flow Hedges—Interest Credited on an Insurance Contract Liability

815-20-25-47 ~~Paragraph not used.~~ Some insurance contracts (for example, certain whole life policies, universal life policies, repetitive premium variable annuities, and single premium deferred annuities) contain an option allowing the policyholder to put (surrender) the contract to the issuer at contract value. Those contracts, which are not carried at **fair value** by the issuer, bear interest at a fixed rate. **[Content moved from paragraph 944-815-55-1]**

815-20-25-48 ~~Paragraph not used.~~ The issuer is exposed to the risk that an increase in market interest rates will cause the policyholder to exercise its put. Accordingly, the issuer may voluntarily increase the contractual rate on the contract to forestall the policyholder's exercising its put. As a result, the issuer wants to hedge the risk of an increase in future interest cash flows due to an increase in interest rates associated with either of the following circumstances:

- a. The issuer's voluntary increase in the contractual interest rate on existing fixed-rate contracts
 - b. The policyholder's exercise of its put option and the insurance entity's issuance of new higher fixed-rate contracts to new policyholders.
- [Content moved from paragraph 944-815-55-2]**

815-20-25-49 ~~Paragraph not used.~~ In accordance with this Subtopic, Subtopic 815-20 would permit an insurance entity to ~~can~~ qualify for cash flow hedge accounting if it is hedging the possibility that it may need to voluntarily increase the interest rate used to credit interest on certain contract liabilities. Under the cash flow hedging model, the hedged forecasted transactions would be the future interest credited on its then-existing contracts. The hedged forecasted transactions for each interest crediting date could include both the future interest credited on older contracts whose contractual rate has been voluntarily increased and the future interest credited on new contracts with the current higher interest rate issued to new policyholders (which will have replaced older contracts that have been surrendered). In defining the forecasted transactions, the ~~insurance~~ entity shall ensure that the hedged interest relates to a volume of contracts whose existence at the future interest crediting dates is **probable**. **[Content amended as shown and moved from paragraph 944-815-55-3]**

815-20-25-49A In designating the hedged risk, the ~~insurance~~ entity ~~should~~ shall decide whether it is hedging the total variability in those future interest payments or just the variability in the future interest attributable to changes in the designated benchmark interest rate. Although the occurrence of the forecasted transactions (that is, the crediting of interest) must be probable, paragraph 815-20-25-16 states that the cash flow hedging model does not require that it be probable that any variability in the hedged transaction will actually occur—that is, in a cash flow hedge, the variability in future cash flows must be a possibility, but not necessarily a probability. However, paragraph 815-20-25-16 states that the hedging derivative must be highly effective at achieving offsetting cash flows attributable to the hedged risk whenever that variability in future interest does occur. **[Content amended as shown and moved from paragraph 944-815-55-4]**

815-20-25-49B An ~~insurance~~ entity may find it difficult to identify a derivative instrument that will qualify for cash flow hedge accounting, which requires that the hedging relationship be expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk. Because the decision to adjust the interest rate to match the change in interest rates is at the discretion of the ~~insurance~~ entity, it may be difficult to conclude that the changes in the hedged interest payments attributable to the hedged risk will be sufficiently correlated with changes in the cash flows of the hedging derivative. **[Content amended as shown and moved from paragraph 944-815-55-5]**

Amendments to Subtopic 815-45

56. Amend paragraph 815-45-15-2, with a link to transition paragraph 834-10-65-1, as follows:

Derivatives and Hedging—Weather Derivatives

Scope and Scope Exceptions

> Instruments

815-45-15-2 Except as noted in this paragraph, the guidance in this Subtopic applies to all **weather derivatives** that are not exchange-traded (and, therefore, not subject to the requirements of Subtopic 815-10). ~~The guidance in this Subtopic does not apply to contracts written by insurance entities that or that do not~~ entitle the holder to be compensated ~~only~~ if, as a result of an insurable event, 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 (and, therefore, are subject to Topic 834 on insurance contracts).

Amendments to Subtopic 825-10

57. Amend paragraphs 825-10-15-4 through 15-5, with a link to transition paragraph 834-10-65-1, as follows:

[Note: Paragraphs 825-10-15-4 through 15-5 are being superseded by the proposed Update on financial instruments. However, because that guidance is not final, this proposed Update is amending the current content.]

Financial Instruments—Overall

Scope and Scope Exceptions

Fair Value Option

> Instruments

825-10-15-4 All entities may elect the **fair value** option for any of the following eligible items:

- a. A recognized **financial asset** and **financial liability**, except any listed in the following paragraph
- b. A **firm commitment** that would otherwise not be recognized at inception and that involves only financial instruments (for example, a forward purchase contract for a loan that is not readily convertible to cash—that commitment involves only financial instruments—a loan and cash—and would not otherwise be recognized because it is not a derivative instrument)
- c. A written loan commitment
- d. Subparagraph superseded by Accounting Standards Update 201X-XX. The rights and obligations under an insurance contract that has both of the following characteristics:
 1. ~~The insurance contract is not a **financial instrument** (because it requires or permits the insurer to provide goods or services rather than a cash settlement).~~
 2. ~~The insurance contract's terms permit the insurer to settle by paying a third party to provide those goods or services.~~
- e. The rights and obligations under a warranty that has both of the following characteristics and is not accounted for as insurance under paragraphs 834-10-15-1 through 15-5:
 1. The warranty is not a financial instrument (because it requires or permits the warrantor to provide goods or services rather than a cash settlement).

2. The warranty's terms permit the warrantor to settle by paying a third party to provide those goods or services.
- f. A host financial instrument resulting from the separation of an embedded nonfinancial derivative from a nonfinancial hybrid instrument under paragraph 815-15-25-1, subject to the scope exceptions in the following paragraph (for example, an instrument in which the value of the bifurcated embedded derivative is payable in cash, services, or merchandise but the debt host is payable only in cash).

825-10-15-5 No entity may elect the fair value option for any of the following financial assets and financial liabilities:

- a. An investment in a subsidiary that the entity is required to consolidate.
- b. An interest in a variable interest entity (VIE) that the entity is required to consolidate.
- c. Employers' and plans' obligations (or assets representing net overfunded positions) for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in Topics 420; 710; 712; 715; 718; and 960.
- d. Financial assets and financial liabilities recognized under leases as defined in Subtopic 840-10. (This exception does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease.)
- e. Deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions, and other similar depository institutions.
- f. Financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity (including temporary equity) (for example, a convertible debt instrument with the scope of the Cash Conversion Subsections of Subtopic 470-20 or a convertible debt security with a noncontingent beneficial conversion feature).
- g. Insurance contracts as defined in paragraphs 834-10-15-1 through 15-5.

58. Amend paragraph 825-10-25-7, with a link to transition paragraph 834-10-65-1, as follows:

[Note: Paragraph 825-10-25-7 is being superseded by the proposed Update on financial instruments. However, because that guidance is not final, this proposed Update is amending the current content.]

Recognition

Fair Value Option

> > Unit of Accounting

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~~two exceptions:

- a. If multiple advances are made to one borrower pursuant to a single contract (such as a line of credit or a construction loan) and the individual advances lose their identity and become part of a larger loan balance, the fair value option shall be applied only to the larger balance and not to each advance individually.
- b. If the fair value option is applied to an investment that would otherwise be accounted for under the equity method of accounting, it shall be applied to all of the investor's financial interests in the same entity (equity and debt, including guarantees) that are eligible items.
- c. ~~Subparagraph superseded by Accounting Standards Update 201X-XX. 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. ~~Subparagraph superseded by Accounting Standards Update 201X-XX. 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.~~

59. Amend paragraphs 825-10-50-8 and 825-10-50-22, with a link to transition paragraph 834-10-65-1, as follows:

[Note: Paragraph 825-10-50-8 is being superseded by the proposed Update on financial instruments. However, because that guidance is not final, this proposed Update is amending the current content.]

Disclosure

> > Transactions

825-10-50-8 In part, this Subsection requires disclosures about fair value for all financial instruments, whether recognized or not recognized in the statement of financial position, except that the disclosures about fair value prescribed in paragraphs 825-10-50-10 through 50-16 are not required for any of the following:

- a. Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements (see Topics 710; 712; 715; 718; and 960)
- b. Substantively extinguished debt subject to the disclosure requirements of Subtopic 405-20
- c. ~~Subparagraph superseded by Accounting Standards Update 201X-XX. Insurance contracts, other than financial guarantees (including financial guarantee insurance contracts within the scope of Topic 944) and investment contracts, as discussed in Subtopic 944-20~~
- d. Lease contracts as defined in Topic 840 (a contingent obligation arising out of a cancelled lease and a guarantee of a third-party lease obligation are not lease contracts and are subject to the disclosure requirements in this Subsection)
- e. Warranty obligations (see Topic 450 and the Product Warranties Subsections of Topic 460)
- f. Unconditional purchase obligations as defined in paragraph 440-10-50-2
- g. Investments accounted for under the equity method in accordance with the requirements of Topic 323
- h. Noncontrolling interests and equity investments in consolidated subsidiaries (see Topic 810)
- i. Equity instruments issued by the entity and classified in stockholders' equity in the statement of financial position (see Topic 505).

825-10-50-21 Except as indicated in the following paragraph, all of the following shall be disclosed about each significant concentration:

- a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- b. The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the

collateral or other security, if any, for the amount due proved to be of no value to the entity

- c. With respect to collateral, all of the following:
 - 1. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk
 - 2. Information about the entity's access to that collateral or other security
 - 3. The nature and a brief description of the collateral or other security supporting those financial instruments.
- d. With respect to master netting arrangements, all of the following:
 - 1. The entity's policy of entering into master netting arrangements to mitigate the credit risk of financial instruments
 - 2. Information about the arrangements for which the entity is a party
 - 3. A brief description of the terms of those arrangements, including the extent to which they would reduce the entity's maximum amount of loss due to credit risk.

825-10-50-22 The requirements of the preceding paragraph do not apply to the following financial instruments, whether written or held:

- a. The financial instruments described in paragraph 825-10-50-8(a); (c); (e); and (f), ~~except for reinsurance receivables and prepaid reinsurance premiums~~
- b. Financial instruments of a pension plan, including plan assets, if subject to the accounting and reporting requirements of Topic 715.

Financial instruments of a pension plan, other than the obligations for pension benefits, if subject to the accounting and reporting requirements of Topic 960, are subject to the requirements of paragraphs 825-10-50-20 through 50-21.

Amendments to Subtopic 830-10

60. Amend paragraph 830-10-45-18, with a link to transition paragraph 834-10-65-1, as follows:

Foreign Currency Matters—Overall

Other Presentation Matters

> > Accounts to Be Remeasured Using Historical Exchange Rates

830-10-45-18 All of the following are common nonmonetary balance sheet items and related revenue, expense, gain, and loss accounts that shall be remeasured

using historical rates to produce the same result in terms of the functional currency that would have occurred if those items had been initially recorded in the functional currency:

- a. Marketable securities carried at cost, including:
 - 1. Equity securities
 - 2. Debt securities not intended to be held until maturity.
- b. Inventories carried at cost
- c. Prepaid expenses such as insurance, advertising, and rent
- d. Property, plant, and equipment
- e. Accumulated depreciation on property, plant, and equipment
- f. Patents, trademarks, licenses, and formulas
- g. Goodwill
- h. Other intangible assets
- i. ~~Deferred charges and credits, except policy acquisition costs for life insurance companies~~
- j. Deferred income
- k. Common stock
- l. Preferred stock carried at issuance price
- m. Revenues and expenses related to nonmonetary items, for example:
 - 1. Cost of goods sold
 - 2. Depreciation of property, plant, and equipment
 - 3. Amortization of intangible items such as patents, licenses, and so forth
 - 4. ~~Amortization of deferred charges or credits, except policy acquisition costs for life insurance entities.~~

61. Add paragraph 830-10-45-20 and its related heading, with a link to transition paragraph 834-10-65-1, as follows:

> Insurance-Related Balances

830-10-45-20 All items in the statement of financial position and related revenue, expense, gain, and loss accounts from insurance contracts accounted for in accordance with Topic 834 on insurance contracts shall be considered monetary items and remeasured using the current rate.

Amendments to Subtopic 942-605

[Note: Topic 605 is being superseded by proposed FASB Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*. However, because that guidance is not final, this proposed Update is amending the current content.]

62. Supersede paragraphs 942-605-25-1 through 25-2 and their related heading, with a link to transition paragraph 834-10-65-1, as follows:

Financial Services—Depository and Lending—Revenue Recognition

Recognition

> Commissions

~~942-605-25-1 Paragraph superseded by Accounting Standards Update 201X-XX. Insurance commissions received from an independent insurer shall be deferred and systematically amortized to income over the life of the related insurance contracts because the insurance and lending activities are integral parts of the same transactions. The method of commission amortization shall be consistent with the method of premium income recognition for that type of policy as set forth in Topic 944.~~

~~942-605-25-2 Paragraph superseded by Accounting Standards Update 201X-XX. See Section 605-20-25 for additional guidance concerning recognition of insurance commissions from insurance activities of noninsurance entities.~~

Amendments to Topic 944

63. Supersede Topic 944, Financial Services—Insurance, with a link to transition paragraph 834-10-65-1.

Amendments to Subtopic 954-450

64. Amend paragraph 954-450-25-2, with a link to transition paragraph 834-10-65-1, as follows:

Health Care Entities—Contingencies

Recognition

> Medical Malpractice Claims

954-450-25-2 The ultimate costs of malpractice claims or similar contingent liabilities, which include costs associated with litigating or settling claims, shall be accrued when the incidents that give rise to the claims occur. A health care entity

shall evaluate its exposure to losses arising from claims and recognize a liability, if appropriate. The liability shall not be presented net of anticipated insurance recoveries. An entity that is indemnified for these liabilities shall recognize an insurance receivable at the same time that it recognizes the liability, measured on the same basis as the liability, subject to the need for a valuation allowance for uncollectible amounts. The provisions in Section 720-20-25 and ~~Subtopic 944-40~~ Topic 834 on insurance contracts ~~discusses~~ discuss accounting for insurance claims costs, including estimates of costs relating to incurred-but-not-reported claims. Subtopic 450-20 discusses the accounting for loss contingencies.

Amendments to Subtopic 954-720

65. Amend paragraph 954-720-25-4A, with a link to transition paragraph 834-10-65-1, as follows:

Health Care Entities—Other Expenses

Recognition

> Claims-Made Insurance Policies

954-720-25-4A The Claims Made Contract Subsections of Subtopic 720-20 apply if a health care entity purchases a claims-made insurance policy. As discussed in paragraph 720-20-25-14, insured entities (except as discussed in Section ~~944-20-15~~ 834-10-15 on insurance contracts), including those that use a claims-made approach for insuring certain risks, recognize a liability for the probable losses from incurred but not reported claims and incidents if the loss is both probable and reasonably estimable. Consequently, a health care entity that is insured under a claims-made insurance policy recognizes the estimated cost of claims and incidents not reported to the insurance carrier, in accordance with Subtopic 954-450.

Amendments to Subtopic 958-325

66. Supersede paragraph 958-325-60-2, with a link to transition paragraph 834-10-65-1, as follows:

Not-for-Profit Entities—Investments—Other

Relationships

> Financial Services—Insurance

958-325-60-2 Paragraph superseded by Accounting Standards Update 201X-XX. ~~For equity securities held by NFPs that conduct insurance activities, see Subtopic 944-325.~~

Amendments to Subtopic 962-325

67. Amend paragraphs 962-325-35-7 through 35-8, with a link to transition paragraph 834-10-65-1, as follows:

Plan Accounting—Defined Contribution Pension Plans—Investments—Other

Subsequent Measurement

> Investment and Insurance Contracts

962-325-35-7 See paragraphs ~~944-20-05-5 through 5-7~~ 834-10-15-1 through 15-5 for a discussion of the ~~purpose, types, and a general characterization scope~~ of insurance transactions.

962-325-35-8 See paragraphs ~~944-20-15-16 through 15-19~~ 834-10-55-1 through 55-25 for a discussion of ~~the definition of an insurance contract, certain types of insurance contracts, including long-duration contracts that do not subject the insurance entities to mortality or morbidity risks (investment contracts) and annuity contracts.~~

Amendments to Subtopic 965-325

68. Amend paragraphs 965-325-35-3 through 35-5, with a link to transition paragraph 834-10-65-1, as follows:

Plan Accounting—Health and Welfare Benefit Plans—Investments—Other

Subsequent Measurement

> Insurance Contracts

965-325-35-3 Insurance contracts, as defined by ~~Subtopic 944-20,~~ Section 834-10-15 on insurance contracts, shall be presented in the same manner as

specified in the annual report filed by the plan with certain governmental agencies pursuant to the Employee Retirement Income Security Act; that is, either at fair value or at amounts determined by the insurance entity (contract value). Plans not subject to the Employee Retirement Income Security Act shall present insurance contracts as if the plans were subject to the reporting requirements of the Act.

965-325-35-4 See paragraphs ~~944-20-05-5 through 05-7834-10-55-26 through 55-40~~ for a discussion of the ~~purpose, types, and a general characterization scope~~ of insurance transactions.

965-325-35-5 See paragraphs ~~944-20-15-16 through 15-19834-10-55-1 through 55-25~~ for a discussion of ~~the definition of an insurance contract, certain types of insurance contracts, including long duration contracts that do not subject the insurance entities to mortality or morbidity risks (investment contracts) and annuity contracts.~~

The amendments in this proposed Update were approved for publication by the affirmative vote of five members of the Financial Accounting Standards Board. Messrs. Buck and Linsmeier voted against publication of the amendments. Their alternative views are set out at the end of the basis for conclusions.

Members of the Financial Accounting Standards Board:

Leslie F. Seidman, *Chairman*
Daryl E. Buck
Russell G. Golden
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information, Basis for Conclusions, and Alternative Views

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. The objective of the amended guidance is to improve, simplify, and enhance the financial reporting requirements for insurance contracts and to provide investors with decision-useful information. The guidance establishes a principle that classifies insurance contracts under one of two measurement models, referred to as the building block approach (for most life, annuity, and long-term health contracts) and the premium allocation approach (for most property, liability, and short-term health contracts). Insurance contracts accounted for under the building block approach would be measured based on the present value of the fulfillment cash flows (net of the expected cash inflows and cash outflows) and a margin that initially reflects the expected profitability of the contract. Insurance contracts accounted for under the premium allocation approach would include a liability for remaining coverage that represents the contractual premium (gross cash inflows) that is not yet earned and is released in subsequent periods on the basis of the expected timing of incurred claims and benefits and a liability for incurred claims that would be measured based on the explicit, unbiased, probability-weighted estimate ("expected value") of the present value of future cash flows to settle the claims and related expenses.

BC3. The guidance in this proposed Update covers the measurement, recognition, presentation, and disclosures of insurance contracts that an entity issues and reinsurance contracts that it holds in its financial statements.

Background Information

Need for the Project

BC4. Existing U.S. GAAP comprehensively addresses accounting for insurance contracts. However, it has evolved over many years as a result of new insurance products and new contract terms and features, resulting in multiple models. The scope of existing U.S. accounting guidance for insurance contracts is based on whether an entity providing insurance is an insurance company. In

addition, Topic 944, Financial Services—Insurance, requires application of different models depending on the nature of the insurance contract—one primary model for short-duration insurance contracts (that is, for most property, liability, and short-term health contracts), several models for long-duration insurance contracts (that is, most life, annuity, and long-term health contracts) and additional guidance developed incrementally over time as separate pieces of literature. Topic 944 has not been subject to comprehensive reconsideration by the Board before the beginning of this project.

BC5. In contrast to the FASB's existing accounting guidance for insurance contracts, International Financial Reporting Standards (IFRS) do not contain a comprehensive standard for accounting for insurance contracts. In 2002, the IASB decided to address accounting for insurance contracts in a two-phase project. The first phase of the project was completed in May 2004 with the issuance of IFRS 4, *Insurance Contracts*, which provided guidance for insurers that adopted IFRSs in 2005. IFRS 4, which was intended to be an interim standard, made limited improvements to accounting practices for insurance contracts, permitted a wide variety of practices to continue, and avoided major changes that might be reversed upon completion of the second phase.

BC6. As part of the second phase of the project, in May 2007 the IASB issued a Discussion Paper, *Preliminary Views on Insurance Contracts*, which focused on developing a comprehensive accounting model for an entity's rights and obligations (insurance assets and liabilities) that arise from insurance activities.

BC7. In August 2007, the Board issued an Invitation to Comment, *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts*. The feedback received in the 45 comment letters in response to the Invitation to Comment was overwhelmingly in support of the FASB and the IASB working together in an insurance contracts project, and several respondents indicated that it was critical that the FASB be actively involved in the development of any international accounting standard for insurance transactions. That was based on those respondents' views that (a) insurance is a global industry and many U.S. insurers have a significant global presence and (b) convergence of accounting standards in a global marketplace is essential to providing users of financial statements with comparable, decision-useful information. Many respondents thought the FASB's understanding of U.S. insurance products and the insurance marketplace was important to bring to the joint deliberations. Some respondents commented that existing U.S. GAAP was the most logical starting point for a new global standard and it was important that deliberations give more consideration to elements of existing U.S. GAAP, including but not limited to retaining different approaches to reflect differences between life and long-duration health insurance contracts and property/casualty and short-duration health insurance contracts.

BC8. Several respondents noted that, absent the IASB's project on insurance contracts, a comprehensive reconsideration of U.S. GAAP was not needed. However, some respondents noted that there would be a substantial benefit in developing a single comprehensive standard for the accounting for insurance contracts and there were a number of areas in existing U.S. GAAP that could be improved. The multiple standards that provide guidance for insurance contracts contribute to confusion and misunderstanding of insurance accounting, which contributes to a higher risk for errors in financial reporting and a steep learning curve for those entering the business and for those users following the business. A specific area that needed improvement noted by respondents included a requirement that if noninsurance entities become parties to arrangements with economically similar attributes, risk transfer, and cash flows to insurance contracts, the arrangements should be accounted for as insurance contracts. Specific to the long-duration contract model, areas that needed improvements noted by respondents included resolution of the current mixed attribute accounting model that results in accounting mismatches without real economic substance (that is, fair value measurement of most investment assets while many insurance liabilities are based largely on assumptions locked in at issuance), and elimination of the product-specific accounting that is rules based, including but not limited to the differences in the measurement of the liability (that is, expected value based on assumptions locked in as of the issuance date or account balance), amortization of deferred acquisition costs, and recognition of certain options and guarantees. Specific to the short-duration contract accounting model, respondents noted that improvements included the use of probability-weighted averages to measure claim liabilities, clarification of the risk transfer requirements to be considered insurance, and disclosure of actuarial reserve ranges.

BC9. That feedback led to the FASB's October 2008 decision to participate in the project jointly with the IASB. The Board was persuaded to deliberate the issues together with the IASB because insurance is a global industry with many insurance entities operating (mostly through subsidiaries) in numerous countries. Many analysts and investors compare those entities, and the comparison is made difficult by having different accounting standards that sometimes are not easily reconcilable. In addition, the Board felt that there were several areas for potential improvement and areas in which there were inconsistencies between existing U.S. GAAP for insurance contracts and more recently issued guidance. Those included, among other items, reflection of the time value of money for property, liability, and short-term health insurance contract liabilities in which the payout is more than a year after the insured event and that recognition of revenue for long-duration contracts should be consistent with the principles in proposed Topic 606² on revenue recognition and contracts accounted for using the short-duration model. In addition, the Board identified several areas in which

²See footnote 1.

diversity exists in practice and viewed this as an opportunity to mitigate, if not eliminate, that diversity.

BC10. Since then, the Boards have held joint meetings to discuss various proposals. The Boards undertook the insurance contracts project to develop common, high-quality guidance that establishes the principles that an entity would apply in the recognition, measurement, presentation, and disclosure of insurance contracts (including reinsurance) even if the contracts are not issued by an insurance company.

BC11. The FASB contemplated whether insurance contracts should be included in the scope of Topic 606. The Board observed that the revenue recognition guidance might provide sufficient decision-useful information for some insurance contracts but not for all of them. Therefore, the Board decided to address accounting for insurance contracts in a separate project.

BC12. On July 30, 2010, the IASB issued an Exposure Draft, *Insurance Contracts*, which, when finalized, will replace IFRS 4. During the development of the IASB's Exposure Draft, most of the discussions about the proposed insurance accounting approaches were held jointly with the FASB. While the Boards reached common decisions in many areas, they reached different conclusions in others. The FASB sought additional input from its stakeholders before issuing an Exposure Draft, in large part to assess whether the possible new accounting guidance would represent a sufficient improvement to U.S. GAAP to justify issuing new guidance.

BC13. On September 17, 2010, the Board issued, for public comment, a Discussion Paper, *Preliminary Views on Insurance Contracts*. The FASB received 74 comment letters on its 2010 Discussion Paper. In the discussions leading to this proposed Update, the Board considered relevant recommendations and suggestions about the proposed model from those comment letters and the 253 comment letters on the 2010 IASB Exposure Draft.

BC14. The FASB and the IASB also organized six roundtable meetings—two each in Tokyo, Japan (December 9, 2010), London, England (December 16, 2010), and Norwalk, Connecticut, United States (December 20, 2010). The purpose of the roundtables was both to:

- a. Receive input from a wide range of stakeholders, including users, preparers, and auditors of financial statements, regulators, and others
- b. Identify accounting issues to enhance investors' confidence in financial markets.

The FASB also conducted extensive outreach with insurance industry trade groups, preparers, auditors, and users.

BC15. Preparers and users have indicated that many of the changes to the guidance in existing U.S. GAAP as a result of this proposed Update would be an improvement to the accounting for contracts that are accounted for using the

existing long-duration insurance models and could be made through targeted improvements to existing U.S. GAAP. The Board considered this, but does not believe there would be a difference in the accounting guidance if it were to make adjustments to the existing guidance for those targeted improvements or if it were to issue a new standard. However, the Board believes that the issuance of a new standard that incorporates those targeted improvements better achieves a cohesive standard than making significant changes to the structure and content of Topic 944, which many consider a patchwork of different guidance that was developed over time.

BC16. Many preparers and users also have indicated that the existing short-duration insurance models are not broken and, therefore, there is not a need to make changes. Said differently, preparers apply the model consistently each period and users are able to analyze and understand the information provided. They acknowledge that there is diversity in practice for some aspects of the accounting but do not believe those aspects are significant enough to warrant changes. However, for the reasons stated in paragraphs BC8–BC9, and in other areas in this Basis for Conclusions that are specific to the premium allocation approach, the Board has concluded that the guidance in this proposed Update is an improvement to the existing U.S. GAAP short-duration insurance models.

BC17. After jointly deliberating many of the issues arising from the 2010 Discussion Paper and the IASB's Exposure Draft, the FASB and the IASB are issuing separate Exposure Drafts.

Basis for Conclusions

Entities Included in the Scope

BC18. Although current U.S. GAAP for insurance contracts applies only to insurance entities, the Board decided that the guidance in this proposed Update should apply to all contracts that meet the definition of an insurance contract, regardless of the type of entity issuing the contract (that is, the amendments in this Update do not propose entity-based guidance). The Board's approach to standard setting generally has been to consider the accounting for a specific transaction or contractual arrangement and then to develop an accounting method that can be applied to all industries. That accomplishes an overall objective to account for contracts that contain identical or similar economic characteristics in a similar manner. Therefore, regardless of the type of entity issuing the contracts, contracts that transfer significant insurance risk should be accounted for in accordance with the guidance in this proposed Update unless those contracts are excluded from the scope of the guidance in this proposed Update.

Policyholder Accounting

BC19. The proposed guidance on insurance contracts does not address accounting for insurance contracts by policyholders. The Board believes there are no pervasive reasons to address that issue now. Although no specific standard addresses policyholder accounting comprehensively, some existing U.S. GAAP addresses limited aspects of policyholder accounting, such as Subtopic 325-30, Investments—Other—Investments in Insurance Contracts, and Subtopic 720-20, Other Expenses—Insurance Costs, which includes the accounting for retroactive insurance contracts, claims made insurance contracts, and multiyear retrospectively rated insurance contracts. Accordingly, policyholder accounting, excluding reinsurance contracts, is not within the scope of the guidance in this proposed Update.

Definition of an Insurance Contract

BC20. The definition of *insurance contract* determines which contracts are within the scope of the guidance in this proposed Update. The definition of an insurance contract in this proposed Update is broadly consistent with that in existing U.S. GAAP. In developing the definition in this proposed Update, the Board compared the definition of insurance contracts in Topic 944 with the definition in IFRS 4 and evaluated respondents' feedback on the 2010 FASB Discussion Paper. The Board considered possible improvements that could be made to the definition that was proposed in the 2010 FASB Discussion Paper and possible additions of implementation guidance related to that definition.

The Role of Underwriting Risk and Timing Risk

BC21. Existing U.S. GAAP requires the presence of both timing risk and underwriting risk for a contract to qualify as an insurance contract, whereas IFRS 4 treats contracts that transfer either timing risk or underwriting risk as insurance contracts. An insurance contract or a reinsurance contract that transfers only significant timing risk typically limits the amount of underwriting risk to which an entity is exposed, and is commonly entered into by the entity to provide liquidity. Features in insurance or reinsurance contracts that transfer only significant underwriting risk limit the uncertainties about the timing of the receipt and payment of cash flows, thus limiting the amount of timing risk assumed by the entity. A delayed reimbursement of losses by the entity is a possible indication that timing risk has not been transferred. Unlike insurance and reinsurance contracts that transfer only significant timing risk, the recovery of the amount of the initial deposit for an insurance or reinsurance contract that transfers only significant underwriting risk is substantially dependent on the future loss experience of the insured. Depending on that experience, the initial deposit may be recovered or the recovery may be significantly more or less than the original

deposit. Those limitations may result in an insufficient transfer of insurance risk to meet the definition of an insurance contract.

BC22. In existing U.S. GAAP, much of the pressure on the notions of underwriting risk and timing risk arises because the accounting for some insurance contracts (that is, those accounted for using the existing short-duration model) does not require an entity to discount the expected future cash flows when measuring the insurance liability. That pressure is not present in the model proposed in this proposed Update because discounting is required and, therefore, an entity should consider the time value of money in assessing whether risk transfer and additional benefits payable in any scenario are significant. Therefore, the Board decided not to require the explicit presence of both timing risk and underwriting risk.

The Notion of a Loss

BC23. When an entity assesses whether an insurance contract transfers significant insurance risk, existing U.S. GAAP considers whether it is reasonably possible that the insurer may realize a significant loss from the transaction. That is determined on the basis of whether the present value of net cash outflows can exceed the present value of premiums under reasonably possible outcomes. The Board believes that to meet the definition of an insurance contract, a contract should expose the issuer of the contract to a loss, that is, there is a scenario in which the present value of the net cash flows paid by the insurer can exceed the present value of the premiums. The Board decided that contracts that are merely financings should be excluded from the definition of insurance. Paragraphs 834-10-55-8 through 834-10-55-17 include implementation guidance on whether a contract transfers significant insurance risk.

BC24. The Board also considered existing U.S. GAAP guidance for reinsurance contracts, which under very limited circumstances allows for the reinsurer not to be exposed to the reasonable possibility of significant loss for a contract to meet the conditions for reinsurance accounting. For example, considering whether an insurance contract transfers significant insurance risk is problematic if the underlying insurance contracts themselves do not result in the reasonable possibility of significant loss to the cedant. The Board decided that when the reinsurer has assumed substantially all of the insurance risk of the underlying policies, even if that risk does not result in the reasonable possibility of significant loss, the transaction meets the conditions for reinsurance accounting. In that narrow circumstance, the reinsurer's economic position is virtually equivalent to that of having written the insurance contract directly. The risks retained by the cedant are insignificant; therefore, the reinsurer's exposure to loss is essentially the same as the insurer's exposure to loss. Most commonly, that situation arises when an individual risk or insurance contract, rather than a group of risks or contracts, is reinsured. The probability of loss from any individual short-duration insurance contract generally is considered to be remote. Therefore, outcomes

that would expose the assuming entity to risk of significant loss ordinarily could not be characterized as reasonably possible. The Board decided to retain the existing guidance and to clarify that a reinsurance contract is deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the underlying insurance contract is assumed by the reinsurer, even if the reinsurer is not exposed to a loss from the contract. Essentially, the reinsurer is stepping into the shoes of the cedant. The Board noted that substantially all of the insurance risk relating to the underlying insurance contracts is not transferred unless the economic benefit transferred to the reinsurer for the underlying policies is virtually the same as the economic benefit previously held by the cedant.

Exposure to Loss

BC25. Existing U.S. GAAP includes a condition in which an entity should have a reasonable possibility of a significant loss for a contract to be accounted for as an insurance contract. IFRS 4 requires that an issuing entity must be exposed to a significant loss in any scenario that has commercial substance to be accounted for as an insurance contract.

BC26. The Board considered whether it should define the amount of insurance risk in quantitative terms in relation to, for example, either of the following:

- a. The probability that cash outflows under the contract will exceed the expected cash inflows (that is, the probability-weighted average of those cash inflows) from the policyholder
- b. A measure of the range of outcomes, such as the range between the highest and lowest level of payments or the standard deviation of payments.

BC27. The Board rejected defining the minimum probability of a loss that would be required for a contract to be deemed an insurance contract. Instead, the Board decided that contracts that expose an entity to a significant loss in any scenario are insurance contracts and the issuing entity should account for those contracts in accordance with the guidance in this proposed Update. As a result, an insurance contract in which the possibility of a significant loss is low would be accounted for as an insurance contract rather than as a financial instrument, as is the case under existing U.S. GAAP.

BC28. The Board also decided not to define the significance of a loss that would be required for a contract to be deemed an insurance contract. Instead, the Board has provided implementation guidance in paragraphs 834-10-55-8 through 834-10-55-17.

BC29. Defining the significance of insurance risk by expressing the expected mean, that is, the probability-weighted mean, of the present values of the adverse outcomes as a proportion of the expected present value of all outcomes

or as a proportion of the premium has some intuitive appeal because it would consider both amount and probability. However, the Board rejected that notion because it could result in characterizing a contract differently during different parts of its life cycle. For example, a contract could fail that criterion at the beginning of the contract and, therefore, be accounted for as an investment contract (that is, a financial liability) and become an insurance contract as time passes or probabilities are reassessed.

BC30. All of the other alternatives considered by the Board would require quantitative guidance. The Board concluded that quantitative guidance would have created an arbitrary dividing line that would have resulted in different accounting treatments for similar transactions that fall marginally on different sides of the line and would have created opportunities for accounting arbitrage. For those reasons, the Board decided not to include quantitative guidance.

Insurable Interest

BC31. The definition of an insurance contract refers to the fact that an entity accepts risk from the policyholder by agreeing to compensate the policyholder or its designated beneficiary if an uncertain event adversely affects the policyholder. The notion that the uncertain event must adversely affect the policyholder is known as “insurable interest.” That concept is based on whether the policyholder is affected by the adverse event, for example, when the policyholder owns the underlying that is insured and experiences a loss. Without the reference to the adverse effect to the policyholder, the definition might capture contracts that are derivatives, prepaid contracts to provide services in which cost is uncertain, and gambling, among other types of contracts.

BC32. Some stakeholders argue that the definition of an insurance contract should not require an insurable interest for the following reasons:

- a. Contracts that require payment if a specified uncertain future event occurs cause similar types of economic exposure, whether or not the other party has an insurable interest.
- b. In life insurance, there is no direct link between the adverse event and the financial loss to the policyholder. Moreover, it is not clear that survival adversely affects a beneficiary. Any contract that is life contingent, whether it be death or survival, should meet the definition of an insurance contract.
- c. The notion of insurable interest may exclude some contracts that are, in substance, used as insurance. The test should be whether there is a reasonable expectation of some compensation to policyholders.
- d. A business that involves assembling risks into a pool that is managed together would be preferable to the notion of insurable interest.

BC33. The Board also considered that when there is no interest in the survival of the insured, the contract is typically accounted for as an investment under

Subtopic 325-30 on investments in insurance contracts, rather than as an insurance contract by the policyholder. In addition, for a property casualty contract, if the policyholder is not adversely affected by an event and/or the amount paid to the policyholder is in excess of the policyholder's loss, the contract is accounted for as a derivative by both the issuer and the policyholder.

BC34. Based on these considerations, the Board decided to retain the notion of insurable interest because it gives a principles-based distinction, particularly between insurance contracts and other contracts that are used for hedging.

Use of Compensation Rather Than Indemnification

BC35. The Board decided to use the term compensation rather than indemnification in describing the insurance contract benefit. Several respondents felt that indemnification, which is currently used in Topic 944 when describing insurance, better captures the objective of nonlife insurance, which includes benefits paid to indemnify the policyholder for an insured loss and is intended to put the policyholder in the same position as that before the loss occurred. In the Board's view, those terms have broadly the same meaning. However, describing an insurance contract as compensating the policyholder may be more intuitive in some instances, for example, when referring to a death benefit in a life insurance contract that compensates the beneficiary with a specified amount for the loss of the policyholder's life.

Combining Contracts

BC36. The Board considered existing U.S. GAAP guidance that requires an entity, in determining whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk, to have a complete understanding of that contract and other contracts or agreements between the cedant and related reinsurers. A complete understanding includes an evaluation of all contractual features, including either of the following:

- a. The contractual features limit the amount of insurance risk to which the reinsurer is exposed (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract)
- b. The contractual features delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

BC37. The Board decided that this notion should be retained for all insurance contracts and that contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent that are entered into with the same or a related party, should be considered a single contract for the purpose of determining risk transfer when an entity

assesses whether a contract meets the definition of an insurance contract. To apply this proposed guidance, the entity should evaluate the group of contracts together for determination of risk transfer to ensure that the economic substance of the arrangements is reflected and not merely the legal form.

BC38. The Board also decided to incorporate requirements from Topic 606 for when an entity should combine two or more contracts. In the Board's view, the principle in Topic 606 that states that contracts should be combined (a) if they are negotiated as a package with a single commercial objective and (b) if the amount of consideration to be paid in one contract depends on the price or performance of the other contract should apply equally to an insurance contract. If those contracts were not combined, the amount of consideration allocated to each contract might not faithfully depict the obligations created by both of the contracts.

Scope Exclusions

BC39. The Board decided to exclude specified types of contracts from the scope of this proposed guidance. In general, the scope exceptions were provided because other guidance provides better information to the users of financial statements for entities that issue such contracts and/or changing the existing accounting for those contracts would impose costs and disruption with insufficient benefit.

BC40. Many of the contracts excluded from this proposed guidance, such as those stemming from employee benefit plans and business combinations, would continue to be subject to existing requirements. Others, including contracts that are presently accounted for using leases and/or revenue recognition guidance, are the subject of other projects on the Board's agenda. The following paragraphs discuss the more significant of the other scope exceptions.

Product Warranties

BC41. The guidance in Topic 606 identifies the following two categories of product warranties:

- a. Some warranties provide a customer with assurance that the related product complies with agreed-upon specifications. Those warranties do not meet the definition of an insurance contract because they are intended to ensure that the seller satisfied its performance obligation to the customer rather than to ensure that the seller provide compensation for an uncertain future event. Those warranties are within the scope of the guidance in Topic 606.
- b. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

Topic 606 provides factors that an entity should consider in determining whether a warranty provides a customer with a service. Those warranties, which often provide coverage for the customer for faults that arise after the product is transferred to the customer, meet the definition of an insurance contract and are often issued by an unrelated third party.

BC42. In an assurance-type warranty, the customer does not receive a separate service if the warranty only protects the customer from the product defects at the time of sale. In that case, any subsequent repairs or replacements are additional costs of providing the original product and, therefore, relate to an entity's past performance. Likewise, the risk retained by the seller arises from existing contractual obligations to the customer. Therefore, warranties that provide a customer with assurance that the related product complies with agreed-upon specifications are not within the scope of the guidance in this proposed Update. More broadly, product warranties issued by a manufacturer, dealer, or retailer would be outside the scope of the guidance in this proposed Update. Although service-type warranties issued by a manufacturer, dealer, or retailer create economic exposure similar to service-type warranties issued by third parties, the scope of this proposed Update excludes them because they are closely related to the underlying sale of goods.

BC43. Some stakeholders argued that a title insurance contract contains a typical service contract with a customer (that is, the title search) and an assurance-type warranty on the search performed (that is, assurance that the title is free from defect when presented to the customer). Under that view, there is only one performance obligation that should be accounted for in accordance with Topic 606. The Board disagreed with that view and, instead, views the indemnification component to compensate the policyholder if a specified uncertain future event occurs as an embedded service-type warranty. Therefore, the Board decided that an entity that provides title insurance should unbundle the contract into its components, including (a) a title search component, like a service component, accounted for using Topic 606 and (b) an insurance component for the indemnification component that would be accounted for under the guidance in this proposed Update.

Employer-Provided Insurance

BC44. As noted in paragraph 834-10-15-5(b), all employers' assets and liabilities under employee benefit plans would be excluded from the scope of the proposed guidance on insurance contracts. In addition, as noted in paragraph 834-10-15-5(c) employer-provided insurance also would be excluded.

BC45. While providers of insurance receive premiums directly, the premiums to pay for employer-provided coverage may be deducted from employees' salaries either implicitly or explicitly. Some stakeholders stated that those insurance

activities should be within the scope of the guidance in this proposed Update because they meet the definition of an insurance contract. However, other stakeholders noted that the amount deducted from an employee's salary for premiums related to employer-provided insurance would be less than the premiums an employee would pay directly to an entity in the marketplace to obtain insurance coverage outside of the employer-provided plan. Therefore, they noted that employer-provided insurance represents compensation expense and, therefore, should not be considered an insurance contract. The Board gave more weight to the latter argument.

Fixed-Fee Service Contracts

BC46. Under some contracts, a service provider agrees to compensate a customer by providing services following an uncertain event that adversely affects the customer in exchange for a fixed fee. That fee may not be sufficient to cover the costs of services rendered and, therefore, the service provider can suffer a loss. Examples of fixed-fee service contracts include capitation and other fixed-fee medical service arrangements, maintenance and repair contracts, and roadside assistance programs. Those contracts meet the definition of an insurance contract. However, the Board decided to exclude fixed-fee service contracts from the scope of this guidance if they have as their primary purpose the provision of services and they meet all of the conditions in paragraph 834-10-15-5(f).

BC47. In the Board's view, the existing practice of accounting for fixed-fee service contracts as revenue contracts provides relevant information to the users of financial statements of entities that issue those contracts. The Board also believes that changing the existing accounting for those contracts would impose costs and disruption with no significant benefit. Therefore, the Board decided that criteria are necessary to distinguish an insurance contract from a fixed-fee service contract.

BC48. The provision of service as compensation following an adverse event is present in many fixed-fee service contracts, whereas many insurance contracts involve a cash payment to the policyholder. However, an insurance contract also may permit or require the provision of service as compensation. For example, an entity may own an auto mechanic subsidiary and provide auto services to customers as compensation. Alternatively, an insurer may replace stolen goods in kind. Therefore, a cash payment following an adverse event does not distinguish an insurance contract from a fixed-fee contract on a standalone basis.

BC49. The Board noted that the pricing of insurance risk, which is typically performed by an underwriter and determined at an individual contract level, is essential to writing insurance contracts, whereas entities that issue fixed-fee service contracts require less information for pricing. In fixed-fee service contracts, entities often price contracts similarly across customers without

considering specific historical customer behavior. In fact, entities that issue fixed-fee service contracts do not reprice individual contracts based on the collection of more information about a specific customer. Therefore, the Board decided that whether an entity evaluates the risk of an individual contract to ultimately set a price for accepting that risk is indicative of whether the contract is a fixed-fee service contract or an insurance contract.

BC50. The Board also noted that the primary source of significant risk transferred in many fixed-fee service contracts relates to the risk of a customer's overutilization of the services or the frequency risk associated with providing service following adverse events. Entities that issue fixed-fee service contracts do not accept significant severity risk on a customer-by-customer basis. Examples of utilization or frequency risk include how often the customer utilizes the roadside assistance program or visits the doctor's office. In those contracts, there is little or no severity risk. For example, the costs of the services for roadside assistance or a doctor's visit typically are stipulated in the contract (that is, cannot exceed specific amounts). The Board recognized that insurance contracts also expose entities that issue insurance contracts to significant frequency risk. However, on a relative basis, the significant risk transferred in a fixed-fee contract is more attributable to frequency risk than in an insurance contract, which also includes severity risk and timing risk.

BC51. Paragraphs 834-10-55-28 through 834-10-55-39 include examples that distinguish fixed-fee service contracts from insurance contracts.

Charitable Gift Annuities

BC52. Charitable gift annuities that possess a donation element and are issued by not-for-profit entities are not included in the scope of the guidance in this proposed Update. While those contracts meet the definition of insurance contracts, the Board noted that they contain a distinct and unique charitable component, unlike traditional insurance contracts. In the Board's view, the existing practice of accounting for charitable gift annuities at fair value within the scope of Subtopic 958-30, Not-for-Profit Entities—Split-Interest Agreements, provides relevant information for the users of not-for-profit entities' financial statements. The Board believes that changing the existing accounting for charitable gift annuities would impose costs and disruption with no significant benefit.

Guarantees

BC53. Guarantees are similar instruments to insurance contracts in that each requires payment from one party to another based on the occurrence or nonoccurrence of a contractually specified event or condition. If the guarantee exposes the issuer to a significant loss based on the specified event or condition,

and that event or condition results in the holder being adversely affected, the guarantee meets the definition of an insurance contract. The Accounting Standards Codification has three broad guarantee accounting models:

- a. Topic 944 on insurance
- b. Topic 815, Derivatives and Hedging
- c. Topic 460, Guarantees.

The Board considered guarantee contracts that fall within each of those Topics.

BC54. The Board considered whether the guidance in this proposed Update should apply to mortgage guarantee contracts that are presently accounted for under Topic 944. Topic 944 applies to mortgage guaranty insurance entities, except for guidance on premium revenue, claim cost recognition, and acquisition costs for which there is no authoritative guidance. However, there is no other formal guidance for mortgage guaranty insurance entities. Industry practice has evolved such that premium is recognized over the coverage period (consistent with the existing U.S. GAAP short-duration model), deferred acquisition costs are amortized over the contract term based on estimated gross profit (consistent with the long-duration model for nontraditional insurance contracts), and claims are recognized when incurred. Thus, those contracts are accounted for in a similar manner as the existing U.S. GAAP short-duration model, but a liability is not established for incurred-but-not-reported claims. The Board decided that the guidance in this proposed Update should be applied to mortgage insurance contracts because they meet the definition of insurance and there is no other relevant guidance.

BC55. The Board also considered whether the guidance in this proposed Update should apply to financial guarantee insurance contracts presently accounted for under Topic 944, which are defined as contracts issued by insurance entities that provide protection to the holder of a financial obligation from a financial loss in the event of a default. Some respondents to the 2010 FASB Discussion Paper were opposed to including financial guarantee insurance contracts guidance in this proposed Update given that those entities recently adopted new guidance within Topic 944, which was originally issued as FASB Statement No. 163, *Accounting for Financial Guarantee Insurance Contracts*. The Board determined that the guidance in this proposed Update for the building block approach is broadly consistent with existing U.S. GAAP for financial guarantee insurance contracts, except for the following differences:

- a. Changes in cash flow expectations would be recognized in net income, whereas under existing U.S. GAAP those changes are not recorded until they exceed the unearned premium reserve.
- b. The discount rates would reflect the characteristics of the liability, whereas under existing U.S. GAAP the discount rates applied are the risk-free rates.

- c. The margin would be explicit, whereas under existing U.S. GAAP it is implicitly included in the unearned premium reserve.

Considering those differences, the Board concluded that the model in this proposed Update would be an improvement to existing U.S. GAAP and should be applied to financial guarantee insurance contracts. In addition, the changes made by entities to implement Topic 944 would not be significantly changed by the guidance in this proposed Update. Instead, the proposed guidance would enhance those initial changes.

BC56. However, in considering whether the proposed guidance should apply to other types of contracts that are currently accounted for under Topic 815 on derivatives and hedging, the Board concluded that the existing guidance should be retained. Those contracts are already reported at fair value, which is similar to the guidance in this proposed Update (that is, both are current measurements). In addition, excluding those contracts from the scope of the proposed guidance would allow issuers to account for the contract consistently throughout its duration. Technically, a contract would be an insurance contract when the policyholder is exposed to the risk guaranteed, and would be a derivative when the policyholder is not exposed to that risk. However, Topic 815 has provisions such that it is applied to contracts that do not expose the entity to risk throughout its duration and, thus, eliminates the change in accounting models during the duration of the contract.

BC57. The Board also considered guarantees presently accounted for under Topic 460 on guarantees. Although the initial measurement of the guarantee would be similar under existing U.S. GAAP and the guidance in this proposed Update, subsequent measurement under this proposed Update would be based on the present value of expected cash flows rather than recognizing an undiscounted best estimate liability (or updating an initial estimate) when the specified event is incurred. Based on that difference, the Board concluded that the proposed model is an improvement to existing U.S. GAAP. However, the Board decided that the proposed model should not be applied to all guarantee contracts that meet the definition of an insurance contract and, therefore, determined that the following scope exceptions should apply, including many of the scope exceptions currently included in Subtopic 460-10 on guarantees.

- a. Contracts in which the policyholder is not exposed to the risk that is guaranteed throughout the term of the guarantee. The Board believes that if a guarantee is structured in a manner that allows for it to be sold or otherwise transferred separately from the guaranteed asset or liability (even if that sale or transfer has not actually occurred), then the purpose of the guarantee is more than to simply protect the holder from losses resulting from the occurrence of a specified adverse event. Therefore, the Board decided that the economics of those contracts warranted different accounting from what is included in this proposed Update. In addition, the Board noted that this criterion is consistent with the

criterion in Topic 815 that excludes contracts from its scope if the guaranteed party is exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term.

- b. Guarantees of an entity's own performance. The Board views these as warranty-type arrangements that guarantee product or service performance. Examples include health insurance administrative services contracts, contracts related to service call response times, and contracts related to restoration of service times, and so on. Those contracts generally are not within the scope of Topic 460 or Topic 815. As noted, the Board also decided to exclude product warranties issued by a manufacturer, dealer, or retailer from the guidance in this proposed Update (see paragraph BC42). For those same reasons, the Board determined that guarantees of an entity's own performance should be excluded.
- c. The Board decided that an exception also should be provided for guarantees that are both unusual or nonrecurring, and unrelated to the type of risk that is the subject of other guarantees typically issued by the entity. For example, a seller's indemnification relating to a nonrecurring transaction, such as the sale of a business or an asset, often would be considered an unusual or nonrecurring transaction. The Board decided that those transactions should be excluded from the scope of this proposed guidance because the entity did not provide other such guarantees in the course of its normal business activities and, therefore, would not have the data and processes to measure the liability.

BC58. The Board also decided that guarantees that are specifically addressed by other Topics, such as leasing, revenue recognition, or real estate, should not be in the scope of this proposed Update. In those cases, the Board assessed the specific economic characteristics and determined specified accounting for those guarantees. The Board decided that entities issuing those guarantees should not be required to adopt the guidance in this proposed Update because the costs may outweigh the benefits.

BC59. The Board also considered guarantees between related parties and between entities under common control. Topic 460 includes a scope exception from initial recognition and initial measurement provisions for the following:

- a. A guarantee issued either between parents and their subsidiaries or between corporations under common control
- b. A parent's guarantee of its subsidiary's debt to a third party (whether the parent is a corporation or an individual)
- c. A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

BC60. Those exceptions are based on the notion that no arm's-length transaction exists when any of the parent-subsidiary (or common control) guarantees are transacted because the parent controls the resources that affect

whether the triggering event, which would require the guarantor (either the parent or subsidiary) to perform under the guarantee, occurs. The Board noted that if separate company financial statements were presented, users also would receive important information about those guarantees because disclosures are required for guarantees that are subject to Topic 460. The Board also considered an entity's lack of data and processes to measure the liability in accordance with the proposed guidance and concluded that existing guidance should be retained if the issuer of the guarantee also is not issuing similar guarantees to third parties or similar guarantees of debt owed to third parties.

BC61. However, the Board determined that the guidance in this proposed Update should apply to intercompany guarantees issued and to guarantees of the debt owed to a third party provided by a related party or entity under common control if that related party or entity also issues such guarantees to third parties. The Board decided that those transactions should be included in the scope of this proposed Update because the entity provides other such guarantees in the course of its normal business activities and it should have the data and processes to measure the liability.

BC62. In addition, the Board decided that even if the issuer of the guarantee only issues such guarantees to a related party or entities under common control, the guidance in this proposed Update should apply if the issuance of such guarantees is the primary business purpose of the entity. For example, a captive insurance entity may only provide insurance to its parent and related entities; however, its only business purpose is to provide insurance. Therefore, the Board decided that the guidance in this proposed Update should apply to captive insurance entities.

Participating Investment Contracts

BC63. Participating investment contracts are typically issued by life insurance entities and provide the policyholder with a contractual right to receive, as a supplement to guaranteed benefits, additional benefits in which the amount or timing of the benefits are contractually at the discretion of the issuer. The additional benefits may be based on (a) the performance of a specified pool of insurance contracts, (b) investment returns on a specified pool of assets held by the issuer, or (c) the earnings of the issuer. Because those participating investment contracts have similar features to participating insurance contracts, the Board considered whether entities should apply the guidance in this proposed Update to participating investment contracts. For example, the performance of an underlying pool of assets or of the issuer itself may be shared with both participating investment policyholders and participating insurance contract policyholders. In addition, both types of contracts have long maturities, recurring premiums, high acquisition costs, and interdependent options and guarantees.

BC64. The Board decided that participating investment contracts should not be accounted for under the guidance in this proposed Update because:

- a. There is minimal or no insurance risk. Therefore, these contracts do not meet the definition of an insurance contract. Requiring contracts with specific features that do not require the transfer of insurance risk to be accounted for as insurance contracts could have unintended consequences and result in structuring products to obtain a specific accounting result.
- b. Existing U.S. GAAP guidance for financial liabilities addresses the nuances of investment contracts with participation features including the accounting for discretionary components. Applying the guidance in this proposed Update to contracts that do not meet the definition of insurance would require the development of specific provisions such as for contract boundaries.
- c. Although these contracts have features similar to participating insurance contracts, they also have features similar to other financial instruments issued by noninsurer financial institutions. Accounting for these contracts differently than for similar contracts issued by noninsurer financial institutions would reduce comparability with those entities and, therefore, would be contradictory to the objective of developing a standard that should apply to all entities that issue insurance contracts versus an entity-specific standard.
- d. In some jurisdictions, participating investment contracts form a substantial part of an insurer's business. Including a substantial volume of noninsurance contracts in the scope of this proposed guidance may cause the model to take on the character of an industry-specific model.

Recognition

When to Recognize an Insurance Contract

BC65. In developing the recognition principles included in this proposed Update, the Board noted that an insurance contract's coverage period typically begins when the insurer becomes exposed to risk under the contract.

BC66. The Board considered the proposal included in the 2010 FASB Discussion Paper that would require an insurer to recognize an insurance contract when it becomes a party to that contract. Under that proposal, an insurer would become a party to the contract at the earlier of either of the following:

- a. The date on which the insurer is bound by the terms of the contract
- b. Its initial exposure to risk under the contract (that is, when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and when it no longer

has the right to reassess the risk of the particular policyholder and, as a result, cannot set a price that fully reflects that risk).

BC67. The Board noted that an insurer could become a party to an insurance contract before the coverage period starts and that, in many cases, the measurement of an insurance contract would not change materially from when the insurer is bound by the terms of the contract and before the start of the coverage period.

BC68. Respondents raised several operational challenges regarding the proposal in the 2010 FASB Discussion Paper. The most significant was the potential inability to measure the insurance contract liability or asset reliably when a binding offer is made. The Board considered the following specific contracts:

- a. Group health insurance products: During an open enrollment period, individuals may consider the coverage offered for the premium quoted from several different health insurance providers. An entity might not have enough information to estimate the future cash flows reliably at the time the offer is provided to the potential policyholder(s) because it does not know how many potential policyholders will enroll or the coverage that will be selected.
- b. Reinsurance treaties: Reinsurers often underwrite future new business of an entity several months before the entity writes the underlying contracts. In the case of automatic reinsurance, the reinsurer is bound to accept all amounts written by the entity up to a predetermined maximum, but it may not have enough information to estimate the expected cash flows reliably when entering into the reinsurance contract. In addition, the entity writing the underlying contracts may not have enough information to estimate the expected cash flows for the reinsurance contract that it would have to record before its recognition of the underlying contracts that will be covered by the reinsurance contract.
- c. Shared risk contracts: A number of insurers offer to underwrite a percentage of the risk under an insurance contract. Only when a broker has completed the placement of the contract will the various insurers know their relative share of the risk. Therefore, it may be difficult to reliably estimate the expected cash flows until the placement is complete.

BC69. In addition, respondents were concerned that the proposed requirement to recognize an insurance contract from the time at which an entity becomes a party to the contract (for example, the earlier of the date on which the insurer is bound by the terms of the contract or the date of its initial exposure to risk under the contract) would require the entity to track and account for the contract even before the coverage period begins. They noted that the proposed requirement

would require significant system changes and, therefore, the costs would outweigh the benefits.

BC70. The Board considered the following:

- a. Accounting for an insurance contract before the start of the coverage period in the same way as an executory contract. That would mean that an entity would not recognize the contract until one party starts to fulfill its obligations under the contract. In most cases, there would be no significant assets and liabilities to recognize in the time between the signing of the contract and the start of the coverage period, although the entity would need to account for changes in circumstances that would make the contract onerous. As a result, accounting for an insurance contract in the same way as an executory contract would not address the operational concerns raised by respondents to the 2010 FASB Discussion Paper.
- b. Accounting for an insurance contract before the start of the coverage period in the same way as a forward contract (a derivative). This approach would still require tracking of contracts in the precoverage period and would provide little informational benefit because the value of the forward contract would still be difficult and costly to determine, and possibly immaterial.
- c. Recognizing the insurance contract from the beginning of the coverage period, which is the point in time when an entity is exposed to risk. Insurance contracts would be viewed in their entirety, and all features of the contract would be accounted for at the beginning of the coverage period. Therefore, any options and guarantees in the contract, regardless of whether they could be executed at that time, would expose the entity to risk once the contract begins and the insurer has committed to those options and guarantees. For example, in a deferred annuity contract with a guaranteed annuitization option, the entity would be exposed to risk when the contract first begins, which also is when the annuitization options have been committed to by the entity.

BC71. The Board was persuaded by stakeholders' comments and noted the following concerns about the proposal in the 2010 FASB Discussion Paper described in paragraph BC66:

- a. The costs to implement this change would outweigh its benefits.
- b. In most cases, the effect on the financial statements would be immaterial.
- c. The benefits to financial statement users, if any, would be low.
- d. This change would represent a change to existing U.S. GAAP that is not considered an improvement.

BC72. The Board also rejected the alternatives in paragraphs BC70(a) and (b) because insurance contracts do not expose an entity to risk in the precoverage

period. Therefore, the contract should not be reflected in the entity's financial statements until the entity is exposed to risk.

Recognizing an Onerous Contract in the Precoverage Period

BC73. The Board decided that an entity should recognize an additional liability if facts and circumstances indicate that a portfolio of insurance contracts it issues is onerous, that is, if the premium the entity expects to receive for specific coverage will not be sufficient to cover the expected losses. The entity is likely to have factored the possibility of adverse outcomes into its models. If the probability of those outcomes increases, the expected value of the outflows would potentially increase but not necessarily to the point of making the portfolio of contracts onerous.

BC74. The Board decided that if the probability of adverse outcomes increases to the extent that a portfolio of contracts would become onerous in the precoverage period, the Board decided that the recognition of an onerous liability would provide users with information on a timely basis that a portfolio that has not yet been recognized would have a material adverse effect on the financial statements.

Recognizing Reinsurance Contracts

BC75. The Board decided that a cedant should not recognize a reinsurance contract asset or liability until the underlying contract is recognized unless the reinsurance is based on aggregate losses. If the reinsurance is based on aggregate losses, a cedant would recognize the reinsurance contract when the reinsurance coverage period begins. If a reinsurance contract is based on both aggregate losses and on a direct proportion to the underlying contracts, an entity would recognize separately those respective portions of the contract.

BC76. The guidance in this proposed Update would require that an entity recognize an insurance contract asset or liability at the start of the coverage period (unless it is onerous). A ceded reinsurance contract could start on January 1 and provide coverage for all direct contracts expected to be written in the upcoming year (referred to as a risk-attaching contract). The Board considered whether that reinsurance contract should be recognized at the start of the reinsurance coverage period (January 1) even though that period may precede the recognition of the underlying contracts because they would not yet exist. The Board was concerned about recognizing a reinsurance asset before recognizing the liability associated with the underlying contract(s). In addition, the Board decided that reinsurance contracts do not transfer risk if the underlying insurance contract does not yet exist and has not yet been recognized by the entity. The Board also noted that recognizing a reinsurance contract before recognizing the underlying contract is unlikely to provide useful information to users. In addition, the Board considered that adjustments would likely be necessary to reflect the direct contracts written, which inevitably would differ from expectations about

those direct contracts at initial recognition. Therefore, the Board decided to recognize a reinsurance contract asset or liability when the asset or liability relating to the underlying contract is recognized, rather than at the beginning of the reinsurance coverage period.

BC77. However, for other types of coverage in which the protection (or a part of the protection) to the cedant is based on aggregate losses rather than on providing indemnification for an individual underlying contract(s), the Board determined that a cedant should recognize a reinsurance contract asset or liability at the beginning of the reinsurance coverage period. For example, a contract may include a provision that the reinsurer will cover all of the cedant's losses above a fixed amount of losses (an aggregate excess of loss contract). The Board decided that, in those cases, the reinsurer is exposed to risk at the effective date of the reinsurance contract and, therefore, the reinsurance contract asset or liability should be recognized at that date.

Contract Boundary

BC78. To identify the future cash flows that will arise as the insurer fulfills its obligations, it is necessary to distinguish whether future premiums (and resulting benefits and claims) arise from either of the following:

- a. Existing contracts (which are included in the measurement of the contract)
- b. Future contracts (which are not included in the measurement of the existing contract).

In other words, it is necessary to determine a contract boundary.

BC79. The essence of a contract is that it binds one or both of the parties. If both parties are bound equally, the boundaries of the contract generally are clear. Similarly, if neither party is bound, it is clear that no genuine contract exists. However, it may be more difficult to determine where the boundaries lie if the contract binds one party more tightly than the other party. The Board focused on common contracts that bind the entity but not the policyholder by requiring the entity to continue to accept premiums and provide coverage and by permitting the policyholder to stop paying premiums, although it might incur a penalty.

BC80. The Board decided that renewal terms should be included within the boundary of an insurance contract if those renewal terms confer an advantage to the existing policyholder and create additional risk for the entity. That is consistent with the notion that a contract binds an entity by requiring it to provide the policyholder with something of value. If the same terms are available to new policyholders, then the entity is not providing the policyholder with anything of value. Therefore, the Board determined that the point at which the entity is no longer required to provide coverage and the policyholder has no right of renewal is one point on the boundary of the existing contract. Beyond that point, neither party is bound.

BC81. Similarly, at the point at which the entity has the right (conferred by the contract) or the practical ability (for example, through access to claims information) to reassess the risk presented by a policyholder and, as a result, can set a new price that fully reflects that risk, the entity is no longer bound by the existing contract. Thus, the Board concluded that any cash flows arising beyond that point occur beyond the boundaries of the existing contract and should be related to a future contract, not to the existing contract.

BC82. However, a contract may permit an entity to reprice that contract on the basis of general market experience (for example, mortality experience) without permitting the entity to reassess the individual policyholder's risk profile (for example, the policyholder's health). In those cases, the contract boundary is not as clear. While this issue affects all insurance products, it is of particular relevance to nonlife insurance contracts and, more specifically, to health insurance and homeowners insurance written in catastrophe prone areas (that is, coastal areas).

BC83. The Board considered the view that a contract does not confer on the policyholder any substantive rights when the entity has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk. That view, which was proposed in the 2010 FASB Discussion Paper, would require that an entity assess the contract boundary at an individual contract level.

BC84. Some respondents were concerned that the proposal to assess the contract boundary at the individual contract level would be problematic because the contract boundary extends to the period covered by the renewal rights rather than to the original contract term.

BC85. In many jurisdictions, legal or regulatory restrictions prevent an entity from repricing contracts to reflect the risk of particular policyholders, but they permit the entity to reprice the contracts periodically to reflect the risk in the portfolio as a whole. The Board considered a contract in which the entity is required to renew a contract without reassessing the risk in the contract. If the policyholder's particular risk has increased, the value of the contract to the entity has decreased. However, if the contract was considered to be part of a portfolio of similar contracts and the entity could increase the premiums for the portfolio as a whole to reflect all the changes in risks for the contracts in the portfolio, there would be no decrease in value of the portfolio. In effect, the entity would spread the increase in premiums for any one contract across the whole portfolio. In some jurisdictions, an entity is obliged to accept new policyholders by assessing risk based on standard demographic data without assessing individual risk. If the entity was prohibited from repricing renewals to reflect the risk of the particular policyholder but could reprice with reference to those standard demographic tables, the existing policyholders would not have any rights in addition to those of new policyholders.

BC86. Based on those factors, the Board considered assessing contract boundary at a portfolio level. However, the Board decided that assessing contract boundary at a portfolio level may have unintended consequences for many contracts that are currently treated as long duration, that is, it would reduce the contract term for those contracts. That could cause contracts that are generally thought of as having a long duration to apply the premium allocation approach (that is, those cash flows that extend for a long duration would not be included in the measurement of the insurance liability, and therefore, the contract would potentially be measured using the premium allocation approach).

BC87. To alleviate that concern, the Board decided that if the premium charged on a contract does not include compensation for a future risk period (for example, no deposit and/or financing element in the premium for future periods), it would trigger the contract boundary if assessed at a portfolio level. Therefore, the boundary of an insurance contract would be the point at which the insurer has the right or practical ability to reassess the risk of the portfolio that the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio. The Board concluded that in that case, the entity is no longer bound by the existing portfolio of contracts and that any cash flows arising beyond that point occur beyond the boundaries of the existing contract. To the extent that an entity would not be able to charge a price that fully reflects the risks of the portfolio as a whole, the entity would be bound by the existing contract.

BC88. The Board considered whether to draw a distinction between renewal rights that arise from the contract and those that arise from legislation or regulation. Some have argued that renewal rights that do not arise from a contract should not be considered in determining the contract boundary because they are beyond the control of the entity. However, the Board decided that a contract can only exist within the context of its legal and regulatory environment. Therefore, the terms of the contract implicitly include the terms conferred by laws or regulations and there is no basis on which to differentiate between the two. Therefore, the Board decided that all renewal rights should be considered in determining the contract boundary.

Separating the Components of Insurance Contracts

BC89. Insurance contracts create a bundle of rights and obligations that work together to generate a package of cash inflows and cash outflows. In addition, some insurance contracts provide more than just insurance coverage. Insurance contracts can, for example, also provide the policyholder with goods or services other than insurance coverage (a revenue-generating transaction with a customer) or an investment (a financial instrument). Those components, if accounted for as if they were separate contracts (unbundled), would be within the scope of other Topics. As such, goods or services other than insurance coverage would be accounted for using proposed Topic 606 on revenue recognition and investment components would be accounted for using the appropriate guidance on financial instruments.

BC90. The 2010 FASB Discussion Paper and the 2010 IASB Exposure Draft proposed that those components should be accounted for as if they were a separate contract if the components are not closely related to the insurance coverage specified in the contract(s). The Board did not intend that the unbundling principle should require an exhaustive search for noninsurance components in every insurance contract. Rather, the purpose would be to assist investors in understanding an insurance contract with one or more components, while improving comparability between entities across industries. At that time, the Board identified the following benefits of unbundling an insurance contract:

- a. Transparency: unbundling would provide insight into the components of an insurance contract that do not respond to changes in circumstances in the same manner as components affected by insurance risk.
- b. Comparability: the result of unbundling means that an entity would account for a noninsurance component of a contract in the same manner as another entity with a separate but otherwise identical contract (for example, a financial instrument issued by a bank or a fund manager). Thus, users of financial statements would be able to compare the risks undertaken by different entities, regardless of the type of business or industry in which the entities operate.

BC91. However, the Board also noted that there are limitations to unbundling. Separating a single contract into components when the cash flows attributable to the components are intertwined could result in complex accounting. For example, it would require separating the intertwined cash flows, measuring them differently, and tracking them separately throughout the life of the contract. Furthermore, in some cases an insurer may not be able to identify evidence to decide what to allocate to each of the components (in other words, separating the components goes beyond requiring the insurer's judgment and becomes arbitrary).

BC92. In developing the guidance in this proposed Update, the Board considered whether to permit unbundling when it is not required (that is, when components are not distinct). The Board decided that insurers should be prohibited from applying other guidance (that is, revenue recognition or financial instruments guidance) to components of an insurance contract when the criteria for unbundling are not met. The Board decided that permitting unbundling when it is not required (a) would be inconsistent with the reasoning for not requiring it in the first place, which was that when the components are not distinct, unbundling would result in information that is not a faithful representation of each component and so is not decision useful and (b) could undermine comparability. The Board considered three broad areas for unbundling:

- a. Estimated returnable amounts
- b. Goods and services
- c. Embedded derivatives.

BC93. To reflect the nature of the components, the proposed criteria differ for separating the different types of noninsurance components from the insurance components. That is consistent with applying different accounting models to the equivalent contracts accounted for on a standalone basis.

Consideration of Separating Estimated Returnable Amounts

BC94. Before determining whether an explicit or implicit account balance should be separated from an insurance contract and measured using the financial instruments guidance, the Board needed to determine how to define the deposit component. The Board rejected the principle in the 2010 FASB Discussion Paper and the 2010 IASB Exposure Draft that would have unbundled an explicit account balance that is credited a return based on the investment performance of underlying investments. Although that principle would have had the advantage of being simple to determine for many products, it would have perpetuated the criticism of existing U.S. GAAP that numerous models exist and would have applied different accounting to contracts with explicit or implicit account balances, although the contracts are economically similar. Ultimately, the Board determined that the deposit component is the amount that the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs (that is, the estimated returnable amount). The Board decided that principle would best capture the split between the risk the insurer is obligated to fulfill upon an insured event and the amounts that are more representative of a deposit.

BC95. The Board then considered various objectives for separating the estimated returnable amounts from insurance contracts, including the following:

- a. A means to determine total insurance contract revenue recognized in net income
- b. Improved comparability for the statement of financial position
- c. Providing users with a liquidity measure (for example, amounts payable on demand).

BC96. The Board prioritized the objective in paragraph BC94(a), in part, in response to users' emphasis on the importance of including volume information in the statement of comprehensive income. The Board concluded that excluding cash inflows related to an amount that the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs from a volume measure is important to enhance comparability between entities issuing insurance contracts and financial type contracts (that is, a bank or a fund manager issuing financial instruments).

BC97. The Board considered whether estimated returnable amounts should be separated from the insurance contract and accounted for as separate financial instruments in accordance with guidance applicable for financial instruments. Before determining what components should be separated, an entity would already have determined that the contract as a whole is an insurance contract. If

the two components—insurance and the estimated returnable amounts—are measured independently, the sum of the parts most likely will not equal the whole. That also would ignore the interdependencies between the components. Insurers generally do not manage or report on the different components of many insurance contracts separately for regulatory or financial reporting purposes and the additional cost and complexity associated with separation would outweigh the benefits. In addition, unbundling the estimated returnable amounts would require an allocation of expenses (for example, acquisition costs and asset management costs) and income, which would (a) introduce unnecessary subjectivity and complexity into the guidance in this proposed Update and (b) reduce the decision usefulness of the results. Additionally, some Board members noted that users would benefit if all components of an insurance contract were measured using a single measurement approach. Those Board members were concerned that the significance and pervasiveness of returnable amounts in many long-duration insurance contracts would lead to too much unbundling, especially given the interdependencies between the components. Therefore, the Board decided that estimated returnable amounts that are not distinct should not be unbundled and measured using the financial instruments guidance.

BC98. Although the Board decided that most estimated returnable amounts should not be unbundled and measured using the financial instruments guidance, the Board considered whether an entity should be required to present the estimated returnable amounts separately from the insurance contract liability or asset in the statement of financial position. Disaggregating the estimated returnable amounts may offer, depending on the measurement, enhanced statement of financial position comparability for investments. Because one or both components would not be comparable to similar types of components issued as standalone contracts, the Board decided that insurers should not disaggregate the estimated returnable amounts from the insurance component on the statement of financial position.

BC99. However, to achieve the objective of providing users with a liquidity measure for insurance contracts, the Board decided that insurers should disclose the amounts payable on demand by policyholders and the estimated returnable amount that are not affected by the occurrence of an insured event.

Separation of Distinct Investment Components

BC100. Notwithstanding the benefits attributable to measuring all components of an insurance contract using a single measurement approach, the Board decided that unbundling is appropriate in some circumstances. Specifically, the Board concluded that if the estimated returnable amount and the insurance component are both distinct according to the criteria in paragraph 834-10-25-3, an insurer should unbundle the estimated returnable amount (this amount is then referred to as an investment component). That conclusion broadly is consistent with the concept of “sold separately” included in determining distinct performance

obligations in accordance with Topic 606 on revenue recognition and the principle used for unbundling goods and services under the guidance in this proposed Update.

BC101. That criterion generally should limit unbundling to circumstances in which the two components are regularly sold separately in the same market and jurisdiction. However, unbundling would apply to components of a contract that essentially operate separately. Therefore, there should be little subjectivity or complexity in separating the components. That also would mitigate opportunities for circumventing the scope of other guidance by adding insurance risk to noninsurance products. The Board decided that this criterion would balance the objective of measuring estimated returnable amounts and insurance components similar to other financial instruments and insurance contracts with the operational concerns in paragraph BC91.

Separation of Goods and Services Components

BC102. The Board decided that goods and services should be unbundled from an insurance contract according to the principles for identifying separate performance obligations in Topic 606. That is, performance obligations for goods and services that are distinct from the insurance component should be separated and measured in accordance with the relevant requirements of Topic 606 or other applicable U.S. GAAP. The Board decided that the application of those principles results in useful information because it provides more transparency of the profit drivers for the components in a way that is consistent with proposed guidance on revenue recognition and meets the objectives of unbundling included in paragraph BC90. In addition, because most, if not all, goods and services components that are distinct would be accounted for using Topic 606, if the requirements for identifying separate performance obligations differed from those requirements included in that Topic, it may not be clear to entities which guidance should apply to some components. The Board decided that using criteria that are consistent with the revenue recognition proposals should be easier to apply than the “closely related” criteria noted in the 2010 FASB Discussion Paper and the 2010 IASB Exposure Draft, which stakeholders said were not clearly defined.

Embedded Derivatives

BC103. The Board affirmed the 2010 FASB Discussion Paper proposal to separate embedded derivatives as defined in Subtopic 815-15 on embedded derivatives, and to account for the embedded derivative as derivatives at fair value. Section 815-15-25 requires separating an embedded derivative if its economic characteristics and risks are not closely related to the host contract. Subtopic 815-15 also provides guidance for applying the clearly and closely related criterion. The Board concluded that applying the existing guidance would

be consistent with the overall basis for unbundling, which considers the interrelatedness of components within an insurance contract and has provided meaningful information to users of the financial statements. Some respondents to the 2010 FASB Discussion Paper suggested that unbundling embedded derivatives would introduce additional complexities with little additional benefit given that the measurement models in Subtopic 815-15 and in this proposed Update are similar. However, the Board noted that while similar, the measurement models are not the same and the embedded derivatives in an insurance contract should be comparable to other derivatives that are issued separately. In addition, the Board decided that the cost would not be worth the benefit of creating new guidance for separating embedded derivatives within insurance contracts.

Allocation of Cash Flows to Components of Insurance Contracts

BC104. An objective of unbundling is to account for an unbundled component in the same way as standalone contracts with similar characteristics. Therefore, for those unbundled investment components, the Board decided that they should be recognized and measured on a standalone basis in accordance with financial instrument requirements, that is, the transaction price and costs would be allocated as if the investment component was a standalone contract. One of the indicators for unbundling a distinct investment component is that both components (investment and insurance component) are sold in the same market or jurisdiction. That would imply that two distinct components exist and, therefore, an entity would be able to reliably measure both components on a standalone basis. The standalone investment component would not reflect any cross subsidies or discounts arising from the presence of other components.

BC105. In determining the proposed guidance for the allocation of cash flows to unbundled goods and services, the Board concluded that the consideration and any discounts should be allocated to the insurance and goods and services component(s) in accordance with Topic 606 given that the principles for unbundling the performance obligation are based on that Topic.

BC106. However, the Board determined that cash outflows that do not relate to one of the components, such as acquisition costs and some fulfillment expenses related to the insurance contract, should be allocated to the insurance component and the goods and services component on a rational and consistent basis. While the accounting for acquisition and fulfillment costs may differ based on the guidance applied to the specific component, the principle of allocating those costs using a rational and consistent basis would take into consideration the different characteristics of the components and their pricing. Also, because it is difficult to allocate some of those costs in a nonarbitrary way, the Board decided that specifying a single method of allocation would be overly prescriptive. In addition, the principle of allocating costs on a rational and

consistent basis is consistent with other areas of existing U.S. GAAP, including Section 605-35-25 on allocating contract costs for construction-type contracts and Section 330-10-30 on allocating costs to inventory. The Board considered whether to use the same allocation methodology for the transaction price; however, it determined that some of the techniques in Topic 606 would not be applicable. The Board also considered whether the transaction price should be allocated on a rational and consistent basis, but it was concerned that an entity that issues insurance contracts would apply the least costly basis to allocate the cross subsidies and discounts—for example, to allocate those to only one of the components or to allocate in such a way to obtain financial results that would be most beneficial at the time.

Determining When to Apply the Building Block Approach or the Premium Allocation Approach

BC107. The Board considered which insurance contracts should be measured using the building block approach as opposed to the premium allocation approach. In doing so, it determined that certain criteria should be met for a contract to be measured using the premium allocation approach.

BC108. The Board decided that an entity should apply the premium allocation approach if, at contract inception, it is unlikely that during the period before a claim is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract. It also decided that contracts with a coverage period of one year or less should be required to be measured using the premium allocation approach.

BC109. The purpose of the first criterion is to identify contracts for which updating cash flow assumptions (using current assumptions) before a claim is incurred would not provide meaningful information to the users of financial statements and, therefore, the costs of doing so would outweigh the benefits. Conversely, this criterion seeks to identify contracts in which there could be significant variation in expected cash flows that could reasonably affect an insurer's expectations in the period before a claim is incurred, which would indicate that the contract would be better measured using the building block approach in which an insurer is required to record the effect from changes in assumptions each reporting period.

BC110. Some Board members questioned whether this criterion would indicate that catastrophe contracts should be accounted for using the building block approach. In the case of a hurricane, the expectations of catastrophic losses can change from when the adverse event is impending until it occurs (or does not occur). Therefore, expectations of cash flows fluctuate during this time. For other catastrophe events, for example, an earthquake, the adverse event happens instantly with little or no change in expectations of cash flows before the event occurs. However, those Board members noted that entities will have an expectation of catastrophe losses if they are writing this coverage. Therefore, the

presence of a potential insured event does not necessarily mean that an entity will change its estimates of expected cash flows significantly. The Board also noted that for both catastrophes, variation in cash flows would likely only result in greater net cash outflows than those expected at the beginning of the contract. Such variations would be measured by the onerous contract test that is included in the premium allocation approach, thereby eliminating the concern of not updating cash flow estimates in a timely fashion as is required in the building block approach. In addition, those types of contracts typically have a coverage period of one year and, therefore, would be required to apply the premium allocation approach regardless of the first criterion.

BC111. The Board also considered other criteria for application of the premium allocation approach, namely a criterion that stated that significant judgment is required to determine the amount of premium to be recognized in each reporting period. The purpose of this criterion was to identify circumstances in which there is significant uncertainty about the total amount of the premium or how to recognize that premium as revenue over reporting periods. That might be the case in which there is significant uncertainty about the length of the contract, for example, the policyholder may live longer or die sooner than expected or the contract contains options for the policyholder to terminate or extend the contract. However, the Board determined that this criterion would not differentiate contracts that should be measured using the premium allocation approach from those that should be measured using the building block approach because the guidance in this proposed Update would require an allocation of premium over the reporting periods for both the building block and premium allocation approaches.

BC112. The Board considered whether additional criteria should be included to reflect the type of risk or primary performance indicators and metrics managed (such as consideration of investment results, asset-liability management, and variability of amount of risk). The Board decided that, instead, the characteristics of the contracts should determine the accounting approach rather than the manner in which the portfolio of contracts are managed.

BC113. The Board rejected the criteria in existing U.S. GAAP that requires contracts to be accounted for using the short-duration model if the contract provides insurance protection for a fixed period of short duration and the contract enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premium charged or coverage provided. The Board noted that most contracts typically can be repriced at the end of the contract period for renewals. In addition, the contract boundaries as defined in this proposed Update include that notion. The Board also decided that the term *short duration* was not well defined.

BC114. Similarly, the Board decided that an entity should not only use the premium allocation approach for contracts with a coverage period of approximately one year as was considered in the 2010 FASB Discussion Paper.

Respondents to the Discussion Paper commented that the phrase *approximately one year* was not clear because nonlife contracts may have durations longer than one year but share similar economic characteristics with one-year contracts, and the application to reinsurance contracts with specific features was uncertain. However, the Board decided that the premium allocation approach should be applied without further evaluation if a contract's coverage period is one year or less. The rationale for that decision is that it is unlikely that significant variability in the expected value of the net cash flows that are required to fulfill the contract will occur in a contract with a coverage period of one year or less.

BC115. The Board determined that for contracts that meet either of the two criteria decided upon, requiring an insurer to apply the building block approach would not generate sufficient benefits to justify the costs. Some Board members also stated that even if the building block approach were used for the measurement of these contracts, an entity may not arrive at a result that is significantly different from that of the premium allocation approach.

BC116. The Board considered whether an entity should have an option of applying the premium allocation approach to contracts that meet the criteria because the premium allocation approach can be viewed as a simplification of the building block approach. The liability for remaining coverage would be a reasonable approximation of the present value of the fulfillment cash flows and the margin because it is unlikely that there will be significant variations in the expected cash flows before a claim is incurred. If expectations change before a claim is incurred, significant unfavorable changes would be captured by the onerous contract test. Likewise, the liability for incurred claims approximates the present value of the fulfillment cash flows after a claim is incurred. However, the Board believes that the premium allocation approach is a separate measurement model. Although the measurement model is similar in both approaches (that is, uses the present value of expected cash flows), in the premium allocation approach, the Board decided to allow several practical expedients that would cause different results than those obtained if the same contracts were measured using the building block approach. Therefore, to permit use of the premium allocation approach would affect a user's ability to compare those results across entities. In addition, the Board decided that an entity should not record a margin (to defer profit until the uncertainty in the cash flows is reduced) with the liability for incurred claims, which is a significant difference from the building block approach. Because of those differences, the Board concluded that an entity should be required to apply the premium allocation approach to contracts that meet the criteria in paragraph 834-10-25-18.

Initial Measurement

Portfolio

BC117. The 2010 FASB Discussion Paper proposed to define a portfolio of insurance contracts as “insurance contracts that are subject to broadly similar risks and managed together as a single pool.” However, respondents to the Discussion Paper noted that a number of different units of account were required by the model proposed in the Discussion Paper, including a portfolio level, a cohort level for the margin, and a contract level for acquisition costs.

BC118. In determining the definition of the portfolio, the Board considered its intended purposes in the measurement model and determined that the portfolio should be the unit of account used to estimate the expected fulfillment cash flows, determine and recognize the margin and acquisition costs that should be included in the measurement model, and perform the onerous contract test.

BC119. The Board considered whether the existing U.S. GAAP definition of portfolio could be used. Existing U.S. GAAP states that contracts should be grouped to be consistent with the insurer’s manner of acquiring, servicing, and measuring the profitability of its insurance contracts. In existing U.S. GAAP, that definition is included for expensing acquisition costs and determining when a premium deficiency should be recognized. The Board noted that there is diversity in practice surrounding the application of this definition, which affects an entity’s results. The Board decided that because the use of the portfolio is being expanded in the guidance in this proposed Update to include liability measurement and the recognition of the margin, the definition should focus on objectives that are relevant to those items.

BC120. The Board noted that the pooling of similar risks should form the basis on which an entity determines portfolios. However, this attribute can be interpreted in different ways; therefore, other attributes are necessary for the definition to be operable. The Board rejected requiring that a portfolio comprise contracts by line of business or product type. To group contracts by line of business would group contracts at a fairly granular level, which typically would be subsets of contracts with similar risks. In addition, those terms could be interpreted differently in different jurisdictions.

BC121. Several Board members questioned whether the attribute that the contracts are managed together as a single pool was necessary, observing that the criteria relating to similar risks and similar pricing relative to the risk seemed adequate. Therefore, the Board decided to eliminate that attribute.

BC122. The Board considered including the notion that contracts should be grouped into a portfolio if they have similar profitability characteristics. Some Board members noted that the definition of portfolio without the notion of profitability is too broad and could arguably result in an entity combining

contracts with significantly different expected loss ratios into the same portfolio. Those Board members were concerned about earnings management because without the notion of profitability an entity could combine contracts that have different profit percentages and, thus, delay the recognition of losses. Using that concept, the Board decided that a portfolio should group contracts that have similar pricing relative to the risk assumed.

BC123. Finally, in considering that the definition of the portfolio would affect the recognition of the margin, the Board considered whether similar duration and expected patterns of release from risk also should be included in the definition. If the definition does not include these attributes, the level of aggregation would not achieve the stated objective of fully recognizing the margin related to a portfolio in the appropriate period. Furthermore, because entities generally group contracts by issue year for life insurance contracts and by accident year for nonlife insurance contracts, applying the definition of portfolio containing the reference to similar duration and expected patterns of release from risk should not add significant additional complexity or cost to implement.

BC124. Based on these considerations, the Board ultimately defined *portfolio of insurance contracts* as contracts that:

- a. Are subject to similar risks and priced similarly relative to the risk assumed
- b. Have similar durations and similar expected patterns of release from risk, that is, reduction in variability in cash flows.

BC125. The Board considered whether the unit of account should be the individual contract level for certain aspects of the model. The Board decided that the individual contract level would not reflect the economics of insurance contracts because insurance contracts are priced with some element of cross subsidization (that is, when setting its prices, the entity considers the risk of a group of contracts as a whole). In nonlife contracts, assumptions about the pattern of the release from risk and the duration of that risk are not applied downward from a portfolio level to an individual contract level because the insurer does not know which contracts will result in claims (for example, the liability for incurred-but-not-reported claims is based on the portfolio of contracts), when those claims will be reported, or when an ultimate loss amount will be determined. Therefore, determining the measurement of the liability or performing the onerous contract test at an individual contract level for nonlife insurers would not be practicable. However, in life insurance contracts, assumptions that are determined at a portfolio level are typically applied downward to an individual contract level because of the nature of the risk the insurer is assuming (mortality assumptions and so on). For that reason, while the measurement of the fulfillment cash flows and the determination of the margin will be performed at a higher level, the measurement of the liability and margin may be allocated to individual contracts and, therefore, the release of the margin

may happen at that lower level. The Board decided that insurers should not be precluded from releasing the margin at a lower level than the portfolio level.

BC126. Paragraphs 834-10-55-46 through 834-10-55-50 include items to consider in grouping insurance contracts according to the definition of portfolio as proposed in this Update.

Measurement of the Fulfillment Cash Flows

Fulfillment Cash Flows

BC127. The Board believes that insurers should measure insurance liabilities using cash flows that will arise through fulfillment of the contract. That measurement reflects the amount that an entity expects will extinguish the liability through payment of benefits and claims to policyholders as they become due. The present value of the fulfillment cash flows is built up from an estimate of future cash flows and an adjustment for the time value of money.

Market variables used in the estimates of entity-specific cash flows

BC128. The Board believes that measurements are more relevant and reliable if they are consistent, as much as possible, with observable market prices because such measurements:

- a. Involve less subjectivity than measurements that use the entity's own estimates
- b. Reflect all evidence available to market participants
- c. Are developed using a common and publicly accessible benchmark that users can understand more easily than information developed using a private internal benchmark.

BC129. Therefore, the Board decided that:

- a. Market variables should be consistent with observable market prices.
- b. Non-market variables and/or variables that are not observable in the market should consider entity-specific assumptions and, when applicable, market data. In principle, consistency with observable market prices implies that estimates of cash flows should be consistent with the estimates that other market participants would make. However, many variables cannot be observed in, or derived directly from, market prices (for example, the frequency and severity of insurance claims, nonclaims fulfillment costs to settle claims, policy maintenance expenses, and so on). In developing estimates of these variables, an entity would need to consider all available data, both external and internal. The estimates should not contradict current market variables unless the difference is supportable. For example, estimated

probabilities for inflation scenarios should not contradict probabilities implied by market interest rates. For such variables, there is rarely, if ever, persuasive evidence that an entity's own estimates differ from the estimates that other market participants would make, and the distinction between entity-specific estimates and market estimates has little practical significance.

Unbiased measurement of cash flows

BC130. Several respondents to the 2010 FASB Discussion Paper asked for clarification on the expected value measure of cash flows. This was a greater concern for measuring nonlife insurance contracts than life insurance contracts. The Board noted that under existing U.S. GAAP, life insurers perform stochastic modeling for the majority of their products, which includes mortality and lapse rates that are essentially mean rates determined by experience studies (although the models used by life insurers will change to reflect projections for fluctuations in historical rates and should not include adjustments for parameter risks and pandemics). However, nonlife insurers typically record a best estimate liability.

BC131. The Board considered the methods currently used to measure the reserve for nonlife insurance contracts, which generally start with an "actuarial central estimate" that represents the expected value over a range of reasonably possible outcomes. An actuarial central estimate may or may not be the result of the use of a probability distribution or a statistical analysis. Although, in a majority of cases, the scenarios are not explicitly weighted in a probabilistic manner, the estimation process usually considers the results of multiple estimation methods. Estimates are normally derived by considering the range of possible outcomes through the application of multiple methods and include multiple sets of alternative inputs, applying selected weights to the results of the selected methods and inputs. The consideration of the resulting estimates of expected claim payments is reasonably equivalent to the use of probability-weighted cash flows. An entity's management may or may not make an adjustment to the actuarial determined estimates in measuring the liability.

BC132. Based on that understanding, the Board decided to clarify that its objective in estimating cash flows is to determine the expected value or statistical mean of the range of possible outcomes. Thus, the starting point for an estimate of cash flows is a range of scenarios that reflects all relevant information. Depending on the circumstances, an entity might develop these estimates by identifying individual scenarios, by developing a formula that reflects the entity's estimate of the shape and width of the probability distribution, or by random simulation. Each scenario specifies the amount and timing of the cash flows for a particular outcome and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome to derive an expected present value (that is, the probability-weighted mean).

BC133. The Board determined that the objective is not to develop a single “best” estimate of future cash flows but, in principle, to identify all possible scenarios and make unbiased estimates of the probability of each scenario. The Board recognizes that there will be judgment in determining the probability weightings.

BC134. When considering possible scenarios, an entity need not identify every possible scenario but rather should recognize the statistical mean of possible scenarios that incorporates all relevant information and not simply ignore data or information that is difficult to obtain. In practice, it is not always necessary to develop explicit scenarios if the resulting estimate is consistent with the measurement objective of considering all relevant information in determining the mean. Although expected value relies on a range of scenarios that reflect the full range of possible outcomes, the Board decided that practical implementation would depend on actual circumstances. In the Board’s view, enough scenarios should be performed to incorporate all relevant information; if an entity believes it has a sufficient basis to support the mean and performing additional scenarios is not likely to change the mean, an entity does not need to run additional scenarios. Consequently, the Board decided that there should be no requirement to identify and quantify all possible scenarios if the estimate of expected value is unbiased.

BC135. An expected present value is not a forecast that a particular outcome will occur. Therefore, differences between the ultimate outcome and the previous estimate of expected value should not be perceived as “errors” or “failures.” The expected value is a summary that incorporates all foreseeable outcomes. When one of those outcomes occurs, that outcome does not invalidate the previous estimate of the expected value.

Which Cash Flows?

BC136. The Board determined that all direct cash flows that are necessary to fulfill a portfolio of contracts should be included in the fulfillment cash flows. The Board noted that the direct relationship should be at no higher than the portfolio level.

BC137. Some Board members questioned the types of estimated cash flows included in the measurement of the liability, specifically cash flows other than the estimated benefits claim amount. However, the Board observes that to fulfill its obligation to the policyholder, the entity is required to maintain the contract, process changes to the contract, investigate claims, and process the claim payment(s). Therefore, the Board decided that the expected costs for these activities should be included in the measurement of the liability.

BC138. An entity also incurs costs with third parties (that is, not with the policyholder or its beneficiaries) as a result of writing an insurance contract. Such costs include insurance related assessments by state guaranty funds, workers’ compensation second injury funds, and annual fees imposed on health insurers

by the Patient Protection and Affordable Care Act, among others. The Board notes that these are costs of doing business and are outside the entity's obligation to the policyholder or its beneficiaries. Therefore, the Board decided that these and other similar costs should be excluded from the measurement of the liability.

BC139. The Board recognized that there is a balance between identifying the direct costs and including them in the insurance liability and excluding period costs. There were mixed views among the Board members about whether direct costs should include an allocation of overhead costs and, if so, which overhead costs should be included. Some Board members highlighted the interaction between the costs that are included in the cash flows and the effect on the margin; the more costs that are included in the expected cash flows, the lower the margin. Some Board members were concerned that too broad a definition would allow general overhead costs to be included in the liability measurement. However, the Board agreed that the estimates of cash flows should include costs that relate directly to the fulfillment of the portfolio of insurance contracts. Costs that do not relate directly to the insurance contracts or contract activities, such as general overheads, should be recognized as expenses in the period in which they are incurred or should be accounted for in accordance with other applicable Topics.

BC140. The Board noted that the basis for this decision was the direct relationship of the costs to the fulfillment of the contracts and not whether the costs were incremental. The Board rejected the notion of including incremental costs because that approach would capture too narrow a range of costs, that is, it would exclude costs that are allocable to activities to fulfill the entities' obligations that the Board decided should be included in the measurement of the cash flows.

Cash flows that arise from future premiums

BC141. The Board decided that to identify the future cash flows that will arise as the insurer fulfills its obligations, it is necessary to distinguish whether future premiums (and resulting benefits and claims) arise from either of the following:

- a. Existing contracts (that are included in the measurement of the contract)
- b. Future contracts (that are not included in the measurement of the existing contract).

BC142. The Board decided that cash flows related to future contracts should not be included in the measurement of fulfillment cash flows. Those cash flows are delineated by the contract's boundary (see paragraphs 834-10-25-13 through 834-10-25-15).

Risk of an Entity's Nonperformance

BC143. The measurement objective in the guidance in this proposed Update is focused on measurement of the insurance contract obligation and not an entity's likelihood of fulfilling that obligation. Therefore, the Board determined that the fulfillment cash flows should not reflect the risk of nonperformance by the entity, either at initial recognition or subsequently. Some would argue that nonperformance risk is implicitly reflected at the initial recognition of an insurance contract because it is reflected in the amount of premium the policyholder is willing to pay for coverage from a particular entity offering insurance contracts. However, the Board decided that it would be counterintuitive to reflect nonperformance risk in the measurement of the insurance contract liability. For example, if an entity's credit risk increases (that is, it is less likely to be able to fulfill its insurance obligations), it would decrease the fulfillment cash flows (either by a reduction in the nominal cash flows or by an increase in the discount rates) and thereby decrease the insurance contract liability and increase an entity's equity. In addition, an entity typically cannot settle its obligations to policyholders for less than the contractual amount stipulated. Rather, if an entity cannot fulfill its obligations, in some jurisdictions, such as the U.S., it would be subject to regulatory supervision. In that case, the obligations generally are paid by the entity's surplus (that is, retained earnings) and assessments to other entities that write the same type of insurance contracts in the same jurisdictions.

BC144. The Board considered concerns raised by some stakeholders that excluding an entity's own credit risk could lead to an accounting mismatch because the fair value of the assets backing insurance contracts includes changes in credit spreads on those assets, while the measurement of the insurance contract would not include changes in credit spreads on its liabilities. The insurance contracts and the assets may not and, in many cases, will not respond in the same way to changes in credit risk and, therefore, the mismatch would be economic. Therefore, the Board decided not to change its position.

Time Value of Money

BC145. Entities are not indifferent to the timing of cash flows. An amount payable tomorrow is not equivalent to the same amount payable in 10 years. In other words, money has a time value. The Board decided that the measurement of all insurance contracts should reflect the time value of money because that more faithfully represents the insurer's financial position. The Board's basis for requiring discounting for contracts measured using the premium allocation approach is included in paragraphs BC216 through BC221.

BC146. The objective in determining the yield curve to discount the insurance liability is to reflect the characteristics of the liability rather than a single blended asset yield. In theory, the yield curve should reflect the characteristics of the cash flows of the liability, using current observable market prices and excluding factors

related to credit risk. The Board determined two approaches would be appropriate to calculate the discount rates for insurance contracts:

- a. An approach that would require an entity to use risk-free rates plus a premium for illiquidity to discount the cash flows of an insurance contract. This was the approach included in the 2010 FASB Discussion Paper. This approach starts with the risk-free rates on liquid assets, for example, government bonds, and then adds a component to capture the less-liquid nature of an insurance contract liability (a liquidity adjustment) to arrive at the discount rates.
- b. An approach that would require an entity to begin with an asset-yield curve and then remove components not relevant to the liability characteristics, for example, expected defaults. Using this approach, an entity would not be required to explicitly determine the liquidity adjustment.

BC147. The first approach is based, in part, on the notion that many insurance liabilities do not have the same liquidity characteristics as assets traded in financial markets and, therefore, the risk-free rates would not reflect the characteristics of the liability. Risk-free rates are generally described as observable market rates for highly liquid government bonds. Some government bonds are traded in deep and liquid markets, and the holder can typically sell them readily at any time without incurring significant costs or affecting the market price. In contrast, policyholders cannot liquidate their investment in some insurance contract liabilities, whether it be to the entity or a third party, without incurring significant costs or foregoing significant benefits. In some cases, they have no contractual right to liquidate their holding in insurance contract liabilities at all. Stated differently, the holder of a typical government bond acquires two things, a holding in an underlying nontradable investment (paying a return higher than the observed return on the traded bond) and an embedded option to sell the investment (for which the holder pays an implicit premium through a reduction in the overall return). Thus, for a liability that the holder cannot sell or put (or can do so only at significant cost), the discount rates should equal the return on the underlying nontradable investment, with no deduction for the premium on the embedded put option, because no such put option is present in the liability.

BC148. Thus, in determining the discount rates for an insurance contract, the Board considered the differences between the liquidity characteristics of the instruments that underlie the rates observed in the market and the liquidity characteristics of an insurance contract. The Board also considered whether the discount rates should reflect the liquidity characteristics of the item being measured and how such a liquidity adjustment could be measured. The Board noted a few concerns with the first approach (requiring risk-free rates plus a premium for illiquidity of insurance contracts):

- a. The rates may result in volatility due to an accounting mismatch with related assets.

- b. It may result in losses at inception (that is, day one) from discounting at rates that are lower than the rates reflected in the pricing of insurance contracts.
- c. The difficulty in separating liquidity effects from credit effects.
- d. The lack of a standard method for determining the liquidity premium.

BC149. The Board noted that in some jurisdictions government rates are not risk free, so that in addition to the liquidity adjustment, the risk-free rates may not be easily determinable. However, the interest rate swap curve may provide a reasonable alternative, with an adjustment to exclude any counterparty credit risk inherent in those rates.

BC150. With regard to the second approach, the Board noted that an entity should determine an appropriate yield curve based on current information. The Board determined that an entity could start with either the yield curve that reflects current market returns for the entity's actual portfolio of assets the insurer holds or a reference portfolio of assets with characteristics similar to those of the insurance contract liability. This approach assumes that the entity only uses the cash flows of the actual portfolio of assets that closely match the insurance liability cash flows.

BC151. The Board recognizes that in some jurisdictions there will be points on the yield curve in which there is no observable market data, especially for liabilities that are expected to be settled many years from the reporting date. The Board concluded that for points on the yield curve in which there are no observable market prices, an entity should use an estimate that is consistent with existing U.S. GAAP guidance on fair value measurement, particularly for Level 3 fair value measurement. In applying that guidance, an entity would adjust an observable input that relates to a liability whose characteristics are different from the characteristics being measured. Because forecasts of unobservable inputs tend to put more weight on longer term estimates than on short-term fluctuations, that would counteract concerns that current period fluctuations in discount rates exaggerate the volatility of very long-term liabilities.

BC152. The Board considered the adjustments that would need to be made to the yield curve determined based on an entity's actual portfolio of assets or a reference portfolio and determined that entities should (a) adjust for differences between the timing of the cash flows to ensure that the assets in the portfolio (actual or reference) selected as a starting point are matched with the duration of the liability cash flows and (b) adjust for risks inherent in the assets that are not inherent in the liability such as expected and unexpected losses (the risk of losses exceeding the expected value).

BC153. The Board noted that an entity should decide which approach is most appropriate under its particular circumstances. The Board noted that both approaches are imperfect, because they rely on difficult, subjective estimates. Therefore, the Board acknowledged that, in practice, these approaches would likely result in different rates when applied to the same liability. Consequently, the

Board indicated that there should be disclosures about the method and the discount rates used to provide transparency. However, the Board does not intend for an entity to determine discount rates using both approaches in an attempt to reconcile the results.

BC154. Some respondents to the 2010 FASB Discussion Paper suggested that the discount rates should be derived from the expected return on assets backing the liabilities. Proponents of this approach believe that:

- a. It is consistent with some pricing practices.
- b. It prevents losses at inception for some contracts that are expected to be profitable overall and, therefore, reflects the most likely outcome of the insurance activity as a whole, considering the underwriting and investment functions together.
- c. It avoids the volatility that would arise if short-term fluctuations in asset spreads affect the measurement of the assets but not the measurement of the liabilities. For most contracts measured using the building block approach, an entity holds those assets for the long term to enable it to fulfill its obligations under the insurance contracts it issued; therefore, some believe that those fluctuations make it more difficult for users of the entity's financial statements to assess the entity's long-term performance.

BC155. However, the Board rejected applying asset-based rates when the cash flows from the liability do not depend on returns from assets because those rates are irrelevant for a decision-useful measurement of the liability. The objective of the discount rates is to adjust estimated future cash flows for the time value of money in a way that captures the characteristics of the liability, not the characteristics of the assets viewed as backing those liabilities. Therefore, the discount rates should be consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability in terms of, for example, timing, currency, and liquidity. It should exclude any factors that influence the observed rates but are not relevant to the liability (for example, risks not present in the liability but present in the instrument for which the market prices are observed).

BC156. Some view the cash flows that result from a guarantee embedded in an insurance contract as varying with asset returns in scenarios in which the guarantee amount is lower than the proportion of returns promised to the policyholder and fixed in scenarios in which the guaranteed amount is higher than the proportion of returns promised to the policyholder. However, the Board does not regard these cash flows as varying with asset returns because they do not vary directly with such returns in all scenarios. Accordingly, asset-based discount rates would not be appropriate for such cash flows.

BC157. The Board also considered whether the rates used in pricing the contracts could meet the objective to reflect the characteristics of the liability. Rates used in pricing would reflect the time value of money inherent in the

contract at contract inception, might be less volatile than market rates, thereby mitigating some operational concerns about using rates that reflect the characteristics of the liability. However, some Board members were concerned about how observable the pricing rates would be and the complexities in determining current rates in each reporting period after issuance of the contract. If newly issued contracts contain features that change the characteristics of the liability, the new pricing rates could not be used to update the discount rates for contracts previously sold. In addition, some could argue that the rates should be locked in, especially if premium is paid up front because the cash flow characteristics should not change. In addition, for some types of nonlife insurance contracts, expected investment returns are not considered in the pricing.

BC158. In addition, the Board considered prescribing specific discount rates (such as high-quality bond rates) as a practical expedient. Several Board members highlighted the difficulty in determining appropriate rates to use because research has identified only a few countries that have deep and liquid corporate bond markets. Other Board members were concerned that if high-quality bond rates were selected, there would still need to be an adjustment for credit risk because the Board previously indicated that it should not be in the measurement of the insurance liability.

BC159. The Board noted that the objective of the discount rates used to measure participating insurance contracts should be consistent with the objective of the discount rates used to measure nonparticipating insurance contracts. The Board decided that, to the extent that the amount, timing, or uncertainty of the cash flows arising from insurance contracts depends wholly or partly on the performance of specific assets, the insurer should adjust those cash flows using discount rates that reflect that dependency.

BC160. For example, when there is asymmetric risk sharing (such as a unit-linked contract that provides for 90 percent participation in the upside of asset returns but a minimum guaranteed asset return), the Board decided that the risk retained by an entity should be reflected in the measurement.

Acquisition Costs

BC161. An entity often incurs significant costs to sell, underwrite, and initiate new insurance contracts. These costs are commonly referred to as acquisition costs and include commissions and other costs such as those for underwriting, medical inspection, and policy issuance. An insurance contract is generally priced to recover those costs through future premiums and surrender charges.

Which Costs Qualify as Acquisition Costs?

BC162. The Board decided that only direct costs that are related to the successful acquisition of a portfolio of contracts should be included in the measurement of the overall insurance contract liability.

BC163. In the Board's view, costs incurred that did not result in obtaining an insurance contract are not fulfillment costs of a portfolio of contracts and, instead, are simply period expenses. Costs relating to unsuccessful acquisition efforts cannot be considered to provide a future economic benefit to warrant recognition and, therefore, cannot be considered to be recoverable.

BC164. The Board considered its proposal in the 2010 FASB Discussion Paper, which would have limited acquisition costs to incremental costs (that is, those costs that would not have been incurred if the insurer had not issued an individual contract). The Board rejected this approach because:

- a. An entity typically will price an insurance contract to recover not only incremental costs but also other direct costs and a proportion of indirect costs.
- b. Incremental costs would have to be clearly identified as relating specifically to an individual contract, which would eliminate the inclusion of other direct costs and a proportion of indirect costs that are measured at a portfolio level (such as policy issuance and processing), when a portfolio approach is consistent with the way in which the entity prices and manages its business.
- c. The definition of incremental acquisition costs is too narrow to adequately reflect the various sales structures of insurers—for example, it may result in different answers for sales structures that have the same cost level but use different channels (for example, external agents versus direct writing).

BC165. As a result, the Board decided that it was more appropriate to include the direct costs that are related to the acquisition of a portfolio of contracts. The Board decided that under this approach any incremental direct costs at the individual contract level would still be included (a specific contract's commission), but a proportion of other direct costs also would be included (the portion of employee's total compensation and payroll-related fringe benefits related directly to time spent performing underwriting activities). The Board's intention was that the guidance in this proposed Update would allow the same cash flows to be included as acquisition costs as does the guidance in FASB Accounting Standards Update No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*, with the exception of direct-response advertising costs.

BC166. The Board considered whether direct response advertising costs should be included as acquisition costs limited to successful efforts, and whether to

adopt and modify the language from Topic 340, Other Assets and Deferred Costs, specifically paragraphs 340-20-25-4 through 25-11, to provide guidance as to which direct response advertising costs should be included as qualifying acquisition costs. Applying that approach would be broadly consistent with the guidance in Update 2010-26. This approach also would be consistent with the SEC's view that direct response advertising must provide enough information so that the customer can make a decision to enter into a contract for the advertising costs to be capitalized.

BC167. The Board decided that all costs related to direct response advertising should be expensed as incurred. Advertising is typically a period cost because it meets the definition of an expense under existing U.S. GAAP. Expenses are outflows from delivering or producing goods, rendering services, or carrying out other activities that constitute an entity's ongoing major or central operations. Therefore, some Board members noted that all advertising costs meet the definition of selling expenses and should be expensed as incurred. Some Board members asserted that any type of advertising could be described as "solicitation" and noted that Topic 340 originally was written for noninsurance entities, and that the Board has proposed to supersede Topic 340 as part of developing Topic 606, which will require direct response advertising to be expensed as incurred. In addition, the Board believes that, for direct response advertising, the determination of what is a successful effort, as opposed to an unsuccessful effort, would be unnecessarily complex.

BC168. The Board noted that the cash flows that an entity should include as acquisition costs should be the same regardless of whether an entity is applying the building block approach or premium allocation approach. However, the Board decided that an entity should be permitted to recognize all acquisition costs as an expense if the contract coverage period is one year or less and the contract is accounted for under the premium allocation approach. The Board decided that the costs and complexity of tracking acquisition costs for contracts with a coverage period of one year or less would outweigh the benefits of doing so.

BC169. Some direct acquisition costs could be incurred or paid on or before the day the insurance contract is initially recognized (for example, underwriters' compensation, medical inspections, and so on). In those cases, an entity may have incurred acquisition costs before the insurance liability has been recognized. Thus, the Board's decision that an entity should be required to recognize an insurance contract when the coverage period starts results in the question of how to account for such acquisition costs because some would argue that they cannot be included in the cash flows of the insurance contract liability if it has not been recognized.

BC170. The Board considered whether these costs should be recognized as an expense immediately or as a prepayment asset (and derecognize that asset when the coverage period begins). To recognize these costs as an expense or as an asset would result in inconsistent accounting treatment between the

treatment of acquisition costs incurred before and after the start of the coverage period because the guidance in this proposed Update would require that acquisition costs incurred after the start of the coverage period be recognized over the coverage period in the same pattern as the margin for contracts measured using the building block approach or the liability for remaining coverage for contracts measured using the premium allocation approach. In addition, it also would be complex for an entity to determine whether the acquisition costs it incurred related to the precoverage period versus the contract period.

BC171. The Board ultimately decided that those cash flows should be recognized as part of the portfolio of insurance contracts that will be recognized when the coverage period begins. This approach was based on the Board's decision to include costs directly attributable to acquiring the portfolio of insurance contracts, rather than costs at an individual contract level. In current practice, insurers track acquisition costs on a portfolio basis as opposed to an individual contract basis, based on a rolling account of acquisition costs over time. The Board decided that the costs of more granular accounting to address this issue do not outweigh the benefits. The approach would be consistent with the way in which insurers track these costs and is the most practical operably. In addition, the Board decided that the amount of these costs included in the insurance liability for the period of time from the inception of the contract to the start of the coverage period will have a minimal effect on financial statements.

Measurement of Acquisition Costs

BC172. The Board considered the following approaches for the treatment of acquisition costs:

- a. Recognize an expense when acquisition costs are incurred.
- b. Recognize revenue and an expense when acquisition costs are incurred.
- c. Recognize the right to recover acquisition costs as an asset.
- d. Include the acquisition costs in the measurement of the fulfillment cash flows as part of the liability (insurance liability).
- e. Include the acquisition costs in the measurement of the margin for contracts measured using the building block approach, or in the liability for remaining coverage for those measured using the premium allocation approach.

BC173. The 2010 FASB Discussion Paper proposed that the measurement of insurance contract liabilities would include the expected present value of acquisition costs and an insurer would present in net income only net changes in the liability, which was referred to as the summarized margin presentation approach. The Board considered the treatment of acquisition costs in light of the

presentation approach included in this proposed Update, that is, an entity should present premiums, claims, and benefits in net income.

BC174. Those Board members who support expensing acquisition costs as incurred do not view the cost to acquire an insurance contract differently from any other type of selling cost. In most industries, selling expenses are identified in the accounting period in which they are incurred and expensed in the same period. In addition, expensing acquisition costs as incurred is a simple approach. However, most Board members agreed that acquisition costs are recoverable through future premiums or through other features within insurance contracts and, therefore, it would not reflect the underlying economics of the contract to expense those costs when incurred. In addition, expensing acquisition costs as incurred would be inconsistent with the treatment of acquisition costs in other areas of U.S. GAAP.

BC175. The Board considered whether revenue should be recognized when acquisition costs are incurred (and expensed). The Board's 2007 Invitation to Comment proposed that an entity recognize acquisition costs as an expense when incurred and revenue at an amount equal to the portion of the premium that relates to recovering those acquisition costs. This approach would have reflected the notion that a portion of the premium charged to the policyholder relates to the acquisition costs incurred. The Board decided that an entity should not recognize revenue to offset the acquisition costs incurred (typically at the inception of a contract). This decision was based on the view that, consistent with the approach in Topic 606, an insurer should not recognize premium before it provides coverage because it has not satisfied any obligations to the policyholder at that time. In addition, it would be difficult to argue that the portion of premium from an individual contract is directly related to the acquisition costs incurred on that individual contract, given that the pricing of the premium does not fluctuate based on the amount of acquisition costs incurred.

BC176. The Board also considered whether to recognize the right to recover acquisition costs as an asset. Many existing accounting models measure insurance liabilities initially at the amount of the premium received, with deferral of acquisition costs, because the right to recover acquisition costs as a separate asset reflects the economics of an insurance contract. Under this view, acquisition costs are a proxy for the cost of a recognizable customer relationship intangible asset. This approach also is consistent with Topic 606 and guidance in other areas of existing U.S. GAAP. However, some Board members believe that recognizing a separate asset would overstate the insurer's liability and report as an asset a right that does not meet the definition of an asset, especially when it represents costs already paid. Therefore, the Board rejected recognizing the right to recover acquisition costs as an asset.

BC177. The Board also considered whether to view the acquisition costs as part of the fulfillment cash flows for contracts measured using the building block approach, which for this purpose is implicitly included in the liability for remaining

coverage for contracts measured using the premium allocation approach. This would be consistent with the approach proposed in the 2010 FASB Discussion Paper. However, some Board members expressed concerns about including expected acquisition costs to be paid in the same way as cash flows expected to be incurred to fulfill obligations to policyholders because the acquisition costs are not part of the contract between the entity and the policyholders. These Board members also noted that showing a reduction in the liability to fulfill the contract when acquisition costs, which are not part of the policyholder contract, are incurred, could be misleading to users of the financial statements.

BC178. The Board ultimately decided that expected qualifying acquisition costs should be included in the measurement of the margin for contracts measured using the building block approach. The Board decided this is appropriate because these costs are not related to an entity's obligation to the policyholder. Some Board members regard the cash flows relating to claims and benefits as economically different from the cash flows relating to acquisition costs and the margin. Those Board members asserted that there is a distinction between costs to fulfill the contract and costs to obtain a contract. In addition, some Board members noted that if all changes in the insurance liability are shown together (that is, changes in qualifying acquisition costs along with other changes expected in cash flows), users of financial statements cannot clearly determine if an entity changed assumptions about the insurance obligation itself or simply incurred acquisition costs. Therefore, the Board decided that when the acquisition costs are incurred, rather than recognizing an expense, an entity should reduce the margin, which represents a reduction in the expected profit that will be earned over time. If this approach is applied to the premium allocation approach, qualifying acquisition costs incurred would reduce the liability for remaining coverage because, for the premium allocation approach, the margin is implicit in the liability for remaining coverage.

BC179. The Board determined that if the present value of the qualifying acquisition costs that an entity expects to pay related to a portfolio of insurance contracts exceeds the margin on the portfolio, it should recognize an expense immediately in net income. This circumstance would indicate that the expected cash inflows are not sufficient to cover the expected cash outflows, including the acquisition costs. If that approach is applied to the premium allocation approach, expected acquisition costs would be included in determining whether a portfolio of contracts is onerous.

Building Block Approach—Specific Considerations

BC180. The proposed guidance states that an entity should measure an insurance contract in a way that portrays a current assessment of the insurance contract, based on the present value of the fulfillment cash flows and a margin, which at the inception of the contract reflects the expected profitability of the contract. This measurement approach is referred to as the building block approach.

BC181. This measurement approach reflects the objectives of the Board in measuring insurance contracts, including:

- a. Using current estimates of cash flows rather than carrying forward estimates made at contract inception (locked-in estimates)
- b. Using the expected value (probability-weighted mean) of future cash flows rather than a single, most likely outcome
- c. Reflecting the time value of money using interest rates based on observable market data
- d. Including a margin to eliminate any gain at initial contract recognition representing profit at risk, which is recognized as income as the insurer is released from risk.

BC182. These components should be used to measure the combination of rights and obligations arising from an insurance contract rather than to measure the rights separately from the obligations.

BC183. The measurement approach focuses on the fact that insurers generally fulfill their contracts directly over time by paying benefits and claims to policyholders.

Cash Flows That Arise from Participation Features That Depend on Underlying Items

BC184. Some cash flows depend on returns from underlying items. Underlying items may be assets, groups of assets and liabilities, or the performance of a portfolio (or blocks of portfolios) or the entity. In some cases, the contract gives a right to the policyholder to the returns from specified underlying items held and managed by the entity. The Board determined that if that right is contractual and is not based on the entity's discretion, the measurement of the fulfillment cash flows should be based on the measurement of the underlying item in the U.S. GAAP financial statements. However, the insurance contract may state that the entity's obligation is based on a measurement other than a U.S. GAAP measurement, such as U.S. statutory accounting principles. Therefore, when applying the general principles in this proposed Update, an entity would be required to measure its liabilities based on U.S. statutory accounting principles. Because the movement in the underlying item is required to be credited to the portfolio of policyholders regardless of the reason or timing of the movement, the Board notes that the difference between the two measurement bases is a timing difference that will reverse and enter into future calculations of participating benefits (that is, at the maturity of a financial instrument or the sale of the underlying item, both measurement bases will be the same). Therefore, the Board decided to make an exception to the general principles in this proposed Update and require entities to recognize an adjustment in their measurement of the liability to account for this timing difference and reflect the measurement of the underlying item in accordance with U.S. GAAP. The Board believes this can

be analogized to the accounting for deferred taxes under Topic 740 on income taxes, in which an entity adjusts its financial statements for temporary differences between the measurement of an entity's financial assets and liabilities on a tax basis and on a U.S. GAAP basis. The Board also notes that this approach is consistent with current U.S. GAAP.

BC185. However, if the entity's contractual obligation is not directly linked to the measurement of the underlying item in the U.S. GAAP financial statements and the difference will not reverse and enter into future calculations of participating benefits, the measurement of the fulfillment cash flows should reflect the entity's contractual obligation. The Board thinks it would be misleading to users of financial statements if the liability was measured at, for example, amortized cost, but the policyholder could demand payment at fair value of the underlying. This could be the case if the entity's contractual obligation is based on the fair value of the underlying.

BC186. Some cash flows are contractually linked to a segregated portfolio of assets (segregated fund arrangement). The Board considered whether these assets and the corresponding liabilities should be recorded in an entity's financial statements given that all of the risks and rewards of these assets and liabilities are passed through to the policyholders. The Board concluded that the account balances are liabilities of the entity because it is legally obligated to pay the policyholder, the obligation represented by the account balance arises from the creation of the insurance contract, and the amount of the liability can be reliably measured. In addition, the Board concluded that the investments that back an account balance are assets to the entity because it legally owns and controls such investments, the entity will at some point utilize such assets to settle the insurance liability, and such assets can generally be measured reliably.

BC187. The Board considered whether to retain existing U.S. GAAP guidance for segregated fund arrangements. Existing U.S. GAAP guidance requires specialized accounting for the portion of separate account assets representing policyholder funds if four conditions are met: (a) the separate account is recognized legally, (b) the separate account assets supporting the contract liabilities are insulated legally from the general account liabilities of the insurance entity, (c) the insurer must invest the policyholder's funds within the separate account as directed by the policyholder, and (d) all investment performance, net of contract fees and assessments, must be passed through to the individual policyholder. The Board noted that the first two conditions were not differentiating product features that should result in different measurement and presentation and, therefore, decided to only retain the latter two conditions. In addition, the first two conditions may or may not be allowed based on jurisdictional and regulatory rules. Therefore, including those conditions would result in different accounting for similar or identical contracts based solely on where the product is sold. The Board noted that this approach is consistent with the decision made in its project on investment companies that an entity could be, but is not required to be, a legal entity to be an investment company.

BC188. Existing U.S. GAAP guidance requires the portion of separate account assets representing policyholder funds to be measured at fair value initially and subsequently. The Board decided to retain this requirement for arrangements that meet the two specified conditions in paragraph 834-10-30-9. In making this decision, the Board considered the classification and measurement provisions in its proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. Assets held in a segregated fund arrangement are typically held to maximize investment yield for the risk profile. For these types of contracts, the asset duration is not typically a concern. Therefore, insurers typically sell the assets within the segregated funds. In addition, because the policyholder designates the entity's investment of its funds, which can be changed throughout the contract life and can be withdrawn at the policyholder's discretion (typically subject to surrender charges in the early years of the contract), the entity does not have the ability to hold financial assets to collect cash flows. The Board recognizes that an entity may have the objective of both holding financial assets to collect contractual cash flows and selling financial assets; however, an entity does not have discretion over when the assets are sold, although entities may pay policyholders with other funds and retain the assets. The Board also considered that all investments held by an investment company are required to be held at fair value through net income. The Board decided that the similarities between segregated fund arrangements and investment companies (that is, mutual funds) warrant the same accounting for the investments held.

BC189. The Board decided to expand the specialized accounting to an entity's proportionate interest in the segregated fund arrangements, which is generally a percentage of the segregated assets and not specific assets. The Board believes the reasons noted above apply equally to the entity's proportionate interest. The Board recognizes that this could cause diversity between an entity's accounting for real estate held in a segregated fund arrangement and real estate held by the general account, which is required to be held at amortized cost (unless held for sale). However, the Board decided that there should not be a different accounting treatment for the portion of an asset held by policyholders and the portion held by the entity.

BC190. Under existing U.S. GAAP, an insurance entity does not consider any separate account interests held for the benefit of policyholders in an investment to be the insurers' interests. Therefore, it does not combine those interests with its general account interest in the same investment when assessing the investment for consolidation unless the separate account interests are held for the benefit of a related party policyholder. In addition, an insurance entity does not 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. The Board decided that this accounting treatment is appropriate and should be expanded to reflect the

change in conditions to meet the requirements to obtain specialized accounting for segregated fund arrangements.

Cash Flows That Arise from Embedded Options and Guarantees

BC191. Many insurance contracts contain embedded options and guarantees. Depending on the characteristics of the option and guarantee, existing U.S. GAAP requires an entity to account for some embedded options and guarantees as derivatives and some based on a formula that has the effect of smoothing recognition in net income (sometimes referred to as the “glide path” method), and not to account for others.

BC192. The Board decided to retain the guidance for accounting for embedded derivatives, rather than creating an exception for insurance contracts from Subtopic 815-15 on embedded derivatives. Therefore, an entity should separate an embedded derivative from the host insurance contract in accordance with Subtopic 815-15 and should attribute cash flows to such embedded derivatives on a standalone basis. As such, the cash flows related to those embedded derivatives should not be included in the measurement of fulfillment cash flows.

BC193. For other options and guarantees, the Board considered the diversity in current accounting, users’ concerns about the lack of transparency of the expected effect on the financial statements from these features, and preparers’ concerns about accounting mismatches when hedging these features. The Board determined that these options and guarantees should be considered in the expected present value of the cash flows. Although some embedded options or guarantees have no “intrinsic value” because they are currently “out of the money,” there is a time value because they could be “in the money” at some point during the life of the contract. Because the expected present value approach considers all possible outcomes, it incorporates both the intrinsic value and time value of embedded options and guarantees. The Board decided that this more faithfully represents the economic substance of these guarantees and options.

Use of a Deposit Floor

BC194. Although scenarios including policyholder withdrawals would be included in estimating the expected contractual cash flows, the Board decided that no deposit floor or minimum liability should be used. The deposit floor is a term often used to describe the fair value of a financial liability with a demand feature (for example, a demand deposit). The deposit floor is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

BC195. If a deposit floor was applied in measuring insurance contracts, the resulting measurement would ignore all scenarios other than those that involve the exercise of policyholder options in the way that is least favorable to an entity. Such a requirement would contradict the fundamental proposal to incorporate future cash flows on a probability-weighted basis. Therefore, the proposed guidance would not apply a deposit floor in measuring insurance contracts. However, the Board decided that an entity should disclose the amount payable on demand in a way that highlights the relationship between such amounts and the carrying amount of the related contracts (see paragraph 834-10-50-12).

Margin

BC196. The Board determined that an entity should record a margin for the excess of the expected present value of cash inflows over the expected present value of cash outflows. The Board decided that an entity should not recognize a gain at the inception of a contract because it has not yet satisfied any of its performance obligations. In addition, the recognition of a gain at contract inception would be inconsistent with Topic 606.

BC197. In the Board's view, the margin represents the expected profit for an insurance contract at its inception. The premium charged for an insurance contract is priced to cover expected cash flows for policyholder claims and benefits, selling, operating, and maintenance expenses and to provide the entity with an adequate profit. That expected profit, in its entirety, is at risk because of the uncertainty in the expected cash flows (that is, the actual cash flows will not be the same as the expected cash flows). Therefore, the entity cannot reliably determine the ultimate profit to recognize until the risk that the contract is subject to has diminished. This is an important distinction because it establishes the two primary underpinnings for the margin approach:

- a. The entire amount of expected profit (the difference between expected cash inflows and outflows) is at risk.
- b. The risk that the actual profit differs from the initial expected profit is due to the uncertainty of the expected cash flows and, therefore, profit should be earned as the uncertainty in the expected cash flows is reduced.

BC198. The Board decided that an entity should recognize the margin as revenue, with the other consideration received, in net income as it satisfies its performance obligation to the policyholder, which occurs as it is released from exposure to risk. Furthermore, the Board determined that such a release from risk is evidenced by a reduction in the variability of cash outflows required to fulfill the contract.

BC199. In the Board's view, day one losses should be recognized immediately as an expense. The Board decided that recognizing a loss at inception is

appropriate if the amount expected to be paid by the policyholder is insufficient to cover the expected present value of the policyholder benefits and claims.

Alternative approach—risk adjustment and contractual service margin

BC200. The Board also considered the proposal in the 2013 IASB revised Exposure Draft, *Insurance Contracts*, which would require an entity to separately calculate and record a risk adjustment and a contractual service margin.

BC201. In the IASB's proposal, the risk adjustment represents the compensation that the entity requires for bearing the uncertainty in the amount and timing in the remaining cash flows. It reflects the point at which the insurer is indifferent between holding the insurance liability and a similar liability not subject to uncertainty. Thus, the risk adjustment is a measure of the compensation that the entity would require to make it indifferent between:

- a. Fulfilling an insurance contract liability that has a range of possible outcomes
- b. Fulfilling a fixed liability that has the same expected present value of cash flows as the insurance contract.

BC202. In determining the risk adjustment in accordance with the IASB's proposal, an entity would:

- a. Reflect all risks associated with a contract.
- b. Not reflect risks that do not arise from the insurance contract, such as investment risk (except when investment risk affects the amount of payments to policyholders), asset-liability mismatch risk, or general operational risk relating to future transactions.
- c. Consider both favorable and unfavorable outcomes in a way that reflects its degree of risk aversion.
- d. Reflect diversification benefits to the extent considered by an entity in assessing compensation required for bearing risk.
- e. Avoid duplicating adjustments for risk, for example, by including the risk adjustment implicitly in determining the estimates of future cash flows or the discount rates that adjust those cash flows for the time value of money. However, the estimates of future cash flows or the discount rates that adjust those cash flows for the time value of money should not implicitly include any adjustments for risk.
- f. Measure the risk adjustment using a technique that is consistent with the objective. The IASB included examples of risk adjustment techniques, including confidence levels, conditional tail expectation, and cost of capital; however, other techniques may be used.
- g. Remeasure the risk adjustment each reporting period and record any changes in net income in the period of the change.

- h. Disclose the methods used to calculate the risk adjustment and the confidence level equivalent.

BC203. Under the IASB's proposal, a contractual service margin would be recognized for the excess of the expected present value of cash inflows over the expected present value of cash outflows, plus a risk adjustment, to eliminate any gain at inception. Any loss on day one would be recognized as an expense immediately in net income.

BC204. Under the IASB's proposal, in each subsequent reporting period, an entity would:

- a. Adjust the contractual service margin to reflect favorable and unfavorable changes in the estimates of future cash flows used to measure the insurance liability.
- b. Recognize the contractual service margin over the coverage period in a systematic basis that is consistent with the pattern of transfer of services provided under the contract. Any adjustments to the contractual service margin from changes in the estimates of future cash flows should be reflected in subsequent recognition (that is, recognized prospectively).

BC205. The Board rejected the approach proposed by the IASB in its 2013 revised Exposure Draft that would require an entity to explicitly measure the risk adjustment, record a contractual service margin, and adjust the contractual service margin for changes in expected cash flows, primarily for the following reasons:

- a. The risk adjustment and contractual service margin both represent deferred profit. Splitting that deferred profit into two components would be arbitrary.
- b. Some Board members think that there is no well-defined approach that would meet the objective and provide consistency and comparability of results. In addition, some Board members do not believe that several of the methods discussed met the objective of the risk adjustment.
- c. Some Board members think that the risk adjustment introduces bias into the measurement because it is too subjective and would allow for income manipulation after contract inception.
- d. It may be difficult to assess management's ability to estimate the risk adjustment because it is not possible to perform direct back tests to determine whether the risk adjustment at a point in time was reasonable.
- e. Including a risk adjustment is more of a solvency concept, which may be helpful for regulators but may be inappropriate for general-purpose financial statements.
- f. Some Board members think the risk adjustment and contractual service margin approach is unnecessarily complex relative to the benefits that it would provide. These Board members think that it would result in

additional costs without a sufficient increase in decision usefulness or reliability. They also presume that the risk adjustment for many of the contracts that will be measured in accordance with the building block approach will not be significant to the overall measurement of the liability, especially given that it excludes investment risk. In contrast, although the risk adjustment may be significant on contracts measured using the premium allocation approach, the Board decided that the costs to determine the margin after the occurrence of an insured event for contracts measured using the premium allocation approach do not outweigh the benefits.

- g. The risk adjustment approach does not prescribe a unit of account and, therefore, could include multiple portfolios of dissimilar contracts. As such, some Board members do not believe diversification benefits should be included in the measurement of the risk adjustment or that the risk adjustment should be reduced because an entity writes more business or multiple lines of business.
- h. Adjusting the contractual service margin for both favorable and unfavorable changes in cash flow expectations would make the financial statements less transparent about these changes in estimates for the users and would result in smoothing of earnings.
- i. Some Board members feel that adjusting the contractual service margin for changes in cash flows is inconsistent with the reason for having a risk adjustment. They believe that if the margin should be adjusted for any cash flows, it should be adjusted for changes in the risk adjustment. As noted, the risk adjustment represents the compensation the entity requires to bear the risk that the cash flows could exceed those expected, less an amount for diversification benefit. Some Board members would argue that changes in cash flows were anticipated based on using a risk adjustment. Therefore, it potentially would be more reasonable to offset those changes against the risk adjustment. For example, as expected cash outflows increase, the risk adjustment decreases because that change was reflected in the initial risk adjustment (that is, that change was already included in the reserve in the initial risk adjustment). However, if the change in expected cash flows is recorded against the contractual service margin, the only effect in net income would be a release of the risk adjustment, which is reflected as revenue. Some Board members viewed recognizing revenue when the insurer expects greater expected cash outflows as counterintuitive.

Premium Allocation Approach—Specific Considerations

Liability for remaining coverage

BC206. For insurance contracts that meet either criterion in paragraph 834-10-25-18, at initial recognition an entity should measure the liability for remaining coverage as the premiums that are within the boundary of the existing contract and should recognize a receivable for those expected premiums. While the premium receivable is affected by cash receipts, an unearned premium approach should be applied to the liability for remaining coverage.

BC207. The Board decided that contracts measured using the premium allocation approach should be measured using an unearned premium approach. Such an approach is broadly consistent with the customer consideration approach proposed in the forthcoming Topic 606. The assumption underlying the approach is that the liability for remaining coverage represents the entity's stand ready obligation. At contract inception, a liability for incurred claims would not be recognized because that should represent the entity's obligation to pay an amount for a claim that has been incurred.

BC208. The Board observes that the premium allocation approach is similar to the accounting model for short-duration insurance contracts in Topic 944 and is similar to the model used in several countries for short-duration insurance contracts. The existing U.S. GAAP approach recognizes revenue over the coverage period (on a straight-line basis over the coverage period of the contract or in proportion to the amount of insurance coverage provided, if different) and recognizes claims as incurred (that is, a liability is only recognized when an insured event has occurred). The premium allocation approach is based on this approach and does not require an entity to update assumptions for the liability for remaining coverage (preclaims) each period and does not require the entity to perform other more complex requirements of the building block approach. The Board decided that this accounting continues to be appropriate for contracts that meet the criteria to apply the premium allocation approach.

BC209. The Board clarified that an entity should not consider expected changes in coverage (for example, policyholder cancellations) in the measurement of the liability for remaining coverage. The Board views an expected change in coverage as a modification that would require an entity to either derecognize the portion of its obligation when the event occurs or to recognize the additional coverage, and the amounts related to that coverage, in the same manner as that of the initial recognition of an insurance contract. The Board did not see the benefit of having an entity track expected changes in coverage to update the measurement of the liability when it would be offset by an allowance for the premiums receivable, if any, or a contingent liability for the portion of premiums that would need to be repaid to the policyholder if it cancelled. In addition, if expected changes in coverage were included in the measurement, entities would

need to update their assumptions at each reporting period. The Board determined that the additional complexities and costs of including these expected changes in coverage in the cash flows do not outweigh the benefits.

Onerous test

BC210. An onerous contract is usually understood to mean a contract in which the future costs of fulfilling the contract are expected to exceed the premiums expected to arise from that contract. The measurement approach in the proposed guidance is consistent with that notion. A contract is onerous when the present value of expected costs to fulfill the portfolio of contracts for which premium has not yet been recognized (that is, the unexpired portion of coverage) plus the expected qualifying acquisition costs exceed the liability for remaining coverage. The onerous test does not consider the premiums already recognized as revenue as those are deemed to be related to insurance that has been provided, the liability for which is recognized at a current measurement in the liability for incurred claims.

BC211. The 2010 Discussion Paper proposed that for contracts measured using the premium allocation approach, during the coverage period, the onerous test should be performed each reporting period. That would have resulted in an entity updating expected cash flow assumptions for the measurement of the liability for remaining coverage each reporting period, which would conflict with the Board's decision that the assumptions used in the measurement of the liability for remaining coverage should not be updated (unless an onerous determination is made). Some Board members noted that requiring the test to be performed at each reporting period would be burdensome, and onerous contracts are relatively rare.

BC212. The Board rejected that proposal and, instead, determined that an entity should perform an onerous contract test if facts and circumstances indicate that a portfolio of insurance contracts may be onerous. That approach would alleviate the need to monitor individual contracts before the coverage period begins and to perform a measurement of the expected cash flows using current assumptions when there is an assumption that the expected cash flows have not changed in the coverage period. Therefore, the benefits would not outweigh the costs.

BC213. In addition, the Board's inclusion of a qualitative test is similar to qualitative tests using factors or indicators to determine when an asset impairment test needs to be performed in other U.S. GAAP. The Board felt that determining whether a portfolio of insurance contracts is onerous can be analogized to the impairment of assets. That is, there are numerous factors to be considered in an impairment evaluation and the relative significance of the factors will vary from case to case.

BC214. Other guidance in U.S. GAAP requires an annual impairment test regardless of qualitative indicators of impairment. However, the Board decided

that because of the nature of the types of contracts that would be eligible for the premium allocation approach, an annual impairment test should not be required. The Board did, however, prefer to include implementation guidance on when facts and circumstances may indicate a portfolio of insurance contracts is onerous (see paragraphs 834-10-55-132 through 55-136).

BC215. The Board considered whether to require an entity to update the measurement of the additional liability at the end of each reporting period and reverse it to the extent that the insurance contract is no longer onerous. However, consistent with the initial recognition of the additional liability, an entity should only update the measurement if qualitative factors indicate that there potentially could be a change in the liability.

Time value of money

BC216. The Board considered whether the liability for remaining coverage should reflect the time value of money. Respondents to the 2010 FASB Discussion Paper contended that this would overcomplicate the proposed guidance. The Board considered (a) that entities do not necessarily explicitly charge a different premium if the policyholder pays up front or over time, (b) the system implementation challenges of including the time value of money, and (c) the effect on the financial statements.

BC217. The Board concluded that the time value of money should be incorporated into the measurement of the liability for remaining coverage when significant. Users of financial statements are not indifferent to the timing of cash flows. Thus, the Board felt that to measure an insurance liability with a significant financing component using undiscounted cash flows and not accrete interest on that liability would not faithfully represent the insurer's financial position and would be less relevant to users. In addition, the Board decided not to exempt entities from accounting for the time value of money effect of advance payments because ignoring this effect could substantially skew the amount and pattern of profit recognition if the advance payment is large and occurs well in advance of the transfer of the services to the customer.

BC218. The Board thinks that if the entity discounts and accretes interest on the liability for remaining coverage, the amount of revenue recognized when the insurer's performance obligation is satisfied would reflect the "cash selling price" of the underlying insurance service at the time the service is performed. This is consistent with Topic 606. However, the Board considered whether a practical expedient could alleviate some of the concerns.

BC219. The Board considered a practical expedient such that an entity would not have to discount the liability for remaining coverage for contracts with coverage periods of less than one year. This could produce arbitrary outcomes, for example, the time value of money could be material if a short-term contract has a high implicit interest rate. Also, this approach could result in inconsistent

application of discounting between two contracts measured using the premium allocation approach. For example, a contract with a coverage period of 18 months would be required to be discounted if the contract contains a significant financing component, whereas a similar contract with a coverage period of one year would not be required to discount, regardless of when the policyholder paid the premiums.

BC220. The Board decided that an entity need not adjust the liability for remaining coverage to reflect the time value of money if the entity expects, at contract inception, that the time period between when the policyholder pays all or substantially all of the premium and when the entity provides the corresponding coverage is one year or less. For example, an entity would not be required to adjust the liability for remaining coverage for a three-year surety contract if the policyholder is expected to pay premiums at the beginning of each of the three years in an amount that corresponds to the coverage for the upcoming year. However, if the policyholder is expected to pay all or substantially all of the premiums at the beginning of the three years, the entity would not qualify for the practical expedient and would need to reflect the time value of money in the measurement of the liability. The time period of one year or less suggests that the entity is not receiving meaningful additional financing fees from policyholders.

BC221. The Board decided that the liability for remaining coverage should be discounted using the discount rates specified in the proposed guidance (see paragraphs 834-10-30-11 through 30-13) as determined at initial contract recognition. This is consistent with the “locked-in” nature of the liability for remaining coverage because the other assumptions used to measure the liability for remaining coverage are based on those used at inception of the contract. The Board also noted that using the rates determined at contract inception is consistent with the fixed price nature of contracts measured using the premium allocation approach, which effectively locks in a contract price and payment terms. The Board thinks that depicting interest expense using the rates at inception in these cases is a better reflection of the “implicit” interest that has been considered in pricing the payment alternatives. This is consistent with revenue recognition concepts for which the Board decided that an entity should reflect in the measurement of the transaction price only the discount rate that is implicit in the contract at inception.

Reinsurance Contracts

BC222. The Board determined that a cedant should measure a reinsurance contract at initial recognition as the fulfillment cash flows (the expected present value of the cedant’s future cash inflows less the expected present value of the cedant’s future cash outflows that will arise as parties fulfill the reinsurance contract, adjusted for the time value of money). Because the fulfillment cash flows can be viewed as the reinsurer’s share of the expected present value of the cash flows generated by the underlying insurance contracts, the Board decided that a cedant should estimate the fulfillment cash flows, including the ceded

premium and the ceded losses, for a reinsurance contract using assumptions consistent with those used to measure the corresponding part of the fulfillment cash flows for the underlying insurance contract or contracts based on the terms of the reinsurance contract.

BC223. However, the cedant is exposed to the risk of the reinsurer defaulting on its obligation. This risk is similar to the risk of general creditors and bondholders. The Board considered how an impairment model might work in the context of reinsurance contracts and considered the effect of an expected loss model on measuring the risk of nonperformance by a reinsurer. The Board determined that a separate impairment model for insurance contracts was not necessary. The Board decided that the proposed guidance on recognizing an impairment allowance for the risk of nonperformance by the reinsurer should be aligned with proposed Subtopic 825-15 on financial instruments—credit losses, rather than developing impairment guidance specific to insurance. This would require an entity to determine expected default measures for its reinsurers. The Board observes that many entities already apply this approach under existing U.S. GAAP.

BC224. The cedant also is exposed to the risk that the reinsurer disputes its payable to the cedant. The Board does not believe that an entity can apply an expected loss model to disputes and, instead, concluded that an allowance for disputes should be established based on current facts and circumstances. To avoid double counting, the Board decided that the amount of the reinsurance recoverable related to an allowance for disputes should not be included in determining the cedant's current expected credit losses calculated in accordance with proposed Subtopic 825-15.

BC225. The Board decided that regardless of whether the reinsurance contract provides coverage for future (that is, prospective) or past (that is, retroactive) events, upon the recognition of a reinsurance contract, a cedant should not recognize an immediate gain, which is consistent with the notion of no immediate gain when entering into an insurance contract. Some stakeholders, and specifically some reinsurers, stated that it would be appropriate to recognize the effects of reinsurance in income immediately, referring to reinsurance as a sale or a form of extinguishment of debt. Some of these stakeholders also stated that when the ceding entity has been indemnified against loss or liability relating to insurance risk, sufficient risk has been transferred to the reinsurer to result in immediate recognition. However, in the Board's view, immediate recognition is not appropriate unless an extinguishment has taken place. The conditions necessary for indemnification against insurance risk are considerably less stringent than those required for extinguishment, which occurs only when the ceding entity has been entirely relieved of its obligations to the policyholder. In addition, uncertainty in the measurement of the expected cash flows of the underlying still remains and ultimately could affect whether and how much of a gain will be recognized by the cedant.

BC226. The Board decided that a cedant should account for reinsurance contracts using the same approach that the cedant uses to account for the underlying insurance contracts. Therefore, for prospective reinsurance contracts in which the underlying insurance contracts are measured using the building block approach, the cedant should recognize a separate margin, whereas no separate margin should be recognized when the underlying insurance contracts are measured using the premium allocation approach as that implicit margin is included in the liability for remaining coverage for the underlying insurance contracts being ceded. However, for retrospective reinsurance contracts in which the entity expects a gain regardless of the approach used to measure the underlying insurance contracts, the Board decided that a margin should be recognized. This is because under the premium allocation approach, the liability being ceded is the liability for incurred claims, which is measured based on the expected cash flows without any margin. Therefore, to not recognize an initial gain when entering into a retrospective reinsurance contract, a margin should be recognized.

BC227. The Board decided that the margin on reinsurance contracts should be calculated independently of the margin on the underlying business. Except in certain reinsurance structures, such as quota share arrangements, the pricing of the reinsurance contract is not directly linked to the pricing of the underlying contracts. Therefore, the Board decided that the margin, which represents the expected future profit of the reinsurance contract, should be measured based on the excess of the expected present value of cash inflows over the expected present value of cash outflows of the reinsurance contract.

BC228. The Board also decided to recognize losses immediately in net income relating to reinsurance of past events, which is consistent with the accounting for the underlying contracts in this proposed Update. If the amount the cedant paid to the reinsurer for retroactive reinsurance exceeds the recognized liabilities relating to the underlying contracts, this circumstance may result from significant risk of future adverse development on the underlying contracts or may indicate that the underlying contracts' liabilities are understated. One view is that amounts in excess of the recognized liabilities should be recognized as an asset to the extent that they represent protection against future adverse development. However, some Board members noted that when losses arise from retroactive transactions, the reinsured events have already occurred and the coverage period for the underlying contracts has passed. Therefore, the nature of the risks assumed by the reinsurer is fundamentally different when an insured event has already occurred. The uncertainty that is being reinsured is the estimation of the liabilities relating to those past events, and the amount paid to the reinsurer in excess of the recorded liabilities may be viewed as representing at least the minimum liability that should be accrued. Otherwise, the amount does not reflect anticipated future recoveries from the reinsurer and should not be recognized as an asset. Accordingly, the Board concluded that amounts paid for retroactive

reinsurance in excess of recorded liabilities should be charged to expense at the inception of the reinsurance contract.

BC229. The Board decided to defer amounts paid in excess of fulfillment cash inflows for prospective reinsurance coverage. The Board views the amounts deferred relating to prospective coverage as equivalent to prepaid insurance premiums that should be recognized over the contract coverage period with the total cost of reinsurance.

BC230. The Board noted that the decisions about the deferral of a day one gain, the recognition of a loss for retrospective contracts, and the recognition of an expected loss for prospective contracts over the coverage period are consistent with existing U.S. GAAP.

BC231. The Board believes that cash flows that are not contingent on claims or benefits experience, as in the case of typical ceding commissions, overrides for operating expenses (general and administrative expenses such as taxes, licenses, and fees), and profit factors, should be treated as a reduction of the premium ceded to the reinsurer. There are a variety of structures that may or may not explicitly state the purpose of the fee. In existing U.S. GAAP, an entity typically reduces deferred acquisition costs (asset) for the ceding commissions, to the extent that the commissions represent reimbursement of acquisition costs. However, overrides for expenses, which may be separate or a portion of the ceding commission, are reported against the operating expenses. The Board views ceding commissions and other fees paid by the assuming entity to the cedant as economically part of the ceded premiums and inherent in the pricing of the reinsurance contract. Because the premium ceded to the reinsurer and the ceding commission and other fees received from the reinsurer are both part of the same contract (that is, in substance, one net amount is due to/from the reinsurer), the amounts should be combined into one net premium ceded amount. The Board also observed that the variety of types and structures of reinsurance contracts could lead to different accounting treatment if ceding commissions are not treated as a reduction of the premium ceded to the reinsurer, which is what occurs under existing accounting.

BC232. Consistent with the cedant's accounting and based on the Board's reasoning described in paragraph BC231, the Board believes that an assuming entity should treat cash flows that are not contingent on claims or benefits experience, as in the case of typical ceding commissions, overrides for operating expenses (general and administrative expenses such as taxes, licenses, and fees), and profit factors, as a reduction of the premium assumed from the cedant. Unlike direct insurance contracts written in which the insurer's obligation to pay acquisition costs is separate from the insurance contract itself, a reinsurance contract includes the reinsurer's obligation to pay these acquisition costs to the cedant. Therefore, this approach is consistent with excluding estimated returnable amounts from revenue. In most contracts, the cash flows received from the cedant are net of these acquisition costs.

BC233. There is diversity in current practice for the accounting for cash flows that are contingent on claims or benefits experience (often referred to as loss sensitive features). An example of a loss sensitive feature is a sliding scale commission, that is, a commission that is based on the claims or loss experience of the entity. For example, in a reinsurance contract, the commission paid to the cedant by the reinsurer decreases as the underlying losses that the cedant passes on to the reinsurer increases. Some entities recognize such adjustments to premiums ceded or commissions received while other entities account for these adjustments directly through benefits and claims. The Board noted that requiring a cedant to pay additional premiums and/or receive lower commissions to recover a higher amount related to losses is economically equivalent to the cedant recovering a lower amount related to losses. Therefore, the Board decided that cash flows that are contingent on claims or benefits experience should be treated as part of the claims and benefits cash flows, rather than as part of the premiums, if those amounts are not included in the estimated returnable amount (that is, amounts that will be returned to the cedant regardless of whether an insured event occurs). The Board noted that this would establish a uniform accounting treatment for these features.

BC234. The Board contrasted loss sensitive features to those in which a cedant has a unilateral right to pay additional premium for additional future coverage. The Board determined that such premium adjustments would be treated in the same way as other changes in premium estimates because the additional premium is paid for additional coverage, which distinguishes it from the additional premium being paid for past coverage.

BC235. The Board considered specific U.S. GAAP guidance that was developed to address perceived abuses related to reinsurance contracts including risk transfer, retroactive reinsurance, multiyear retrospectively rated contracts, and others, all of which are mostly related to reinsurance of short-duration contracts. The Board observed that discounting the liability for incurred claims would mitigate or eliminate opportunities to circumvent the intent of existing U.S. GAAP guidance. In addition, the Board clarified that all contractual features within the contract boundary should be included in the expected cash flow measurement, thus eliminating the perceived benefits of various contract structuring.

Insurance Contracts Acquired in a Business Combination or Portfolio Transfer

BC236. The Board noted that insurance contracts acquired through a combination of entities or businesses under common control should apply the guidance in Subtopic 805-10, Business Combinations—Overall. The Board considered whether any special guidance was required beyond that already described in U.S. GAAP for business combinations that involve insurance contracts. The Board decided on an approach that would be consistent with business combination guidance that requires an insurer to measure the fair value

of the insurance liabilities assumed and insurance assets acquired. The components of that fair value would then be allocated as follows:

- a. The expected net cash flows, measured using current assumptions, and using the discount rates determined at the acquisition date
- b. The margin, measured as the difference between the fair value of the insurance contracts assumed and the expected net cash flows determined in (a).

BC237. The Board acknowledged that the fair value attributed to the insurance contracts could be thought of as the hypothetical premium received by the acquirer for assuming the insurance contracts and, therefore, recognizing a margin for a day one gain is consistent with the treatment in the proposed guidance for direct contracts written. The Board also decided that the discount rates at the acquisition date (determined consistent with the insurance contracts model) should be the interest accretion rates because those are the entity's initial recognition rates.

BC238. The Board also determined that an entity should recognize a loss if the measurement of the portfolio of liabilities in accordance with the proposed guidance exceeds the fair value of the portfolio of liabilities. Under existing U.S. GAAP, entities record a "negative intangible," which is sometimes referred to as negative value of business acquired, which is recognized in net income using the same assumptions used in measuring the liability for future policyholder benefits or in proportion to the recognition of estimated gross profits.

BC239. The Board considered what would cause the present value of the fulfillment cash flows to exceed the fair value of the portfolio of insurance contracts acquired in a business combination. The most likely cause is the fact that the fair value measurement requires an entity to include risk premium, most likely in the discount rates, reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows. However, the present value of the fulfillment cash flows does not consider the risk of nonperformance by the entity. Therefore, in most situations the discount rates used in determining the fair value of the insurance contracts in accordance with Topic 805 would be higher than those used in the measurement of the fulfillment cash flows under this proposed Update, resulting in fair value being lower than the fulfillment value. Another reason that the present value of the fulfillment cash flows would exceed the fair value of the portfolio of insurance contracts acquired in a business combination is that the acquirer is willing to take fewer assets from the acquiree because it expects additional cash inflows from policyholders (outside of the boundary of the contracts being measured), profit on the contracts, and a spread on the investments acquired. The Board concluded that the immediate recognition of a loss in such circumstances faithfully represents the fact that the entity has acquired an obligation that it expects to fulfill but received a lower premium to do so.

BC240. The Board considered whether the difference generated by using different discount rates for determining the fair value of the portfolio of contracts and the measurement of the liability should be recognized as an implicit acquisition cost. However, the Board noted that this difference would not reflect costs the acquirer paid to acquire the contracts and, thus, would not faithfully represent the costs of the actual transaction. The Board's decision also was influenced by its decision that ceding commissions and other fees transferred between a cedant and a reinsurer should be part of the ceded premium and not recognized as an acquisition cost, which can be analogized with possible implied acquisition costs in a business combination. In addition, the Board decided that this would add a complexity to the model that did not outweigh the benefits.

BC241. The Board acknowledged that this is inconsistent with Topic 805 on business combinations, which requires an entity to adjust goodwill for the difference between the measurement of assets and liabilities that are precluded from being recognized at fair value and those assets and liabilities that are recognized at fair value. Several Board members noted the inconsistency with Topic 805 in recognizing a margin for a day one gain instead of affecting goodwill and that adjusting goodwill only when there is a loss is inappropriate. These Board members noted that this decision is consistent with the measurement of insurance contracts that are obtained directly by the entity, assumed in a reinsurance transaction, or assumed in a portfolio transfer and placed more weight on creating consistency within the guidance in this proposed Update than on creating consistency with other existing U.S. GAAP.

BC242. The Board also concluded that insurance contracts acquired in a portfolio transfer that do not meet the criteria in Topic 805 to be considered a business combination should be accounted for in accordance with the guidance in this proposed Update. Respondents to the 2010 FASB Discussion Paper commented that portfolio transfers are economically similar to acquisitions from a business combination and should be accounted for similarly. The Board agrees with this but does not think that goodwill should be recognized for transactions other than those transactions to which Topic 805 applies. However, the guidance in this proposed Update would result in similar accounting for insurance contracts acquired in a business combination, a portfolio transfer, or directly by the insurer.

Subsequent Measurement

Cash Flows Based on Current Estimates

BC243. The Board proposes that estimates of cash flows should be based on current information and updated at the end of every reporting period rather than carrying forward estimates made at contract inception (that is, locked-in estimates). The inputs used to determine these estimates should be consistent with observable market data, if available.

BC244. This is consistent with existing U.S. GAAP guidance for specific types of contracts; however, for traditional long-duration contracts, entities make estimates at inception of the contract and use the same estimates throughout the life of the contract. Although a loss recognition test is performed, the measurement of the liability is updated only if management determines that the expected cash outflows of a portfolio of insurance contracts will exceed the expected cash inflows. The Board believes that using current estimates would:

- a. Give a more faithful representation of an entity's contractual obligations and rights and convey more useful information about the amounts, timing, and uncertainty of the cash flows generated by those obligations and rights. Given the uncertainty associated with insurance liabilities and the long duration of many insurance contracts, current information about the amount, timing, and uncertainty of cash flows is particularly relevant for users.
- b. Incorporate all available information in the measurement thus avoiding the need for a separate test to ensure that the liability is not understated (that is, a "loss recognition" or "liability adequacy test") other than during the coverage period for contracts measured using the premium allocation approach (that is, the onerous contract test for the liability for remaining coverage).
- c. Be consistent with other areas of U.S. GAAP, including the measurement of most financial instruments under Topic 825, Financial Instruments, and the measurement of contingencies under Topic 450, Contingencies, which requires a best estimate. In addition, this would be consistent with proposed Subtopic 825-10 on credit losses.

BC245. To provide transparency to the users of the financial statements, the Board determined that changes in the fulfillment cash flows should be recognized in net income when the expectation is changed, rather than offsetting such amounts against the margin for contracts measured using the building block approach (see paragraph 834-10-35-3) or the liability for remaining coverage for contracts measured using the premium allocation approach when a portfolio of contracts is deemed onerous.

Discretionary Participation Features Based on Performance of the Entity

BC246. The Board decided that the measurement of the fulfillment cash flows for a contractual participation feature that includes discretionary elements should reflect an entity's expectations of the timing and amount of discretionary payments to a portfolio of policyholders. The Board considered how this decision relates to mutual insurers that issue participating contracts in which policyholders are eligible to receive dividends once declared by the entity.

BC247. Some Board members suggested that the liability for policyholder dividends should only be recognized when it is declared because, before that

time, if the entity has discretion in declaring a dividend, the dividend does not meet the definition of a liability. This would be similar to the treatment for the accounting for dividends paid to shareholders of a public entity. In addition, several Board members were concerned that the entity's results could be manipulated by changing expectations of dividends to be paid but not yet declared. However, this approach would not be consistent with the proposed model because it uses an expected value approach that includes future expectations of net cash flows. Excluding the expected dividends could overstate equity until the dividends are declared and misstate income.

BC248. The Board views the discretionary participation feature to receive dividends based on the performance of an entity in the same manner as other discretionary participation features that are measured based on the present value of expected cash flows. That expectation should be remeasured each period and the amounts related to the expected dividends should be disclosed in the notes.

BC249. In the 2013 revised Exposure Draft, the IASB concluded that the measurement of the fulfillment cash flows for a discretionary participation feature that provides policyholders with the right to participate in the surplus of the entity should include the relevant remaining surplus of the entity. That is because the IASB believes that all relevant surplus is eventually required to be returned to policyholders over the long term. Under the IASB's model, these amounts should be included in expected cash outflows in the liability to policyholders and not be disaggregated from other expected cash outflows. This means that there would be no profit or equity reported in any accounting period for mutual insurers that are entirely owned by their policyholders.

BC250. The Board disagrees with this accounting treatment. Similar to all other entities, mutual insurers retain an appropriate amount of surplus for future expenditures that are not currently recognized as liabilities or that qualify as fulfillment cash flows, for example, future period costs, unforeseen risks, and jurisdictional minimum capital requirements. Therefore, there is no obligation or intention to pay out all of the mutual insurers net performance or "notional surplus" to policyholders. The Board also considered the following in reaching this conclusion:

- a. Recognizing the net performance of the insurer as part of the insurance contract liability does not provide useful information to users of the mutual insurer's financial statements regarding its underwriting and investment performance.
- b. Insurance contracts issued by insurers that are not mutual insurers in many instances are virtually identical to the eligible participating insurance contracts issued by mutual insurers.
- c. If one were to assume that the mutual insurer operated into infinity, there would be a surplus unless the insurer voluntarily decided to change its structure, or to stop selling insurance, or to cease being a going concern.

Time Value of Money

BC251. The Board decided that changes in the fulfillment cash flows due to changes in the discount rates should be recognized in other comprehensive income.

BC252. Many respondents to the 2010 FASB Discussion Paper were concerned that gains and losses from underwriting and investing activities would be obscured by more volatile, potentially larger, gains and losses that arise when there are changes in the discount rates applied to the cash flows that arise from insurance contracts. In contracts in which the amounts paid to the policyholder are fixed or otherwise not dependent on the performance of underlying items, gains and losses arising from changes in the discount rates do not affect the ultimate amount paid to policyholders because the effects of discounting future cash flows reverses over time until the entity fulfills the liability. In contrast, changes in estimates from underwriting, such as changes in mortality assumptions, lapse assumptions, and assumptions about the frequency and severity of claims, would affect the amount paid to policyholders when the contract is settled.

BC253. To better segregate the effect of changes in cash flow estimates from underwriting from the effects of changes in discount rates, the Board decided that an entity should recognize (a) in net income, the interest expense determined using the discount rates at inception of the contracts and (b) in other comprehensive income, the effect of changes in discount rates. In the Board's view, that would provide users of financial statements with information about the time value of money that the entity assumed at inception of the contract while highlighting current changes in value that arise from underwriting and investing performance.

BC254. An entity would recognize in total comprehensive income the change in the insurance contract liability for the reporting period, determined by discounting the cash flows using the current discount rates that apply at the end of the period. The amount recognized in other comprehensive income would be the difference between the effects of discounting the cash flows at current rates at the end of the period and the effects of discounting those cash flows at the discount rates at inception of the contract. That would mean that the entity would report a current view of performance in total comprehensive income. However, total comprehensive income would be subdivided to report, in net income, the performance of the contracts based on the discount rates that applied when the contracts were issued.

BC255. For contracts with discretionary participating features in which the amounts expected to be paid to the policyholder are dependent on the expected crediting rate, the Board decided that the interest accretion rates should be adjusted upon any change in expectations of a crediting rate that will affect the measurement of the insurance contract liability. That is based on the fact that

movements in interest rates can affect the cash flows of universal life and other asset-affected contracts. It also is based on the notion that presenting interest expense based on rates locked in at the inception of such a contract would be inconsistent with the variable rate nature of the amounts “borrowed” by the insurer under the contract. These contracts have similar economic features to floating rate interest payments on amounts borrowed by the entity. Because those payments vary with changes in interest rates, portraying the interest expense as if it resulted from fixed rate financing would be inconsistent with the objective of recognizing in other comprehensive income changes that reverse when the contract is settled.

BC256. The Board determined that the interest accretion rates should be adjusted to recognize any changes in estimated interest crediting and related expected cash flows. The Board concluded that the adjustment to the interest accretion rates should result in the recognition of interest expense on a level-yield basis over the remaining life of the portfolio of contracts. The degree to which the interest accretion rates for the portfolio are adjusted should reflect the relative value of the account balances to be credited and the extent to which the change in expected interest crediting rates for the portfolio related to the changes in expected asset returns to that portfolio affect the present value of expected cash flows of those account balances. The Board decided that resetting the interest accretion rates to rates that reflect the estimated remaining interest expense is necessary to ensure the total interest expense recognized over the life of the contracts are accurately portrayed. However, the degree to which entities adjust the locked-in interest accretion rates should reflect the extent of change in amounts expected to be paid to the policyholder as interest. Therefore, the adjustment should be a function of the expectations of the crediting rate and reflect the relative value of the account balance to be credited as compared to the total obligation (that is, if only a portion of the liability is affected by any crediting rate changes).

BC257. That general conclusion does not apply to cash flows that arise from participation features that give a right to policyholders to receive the performance of an underlying item when that right is contractual and does not allow an entity discretion regarding the amounts paid. The Board decided that, depending on the entity's obligation, interest expense on the fulfillment cash flows or the adjustment to the fulfillment cash flows may be presented on (a) a consistent basis with the equivalent investment income on the underlying items (that is, in other comprehensive income or net income) or (b) a consistent basis with all other changes in the measurement of the fulfillment cash flows (that is, in net income). See paragraphs 834-10-35-6 through 35-10.

BC258. The Board considered whether changes in the fulfillment cash flows that arise from changes in interest sensitive assumptions also should be recognized in other comprehensive income. There are a myriad of factors that influence the timing and amount of the expected cash flows of an insurer. The Board recognizes that some of those factors are sensitive to changes in interest rates

because of contractual features, behavioral elements, or the market. For example, assumptions about interest rate guarantees and options are sensitive to interest rate movements as are lapses and annuitization rates for certain products. However, there is not necessarily a causal relationship between changes in interest rates and changes in interest-sensitive assumptions. In addition, although the change in assumptions may be short term (for example, the assumptions will change as interest rates change), the change indicates the increased exposure the insurer bears at that time, which may not reverse over time. Therefore, the Board rejected the notion of including changes in the fulfillment cash flows that arise from changes in interest-sensitive assumptions in other comprehensive income.

BC259. Instead, the Board believes that reporting the effect of changes in the fulfillment cash flows from interest-rate-sensitive assumptions in net income is the most understandable and transparent way to report the changes. In addition, for options and guarantees that are part of the fulfillment cash flows, this approach is consistent with the treatment of all freestanding derivatives.

BC260. The Board considered whether a loss recognition test was needed in light of the fact that under the proposed guidance as a result of the approach included in paragraph 834-10-35-24, the net income would not reflect the value of the liability using the current discount rates. That could potentially delay losses in net income in situations in which asset returns are lower than expected because an entity may record a negative interest margin. Without that loss recognition test, the negative spread would appear in the income statement as interest expense (calculated at the rates that existed at contract inception) and interest income (generally based on the interest rate environment existing at the date of asset acquisition) would be recognized over the remaining life of the contracts. Some believe that those losses should be reported immediately in net income in the period in which the entity changes its assumptions that trigger an expectation that the assets backing the liability are insufficient to fund the liability. Some Board members argued that without loss recognition, the retained earnings distributable to shareholders would be overstated.

BC261. Some Board members had concerns about requiring a loss recognition test. Those Board members noted that a loss recognition test was inconsistent with the approach included in paragraph 834-10-35-5 to recognize changes in the insurance liability arising from changes in the discount rates to other comprehensive income. Others suggested that measurement of an insurance entity's assets should be separate from the measurement of its liabilities, and that in other areas of U.S. GAAP such a test is not required. For example, a financial institution would not record a loss if its financial liabilities have contractual yields that exceed its asset returns. The Board noted that accelerating the recognition of losses from other comprehensive income would not provide neutral information because it would treat gains and losses differently, and the interest expense in net income would be a combination of "historical" and "current" discount rates. In addition, that approach would require

an entity to designate its assets to portfolios of insurance contracts, which is not performed in current practice for some entities, specifically nonlife insurers and noninsurance regulated entities. Therefore, this approach could add complexity to the model.

BC262. Ultimately, the Board decided that inclusion of a loss recognition test was inconsistent with the approach in this proposed Update to measure changes in the insurance liability arising from changes in the discount rates to other comprehensive income.

Other Alternatives Considered to Reflect the Time Value of Money

BC263. The Board considered determining the interest accretion rates using the “current portfolio book yield” of underlying assets that back the insurance contract liability. The current portfolio book yield consists of:

- a. The asset rates that are reported in net income. It is the market yield for assets measured at fair value through net income and an amortized cost-basis yield for assets measured at amortized cost or at fair value through other comprehensive income; plus
- b. Adjustments for expected/unexpected defaults and expected reinvestment rates when assets and liabilities do not match.

BC264. The Board rejected this approach for the following reasons:

- a. The current portfolio book yield differs from the discount rates that reflect the characteristics of the cash flows from the insurance contracts. The Board decided that presenting interest expense in net income using discount rates with no relationship to the rates used to measure the insurance contract liability would not provide useful information.
- b. Changes in the book yield will not necessarily trigger a change in the interest credited to policyholders. Reporting changes in the interest expense that are unrelated to changes in the measurement of the insurance contract liability would be difficult for users of financial statements to understand.
- c. The amount of interest expense cumulatively recognized might not equal the amount of discount actually unwound on the liability. That is because the amount of interest expense is a function of the accounting basis for the underlying assets. For example, when market rates change after the assets are recognized but before the insurance contract is recognized, the initial investment income would be based on a book yield that may differ from the rates used to discount the liability. Consequently, that difference will represent a “permanent” difference between the interest expense cumulatively recognized and the amount of discount actually unwound on the liability.

- d. It may be difficult to identify the assets held by the entities to back specific insurance contracts given that some entities do not designate their asset portfolio to back specific portfolios of insurance contracts.

BC265. The Board also considered an approach that would present the effect of the changes in the discount rates below the operating earnings line. Operating earnings is used to assist users in predicting future performance by distinguishing core results from noncore, ancillary, unusual, or volatile items. Some stakeholders suggested that such an approach could be useful in highlighting underlying performance when the assets backing insurance contracts are measured at fair value through net income and would reduce the effects of the accounting mismatch in net income when the assets backing insurance contracts are measured at fair value through other comprehensive income or amortized cost.

BC266. However, the Board noted that it is beyond the reasonable scope of this project to develop a comprehensive definition of operating earnings. While many entities present operating earnings outside of the financial statements, there is diversity in practice about the items that are included or excluded. This approach would require the Board to determine which items, insurance and noninsurance related, should be considered operating items. In addition, some Board members find it unacceptable not to report the effects of asset and liability management as part of the core operations of an entity that issues insurance contracts.

Require or Permit the Effect of Changes in the Discount Rates to Be Recognized in Other Comprehensive Income

BC267. The Board's proposals to segregate the effect of changes in discount rates from underwriting and investing performance would apply to all cash flows that do not contractually depend on underlying items, including those cash flows arising from reinsurance contracts and contracts to which the premium allocation approach is applied.

BC268. The Board rejected an alternative that would have made this proposal optional rather than a requirement. The Board decided that allowing an option would result in lack of comparability and reduce transparency. In addition, the Board's objective in presenting the effects of changes in discount rates on the insurance contract liability is to separate underwriting and investing performance from the effects of changes in discount rates that reverse over time. That objective would not be achieved if some entities presented those changes in other comprehensive income and some entities did not.

BC269. The Board also considered whether to permit an option, but limit its use to cases in which exercising the option would eliminate or significantly reduce an accounting mismatch. However, such an option would not fully eliminate mismatches when assets are measured using a mixture of fair value through

other comprehensive income, fair value through net income, and amortized cost. It could be possible to determine the extent of the mismatch based on the overall asset mix at the end of each reporting period; however, such an approach could change each period and would make it difficult to understand the amount depicted by interest expense for a portfolio of contracts. Electing the fair value option based on portfolios also is possible; however, entities typically back their portfolios with a mix of asset types. To eliminate all accounting mismatches, the Board considered allowing an option based on a contract-by-contract election. However, when an entity aggregates insurance contracts into portfolios or the entity holds a mixture of assets, it is impracticable to determine whether there is an accounting mismatch at a contract level, and the result would be arbitrary and meaningless.

Measuring the estimated returnable amount to be excluded from revenue

BC270. The Board determined that the measure of revenue presented in net income should exclude receipts of amounts that are expected to be paid to policyholders or their beneficiaries regardless of whether an insured event occurs, and claims and benefits should exclude the repayment of those amounts. This is because the cash flows related to the estimated returnable amounts are not expected to be subject to insurance risk. The Board thinks that excluding that component from the insurance contract revenue and expense amounts in net income better reflects the consideration received and costs of insurance risk. Therefore, the premiums and claims would include only the amounts relating to insurance coverage and other services provided. The total premiums presented in net income over the duration of a contract would then be consistent with the amounts presented as revenue by other entities that provide services to customers. The proposed guidance refers to the premium measure that excludes the estimated returnable amounts as the “insurance contract revenue.”

BC271. The Board considered three approaches to measure the estimated returnable amount to be excluded from insurance contract revenue in net income. The first two alternatives involved measuring the estimated returnable amount as the present value of amounts that an entity is obligated to pay the policyholders or their beneficiaries either: (a) regardless of whether an insurance event occurs or (b) absent an insured event.

BC272. The difference between the two alternatives is that the first alternative would consider the insurance component as the amount the insured would receive in excess of the estimated returnable amount, whereas the second alternative would treat all of the obligatory payments relating to the insured event as attributable to the insurance component and all of the payments in the absence of the insured event as attributable to the estimated returnable amount to determine the split between the components. That is, under the second alternative, no bifurcation of the insurance component would be performed.

BC273. The Board also considered a third alternative, which would require recognition of premiums equal to the explicit or implicit cost of insurance and other fees charged to policyholder account balances. The estimated returnable amount would be determined each period as the increase or decrease in the cash surrender value (or other account balance the policyholder is entitled to in the event of lapse, and so on) for the period plus the amount of actual surrenders plus the cash surrender value implicitly included in any death benefits paid. Revenue for the insurance component would reflect the difference between the amounts allocated to revenue for the entire contract each period less the amounts allocated to the estimated returnable amount each period. Some Board members preferred this approach because it objectively measured the allocation based on actual increases to the estimated returnable amount. However, based on the decision to recognize revenue using an earned premium approach, this approach could result in negative premiums and additional complexities.

BC274. The Board decided that the amount of consideration allocated to the estimated returnable amount and excluded from the revenue presented in net income should be equal to the cash flows that an entity estimates it will be obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs. The Board selected this approach because of its compatibility with the earned premium approach for determining insurance contract revenue. In addition, this decision was based on the following reasons:

- a. The Board believes there is no insurance risk included in those cash flows.
- b. The cash flows are determined without regard to the occurrence of an insured event so entities do not have to identify an insured event, which reduces the complexity for contracts with more than one insured event.

BC275. In addition, the Board decided that at each reporting date, the cash flows (allocated to the insurance component and the estimated returnable amount) should be reestimated based on current assumptions utilized in the measurement of the insurance contract liability, with any effect on insurance contract revenue allocated prospectively, from the beginning of the period in which the re-estimation occurs to periods in proportion to the value of coverage (and any other services) that the entity estimates will be provided in those periods. That re-estimation is consistent with allocating the insurance contract revenue to periods in proportion to the value of coverage (and any other services) provided during the period. Prospectively adjusting the premium for any changes in estimates would mitigate the potential volatility in revenue that might otherwise exist from changing assumptions.

Foreign Currency

BC276. The exchange rate to be used in the remeasurement process for foreign currency transactions in existing U.S. GAAP is dependent on the classification of

the account as monetary or nonmonetary. Accounts classified as monetary are remeasured using the current rate while accounts classified as nonmonetary are remeasured using historic rates.

BC277. In considering whether or not to treat all components related to an insurance contract as monetary or nonmonetary, the Board considered several specific components that Topic 830, Foreign Currency Matters, classifies as nonmonetary, including the liability for remaining coverage, the margin, and acquisition costs.

BC278. The Board considered whether the liability for remaining coverage should be classified as a nonmonetary item because it represents deferred income and cash transactions that do not affect the measurement of the liability. However, the Board concluded that the liability for remaining coverage also could be considered a proxy for the liability for incurred claims. That is due to the fact that, as it is earned, a significant percentage of the liability for remaining coverage is recognized as a liability for incurred claims that is subsequently paid out in cash and is classified as a monetary item. Thus, the liability for remaining coverage also should be considered a monetary item. Finally, the Board considered that the assets backing the liability are either cash or receivables, both of which are monetary items. Therefore, to avoid any potential accounting mismatch, the liability for remaining coverage should be classified as a monetary item.

BC279. The Board also considered whether the margin should be classified as a nonmonetary item because it essentially represents a deferred gain. However, under U.S. GAAP the margin is presently deemed to be a monetary item because it is implicitly included in the insurance contract liability. The Board believes that explicitly recognizing the margin under the proposed guidance should not change its classification from monetary to nonmonetary. One of the reasons for classifying an item as nonmonetary is because the cash is transacted at a historical rate and, therefore, the resulting asset or liability and the recognition of those items in net income should be at the historical rate. However, in regard to the margin, the cash has not necessarily been transacted. That means that the margin is based on the expected cash inflows and cash outflows. However, the entity may receive premiums over the life of the contract and, therefore, cash is transacted at those current rates. Splitting the margin into expected profit on cash received and expected profit on cash not yet received would be complex, if not impossible, given that the margin is determined based on the insurance contract as a whole.

BC280. The Board also considered whether acquisition costs should be classified as nonmonetary. The reasons for treating deferred charges or credits and the amortization thereof as nonmonetary is because when those charges were incurred, they were recognized at the current rate at that time. Subsequent recognition of those deferred charges does not involve cash settlement and, therefore, those charges should be recognized at the historical rate. However,

the guidance in this proposed Update proposes that acquisition costs should be reported with the margin for contracts accounted for under the building block approach and that the liability for remaining coverage for contracts should be accounted for under the premium allocation approach. While some may argue that a portion of the acquisition costs should be classified as nonmonetary, the Board concluded that the added complexity of following such an approach would outweigh any benefit received.

BC281. Ultimately, the Board concluded that all components related to insurance contracts should be classified as monetary for purposes of remeasurement. That conclusion was reached, in part, to provide for consistent accounting treatment across all components of an insurance contract. In addition, the Board determined that it will be simpler for preparers to treat all components of insurance contracts in the same manner.

Building Block Approach—Specific Considerations

Cash Flows That Arise from Participation Features That Depend on Underlying Items

BC282. If a participation feature gives a right to the policyholder to receive the performance of an underlying item as measured in accordance with U.S. GAAP and that right is contractual and does not allow an entity discretion about the amounts to be paid to policyholders, the Board determined that the measurement of the fulfillment cash flows should be based on the measurement of the underlying items. Measuring the dependent cash flows and underlying items on the same basis would eliminate an accounting mismatch that does not have economic substance.

BC283. In some circumstances, an entity's obligation may be based on a measurement basis of the underlying that is other than U.S. GAAP that can result in timing differences between the measurement of the return on the underlying items and the measurement of the obligations arising from the insurance contract's performance-linked participating features that will reverse and enter into future calculations of the participating benefits. For example, many participating contracts pay dividends based on income determined on a statutory basis. Certain assets and liabilities are measured differently under statutory-based accounting and U.S. GAAP-based accounting, including but not limited to debt instruments being carried at amortized cost instead of fair value through other comprehensive income or net income. Because the differences between the two measurement bases will reverse and enter into future calculations of the dividend provision and, therefore, the ultimate return to the policyholders will be the same under either reporting basis, regardless of the different accounting measurement bases, the Board decided that an entity should make an adjustment to the measurement of the fulfillment cash flows to reflect this

difference. The Board recognized that limitations may exist on the amount of earnings from participating insurance contracts that may be distributed to shareholders because of the measurement differences in the underlying items. To reflect those limitations, the Board decided that the amount that cannot be distributed to shareholders should be excluded from shareholders' equity by recognizing that amount as an adjustment to a liability relating to participating policyholders' funds. The Board also noted that this is consistent with existing U.S. GAAP and with the decision to reflect the measurement of the underlying item in the measurement of the fulfillment cash flows when the right to the policyholder is based on a measurement in accordance with U.S. GAAP. That is, the adjustment eliminates an accounting mismatch that does not have economic substance.

BC284. If the changes in measurement of the fulfillment cash flows were presented differently than the changes in the underlying items, there would be an accounting mismatch. Therefore, the Board concluded that the changes in the measurement of the fulfillment cash flows that are contractually linked to an underlying item should be presented in the same way within the statement of comprehensive income (that is, consistently in net income and/or other comprehensive income) as the changes in the underlying item.

BC285. The Board considered whether the decision to adjust the measurement of the liability for differences in the measurement of the underlying item should apply when the difference does not reflect a timing difference that will reverse and enter into future calculations of the participating benefits. An example of that circumstance would be the right of the policyholder to receive the performance of an underlying item based on the fair value of the underlying item. For example, the policyholders of a variable annuity or variable universal life insurance contract are entitled to their account balance, the measurement of which is based on the unit value, which is the fair value of the underlying assets, regardless of the measurement of those underlying assets in the entity's U.S. GAAP financial statements (under the guidance in this proposed Update those underlying assets would be required to be recognized at fair value through net income in this circumstance). The Board observed that, regardless of the measurement of the underlying, the entity is obligated to return the performance of the underlying based on the fair value of the underlying. Therefore, in the Board's view, the difference in the measurement bases of the liability and the underlying is an economic difference and should be accounted for as such. Some Board members view that type of arrangement as a derivative and, therefore, believe that the accounting should be consistent with accounting for derivatives, which would be to recognize the changes in the measurement of the derivative in net income.

BC286. The Board considered whether the measurement of the fulfillment cash flows should include only those amounts expected to be paid to current policyholders. Typically, those participating features are based on a portfolio of contracts. Therefore, if a policyholder terminates early (either due to death or

lapse), the additional liability generated from the movement in the underlying item is reallocated among the remaining policyholders in the portfolio. In those circumstances in which a policy's terms continue to obligate the insurer to make performance-linked cash flows to any policyholder within the portfolio (or a block of portfolios), those cash flows should be reflected in the measurement of the fulfillment cash flows regardless of whether the amounts are expected to be paid to current or future policyholders.

Noncontractual and Discretionary Participation Features

BC287. Some contracts include a contractual participation feature in an underlying item that includes discretionary elements on the amount of the performance that will be shared with the portfolio of policyholders. Some stakeholders suggest that all cash flows that vary with returns on underlying items held by an entity should be adjusted to reflect the measurement basis of the underlying items even if there is no contractual linkage between the items and/or the entity has discretion on the amount that is passed through.

BC288. Even without a contractual linkage, the cash flows arising from the contract may vary with changes in the returns of the underlying items, as follows:

- a. Some contracts provide returns affected by the performance of assets but such amounts are returned (or credited) to the policyholder at the entity's discretion. An example of such contracts includes universal life contracts in which outflows from the contract are expressed in terms of interest that is credited to the policyholder. The amount of interest credited to the policyholder is solely or predominantly at the entity's discretion, and the entity has a right to change the amount or timing of cash flows. The entity may or may not manage the specified underlying items on which that interest credited is dependent.
- b. Some contracts provide policyholders with a contractual right to returns on specified investments, but that right is not linked to underlying items that the entity holds (for example, index-linked contracts in which the policyholder participates in the market value of items as observed in markets or other external indexes).
- c. In some cases, the contract specifies that the issuer must hold the underlying items directly (for example, in some unit-linked contracts). In other cases, although the entity may choose to hold the assets underlying an index-linking feature to reduce its own risk exposure, the contract does not require the issuer to hold the assets on which the payment to the policyholder is based.

BC289. In the Board's view, the justification for adjusting the measurement basis for liabilities does not apply when there is no contractual link or the amount passed through is discretionary. However, the Board concluded that expected

cash flows relating to noncontractual or discretionary performance-linked features should be considered in the measurement of the fulfillment cash flows.

Recognizing Revenue

BC290. The 2010 FASB Discussion Paper proposed a “summarized margin presentation” in the statement of comprehensive income for contracts accounted for under the building block approach. Some stakeholders assert that the summarized margin presentation views all cash inflows associated with an insurance contract as deposits received from the portfolio of policyholders and all the cash outflows as repayments to the portfolio of policyholders. Neither the deposits nor the repayments are presented as revenues or expenses in net income. Instead, the summarized margin presentation separately presents the main sources of income or loss arising from the change in the insurance contract liability. Other stakeholders view the summarized margin presentation as a consequence of the net approach used to measure the insurance liability. That is, because of the net measurement of the liability, the notion of revenues and expenses is overridden and it is not necessary to show cash inflows and outflows generating a margin on the statement of comprehensive income. Under this approach, an entity would not need to determine the estimated returnable amount or when it has satisfied its performance obligation, which is difficult to measure. However, one consequence of this presentation is that information about the premiums, claims, and expenses for the period would not be presented in the statement of comprehensive income.

BC291. Many respondents were concerned that the summarized margin presentation would omit information about an entity's level of activity from the statement of comprehensive income. That information would be provided only in the notes to the financial statements, for example, information about contracts that were issued in the period. Some respondents noted that other entities, such as manufacturing entities, do not present revenue net of costs of goods sold. Instead, the consideration received from customers is recognized as revenue and the costs of goods sold are recognized as an expense. Some observed that many users of financial statements use measures of revenue and expense to reflect information about activity.

BC292. The Board was persuaded that the statement of comprehensive income of an entity that issues insurance contracts would be more understandable and comparable to those of other entities if it reflected insurance as a service and an investment depending on the type of contract. Therefore, the Board determined that an entity that applies the building block approach should present revenue, claims, benefits, and an underwriting margin in the statement of comprehensive income.

BC293. The Board considered the following methods to recognize the insurance contract revenue in the statement of comprehensive income, each of which are discussed below:

- a. The premium due method
- b. The written premium method
- c. The earned premium method.

BC294. In all of the methods, the insurance contract revenue recognized over the duration of the contract will equal the total premium for insurance coverage, and the costs recognized over the duration of the contract will equal the total amount of claims, benefits, and nonclaim fulfillment services incurred, adjusted to reflect the time value of money. In addition, the net income each period would be the same in all of the methods because the claims-benefit expense recognized would be for the related amount of insurance revenue recognized or vice versa.

BC295. The premium due method would allocate premiums to the reporting periods in which the premium is due to the entity (that is, invoiced or receivable) and is similar to the method used by many insurance entities today for recognizing premium on some long-duration contracts (however, all the premium received is recognized in revenue under existing U.S. GAAP for those contracts). At the same time, offsetting amounts would be allocated and presented as claims and/or benefits expense. In other words, when each premium becomes unconditionally due, it would be presented as income. At the same time, an expense would be presented for the same amount. That expense could be presented as a single line item with changes in expected cash flows, as “change in liability.” The entity additionally would present as revenue the amounts that are charged or credited to net income applying the building block approach, for example, the release of the margin.

BC296. The written premium method would allocate insurance contract revenue and costs to the periods in which the contracts are initially recognized (written). That method provides information about (a) new business written during the period and (b) claims expense, which represents the amount of obligation the entity has accepted in exchange for the expected consideration. The insurance contract revenue would be the expected present value of the rights that the entity receives when contracts are recognized, that is, the insurance contract revenue expected to be received for contracts written in the period. That amount includes all inflows relating to the insurance component, over the entire life of those contracts, included in the initial measurement of the insurance contract liability. The expenses would be the expected present value of the obligations that the entity assumes, including nonclaims fulfillment costs measured consistently with the initial measurement of the liability in the statement of financial position. Assumption changes regarding those amounts as well as actual changes would be recorded as adjustments to these initial amounts recognized.

BC297. The earned premium method would allocate insurance contract revenue between reporting periods applying the principles in Topic 606 for performance

obligations that are satisfied over time. The goal is to allocate the consideration between periods by reference to the relative value of the services provided in each period. In principle, this seeks to identify the price that an entity would have charged for coverage in that specific period if each period were charged for separately through a series of forward starting contracts. One driver for this allocation could be claims and/or benefits and contract-related expenses (those related to maintenance of the contracts and claims settlement) expected to be incurred in the period. Actual claims and/or benefits and expenses would be presented in the statement of comprehensive income as incurred.

BC298. The Board noted that the written premium method is the least complex of the approaches and provides information about new insurance contracts. Some Board members also noted that the written premium method best addresses respondents' desire for volume information in the statement of comprehensive income. However, that method would recognize revenue and expenses before the entity satisfies its performance obligations, which is not a commonly understood notion of revenue and expense. That method also introduces more volatility into the statement of comprehensive income because both the revenue and expenses are measured using estimates of future cash flows, which are uncertain. For those reasons, the Board rejected the written premium method.

BC299. The Board noted that the premium due method is used in existing U.S. GAAP and several other jurisdictions for recognizing premium in net income for traditional long-duration insurance contracts. The premiums due in the period are subject to less measurement uncertainty than the premiums written. As such, the insurance contract revenue measure is an objective, tangible measure of new business and is a useful anchor in facilitating analysis of ratios. However, the insurance contract revenue often would be recognized before the entity has performed the corresponding service, and, similarly, expenses often would be recognized before they have been incurred. Under the premium due method, the amounts presented as insurance contract revenue and claims, benefits, and contract-related expenses vary depending on the timing of when premium is due based on the contract versus when services are provided. Consequently, economically similar contracts would be presented differently in the statement of comprehensive income merely because the billing terms differ. For those reasons, the Board also rejected this approach.

BC300. A disadvantage of the earned premium approach is that it would require separate presentation of changes in estimates and the reversal of previous changes in estimates in the statement of comprehensive income, which neither the premium written method nor the premium due method requires. In addition, it requires entities to develop assumptions to determine the value of coverage provided. Despite the operational challenges, the Board determined that the benefits of the earned premium method outweighed its complexity. Some Board members view the liability as two components that transition over the life of the contract—a decrease in the liability for remaining coverage increases the

insurance contract revenue recognized and the recognition of benefits corresponds to the timing of incurred claims or an increase in the liability for incurred claims.

BC301. Some Board members noted that the earned premium method is broadly consistent with concepts of revenue recognition for other industries and that it is broadly consistent with the premium allocation approach. Other Board members do not think the method is consistent with the concepts in revenue recognition because the amount of revenue is driven by both the claim payment to the policyholder and other expenses to maintain and fulfill the contract for the period, the latter of which they believe would not result in revenue being recognized for the period.

BC302. As referenced in paragraph BC297, the Board considered whether a driver of the insurance contract revenue allocation should be the expected claims and/or benefits and contract related expenses to be incurred in a period (that is, based on the likelihood of an event occurring). Some Board members raised concerns that specifying the driver would be too prescriptive and that other allocation methods might comply with the principle that insurance contract revenue should be recognized over the reporting period in proportion to the relative value of the coverage and other services that the entity provided in that period. Therefore, the Board decided that one driver of the insurance contract revenue allocation could be the likelihood of an event occurring in a period based on the assumptions used in the entity's measurement of the fulfillment cash flows or the expected claims and/or benefits and contract-related expenses incurred during the period but that the entity would not be precluded from using other methods that meet the objective. Some would argue that the relative value to the policyholder of the services an insurer provides each period might be a function of the insurer's obligation to stand ready to cover claims during the period or a function of an entity's net amount at risk. However, an entity may find it difficult to measure the obligation to stand ready to cover claims during the period or its net amount at risk each period.

BC303. The Board considered whether the coverage for the entire contract should be regarded as a single performance obligation that would be satisfied over time and would require reallocation of the revenue for the insurance component each period based on most recent estimates or whether each period's coverage should be treated as a distinct performance obligation that would allocate revenue to each period on the basis of initial estimates of the pattern of expected cash flows. The Board concluded that the services provided in a later period of coverage might reasonably be considered highly dependent on the earlier period's services if renewal options also are dependent on the events of the earlier periods, as is typically the case. Accordingly, in applying the concepts from the proposed revenue recognition model, the obligation to provide coverage in any particular period of the entire coverage period is not a separate performance obligation, and the coverage and services provided over the whole duration of the contract would be treated as a single performance obligation that

is satisfied over time. Thus, consistent with Topic 606, the revenue would be reallocated when there is a change in pattern of expected cash flows.

Accretion of interest on consideration received

BC304. The earned premium method includes accretion of interest on the consideration received, that is, the future revenue that is attributed to funding the costs of claims and other fulfillment costs to reflect the time value of money for the period between premium receipt and provision of the corresponding coverage. Mechanically, interest would be accreted on the present value of the expected cash inflows that initially are recognized in the insurance contract liability through the dates the revenue is recognized. Therefore, interest expense should be recognized for the difference between the present value of cash inflows from the date initially recognized through the date cash is received (that is, the amount should reflect the consideration received from the policyholder) and from the date cash is received through the date revenue is recognized (that is, the amount that would have been charged to the policyholder if the cash was received at that date). Similarly, claims are measured at their present value at the date on which they are incurred. Accordingly, those amounts implicitly include both the discounted amounts used to measure the initial insurance contract liability (and any subsequent changes in estimates of future incurred claims) and the interest accreted between the dates those claims are initially recognized in the insurance contract liability and the dates that claims are incurred.

BC305. The Board decided that including accretion of interest in the determination of insurance contracts revenue for contracts accounted for under the building block approach is consistent with the guidance in this proposed Update for contracts accounted for under the premium allocation approach and Topic 606. That is, discounting and interest accretion to reflect the time value of money are required in both cases in measuring the liability for remaining coverage for contracts that have a significant financing component.

BC306. In addition, under the earned premium method, the Board decided that accretion of interest on insurance contract revenue is mechanically necessary to ensure that:

- a. Underwriting income is equal to the sum of the margin released and changes in estimates of cash flows.
- b. After all changes in estimates of future incurred claims have unwound, the cumulative underwriting income is equal to the excess of cumulative revenue over cumulative claims and expenses.

Recognizing Claims and Expenses

BC307. Measurement of an insurance contract is inherently subject to measurement uncertainty. Determining insurance contract revenue would mean

that the uncertainty is reflected in the timing of insurance contract revenue, rather than in the estimates of claims and benefits. As a result, the claims and expenses would be reported when actually incurred. The Board decided that reporting claims and expenses when actually incurred would provide useful information to users of financial statements.

Recognizing the Margin

BC308. The 2010 FASB Discussion Paper would have required a formulaic approach to recognizing the margin over the coverage and settlement period. That approach calculated a ratio of the experience to date (premiums allocated plus the claims and benefits paid to date) divided by the total expected fulfillment cash flows (expected premiums plus total expected claims and benefits) to determine how much margin should have been earned to date. Each component was updated at each reporting date to reflect experience (backward looking) and changes in estimates (forward looking). The inclusion of premiums in the calculation of the ratio was intended to reflect the protection component of the contract while the inclusion of claims and benefits was intended to reflect the entity's exposure to risk from uncertainties related to cash flows. Many respondents to the 2010 FASB Discussion Paper preferred a principle to a formulaic approach.

BC309. The Board explored several methods, including amortizing the margin over the coverage period or over the risk period, providing a weighting to the inflows (premiums) and outflows (claims), or creating a principle.

BC310. The Board agreed with respondents not to provide a formulaic approach for recognizing the margin but, rather, to determine a principle. Having established the margin as the expected profit at risk, the Board determined the obligation that an entity must satisfy to earn that potential profit. Using the definition of an insurance contract and accepting that an entity is obligated to perform under the contract, the Board decided that the entity should earn the expected profit of the contract by satisfying its obligation to stand ready to compensate the policyholder in the event of an occurrence of a specified uncertain future event that adversely affects the policyholder.

BC311. In considering how an entity might satisfy the obligation, the Board reasoned that the entity's exposure to risk is a result of the uncertainty of the specified future event. That uncertainty can take two forms:

- a. The amount the entity will need to pay upon settlement (including whether the entity will have to pay at all)
- b. The timing of the uncertain specified future event.

BC312. Therefore, the Board concluded that an entity should earn its expected profit upon release from this exposure to risk (that is, when the forms of uncertainty become more certain). By extension, because each form of

uncertainty affects the variability of the expected cash flows, an entity could use that variability in cash flows as a proxy to measure the release from exposure to risk.

BC313. Some Board members indicated that the obligation to provide insurance coverage should be the primary driver of the recognition of the margin. Therefore, those Board members recommended limiting recognition of the margin to the coverage period. While they acknowledged the potential uncertainty in cash flows in the settlement period, they argued that the change in the expected cash flows recognized in net income without margin offsets during the settlement period, better reflects the economics of the circumstances.

BC314. Other Board members suggested that the proposed guidance should not specify the period of recognition but rather should provide a principle (for example, period of risk exposure). Those that preferred a principle rather than a formulaic approach indicated that a formula would not be economically relevant for every type of insurance contract. They commented that a formulaic approach would potentially delay profit recognition beyond (a) the period in which the entity provides all risk protection services or (b) the period in which the entity expends the majority of the costs and efforts to settle the claims.

BC315. Some Board members noted that including premiums in a formulaic approach to determine realization of the margin is not appropriate. Those Board members did not believe that the receipt and subsequent allocation of premiums have any bearing on the satisfaction of the performance obligation of an entity, nor are they representative of risk exposure. An entity's exposure to risk relates to the probability of insured events occurring, not on the risk that a policyholder fails to make premium payments. If the entity does not receive premiums, it does not provide coverage and, thus, has no risk exposure. Therefore, the determination of profit should focus on the primary operating activity of assuming risk exposure.

BC316. The Board ultimately decided that an entity should recognize margin as revenue in net income as it satisfies its performance obligation to the policyholder, which is as it is released from exposure to risk. Furthermore, the Board determined that such a release from risk is evidenced by a reduction in the variability of cash outflows required to fulfill the contract. Underlying that decision is that the margin for contracts measured using the building block approach would be recognized over both the coverage and claim settlement period.

BC317. The Board also decided that an entity should consider specific facts and circumstances to qualitatively determine if a reduction in the variability of cash flows has occurred to the extent an entity is released from risk. That qualitative determination, including using facts and circumstances to determine if a reduction in the variability of cash flows has occurred, is described in paragraphs 834-10-55-137 through 55-152.

Recognizing Acquisition Costs

BC318. Although the Board views acquisition costs as a reduction in the expected profit for a portfolio of contracts and, therefore, decided that the margin should be reduced when acquisition costs are incurred, some Board members concluded that it is important to recognize the total consideration received for the insurance component and the total acquisition costs paid in the statement of comprehensive income. Other Board members are troubled by recognizing amortization of acquisition costs when the acquisition costs are not reflected on the balance sheet, and are divided on how they would resolve this issue. Some Board members would reflect acquisition costs as an asset, while others would not reflect the amortization in net income and would recognize the net profit as the entity is released from risk (that is, the margin net of the acquisition costs). The Board ultimately concluded that the pattern for recognizing acquisition costs should be consistent with the pattern for recognizing the margin.

Unlocking the Margin

BC319. The 2010 FASB Discussion Paper would have required an entity to record changes in the actual and expected cash flows directly to net income. Feedback from some stakeholders indicated an insurer should reflect the changes in nonmarket variables, such as mortality and morbidity rates, in net income because managing the risks associated with those assumptions is the core business of an insurer. Accordingly, they noted that recognizing those changes in net income would provide useful information about how the entity has performed in the period. However, other stakeholders observed that those inputs relate to the long term, generally do not have a quoted market price, and typically do not fluctuate significantly over a short-term period (unless there is a significant change in the environment of the insured risk). Accordingly, they would argue that those assumptions always relate to future expectations and should adjust the margin.

BC320. In its 2013 revised Exposure Draft, the IASB decided that the contractual service margin would be adjusted to reflect differences between current and previous estimates of cash flows relating to future coverage or other future services. Therefore, those changes in the present value of expected cash flows would not be recognized immediately in net income. The IASB's rationale for unlocking is that not adjusting the margin in future periods to reflect changes in the expected cash flows (that is, locking) is inconsistent with the subsequent measure of the other elements of the model. In the case of adverse development, locking the contractual service margin could result in the recognition of a loss in one period and gains from the release of the margin in future periods. Conversely, favorable development would be immediately recognized as a gain, which is inconsistent with the Board's decision in this proposed Update to prohibit the recognition of gains at initial recognition of a

portfolio of contracts. Unlocking the margin avoids the incentive to overstate the estimates of expected cash flows at inception so that an entity can subsequently recognize favorable development and a gain. Based on those factors, the IASB thinks that unlocking the contractual service margin would provide a more faithful representation of the remaining unearned profit.

BC321. The Board noted that the margin under this proposed guidance is different from the contractual service margin in the IASB's proposed model and, therefore, a direct comparison cannot be made. Although still not a direct comparison, a more reasonable comparison would be to also consider the treatment of the risk adjustment in the IASB's proposed model. In its 2013 revised Exposure Draft, the IASB decided that changes in the remeasurement of the risk adjustment each reporting period would be recognized immediately in net income.

BC322. The Board determined that remeasuring or recalibrating the margin was inappropriate because it would provide a potential opportunity to reestablish margin previously earned in subsequent periods based on changes in the variability of cash flows. One of the primary criticisms of U.S. GAAP is the understandability of the amortization of deferred acquisition costs for certain products that require entities to unlock their assumptions and record a cumulative catch-up adjustment in net income. The Board considered unlocking the margin and recognizing the change prospectively versus retrospectively. However, the Board decided that future results would be skewed based on past experience. The Board concluded that unlocking the margin would result in similar confusion.

BC323. The Board also observed that adjusting the margin to reflect changes in the expected cash flows would effectively absorb changes in assumptions and act as a "buffer" for potentially smoothing either favorable results or unfavorable results. That treatment would have the effect of not adjusting net income until there was a trigger of loss adequacy resulting in loss recognition when the margin becomes negative. That essentially would result in a similar net outcome as the model included in Topic 944 that is applied to traditional, limited payment and certain participating long-duration contracts. Under that model, the assumptions that are set when the contract is initially recognized are used in the subsequent measurement of the reserve, which includes an implicit margin. If a loss recognition (sometimes referred to as a loss adequacy) test indicates the expected cash outflows of a portfolio of insurance contracts will exceed the expected cash inflows, the entity is required to record an additional reserve with an immediate effect on net income. Both approaches (that is, unlocking the margin and locking in the assumptions until loss recognition is triggered) would produce similar results as the pattern of profitability is smoothed over the life of the contract. Stated differently, if an entity remeasures assumptions and the effect of that remeasurement is essentially placed back into the liability, it would have a similar effect on net income as under current U.S. GAAP. However, current U.S. GAAP does not allow an entity to subsequently recognize an immediate gain in net income after a loss has been recognized when

assumptions about expected cash flows favorably change, whereas unlocking the margin for both unfavorable changes and favorable changes in the expected cash flows would result in an immediate gain being recognized.

BC324. Some Board members were concerned that showing current results that are affected by changes in expectations made in prior periods may be confusing to users of the financial statements. Recognizing the changes in expected cash flows in net income as they occur would be more explainable to users of the financial statements and would not skew future results.

BC325. The Board also was concerned about the different treatment of changes in cash flows as a result of actual experience versus expected cash flows. It is difficult to determine what constitutes an experience adjustment as opposed to what is a change in expected cash flows, given that the cash flow assumptions are determined at a portfolio level and are often pushed down to the individual contract level. A different profit pattern could result depending on whether the change is identified initially as a change in estimate or only subsequently as an experience adjustment. That creates an inconsistency depending on whether the change in estimate is identified in advance (and therefore treated as a change in estimate) or subsequently (and therefore treated as an experience adjustment). Some view that effect as incongruous given that one of the key reasons to unlock the margin is to avoid an inconsistency between measurement of the insurance contract on day one and subsequent measurement.

BC326. The Board also considered the notion of risk in this proposed model and in the IASB's model. Not unlocking the margin for changes in expected cash flows could be considered consistent with the immediate recognition in net income for changes in the risk adjustment in the IASB's model.

BC327. The Board also noted that two of the key objectives of this project are to reflect updated assumptions in the measurement of the liability and increase transparency to the users. The Board believes that neither would be achieved if the margin is unlocked. Rather, the Board believes that recognizing changes in expected cash flows in net income as they occur will show how assumptions about the insurers' core business have changed, which would provide transparency to users of an entity's financial statements.

BC328. The Board noted that while the margin is not adjusted for changes in expected cash flows, the recognition pattern of the margin may be affected by actual experiences and/or changes in the expected cash flows if they relate to an entity's release from risk.

Unlocking the margin for contracts expected to generate a loss

BC329. The Board considered whether the margin should be adjusted for changes in actual or expected cash flows if it is determined that the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance

contracts will exceed the expected cash inflows. While a locked margin approach, taking into consideration the other items recognized in net income in the guidance in this proposed Update, would ultimately result in recognizing the correct amount of profit over time, a portfolio could be expected to generate a loss while showing profit recognition in later periods. If expected cash flow estimates indicate that the portfolio is expected to generate a loss, the Board decided that recognizing the remaining amount of margin in subsequent periods would be inappropriate.

BC330. In that case, the Board decided an entity should recognize the remaining margin in net income when assumptions change such that a portfolio of contracts is expected to generate a loss. A portfolio of contracts would be expected to generate a loss if the present value of payments for benefits and related settlement and maintenance costs exceeds the present value of gross premiums. The Board determined that this write-off would not be eligible for reversal in future periods. If an entity were permitted to reinstate the margin after a loss determination, earnings management opportunities would arise. Prohibiting reversals would be consistent with the Board's decision not to adjust the margin to reflect changes in the expected cash flows.

BC331. Although the decision to adjust the margin for losses only when the portfolio is expected to generate a loss is inconsistent with the decision not to adjust the margin for a decrease in expected profitability, the Board determined that unlocking the margin in this case seemed better than the counterintuitive answer of recognizing a loss in one period and then recognizing profit in subsequent periods. Some Board members do not view less significant losses (where some positive margin is still left) in the same way as a contract that is expected to generate a loss and noted that other models in U.S. GAAP, such as goodwill and long-lived asset impairment testing, have trigger points as well. The Board noted that based on underwriting alone (that is, nonfinancial assumptions versus financial assumptions) it is not typical for the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance contracts to exceed the expected cash inflows and the reversal thereof is even less common.

Accreting Interest on the Margin

BC332. Respondents to the 2010 FASB Discussion Paper generally opposed the accretion of interest on the margin when applying the summarized margin approach (that is, premiums and claims are not recognized in net income). However, the earned premium method in this proposed Update includes accretion of interest on the revenue to reflect the time value of money for the period between premium receipt and provision of the corresponding coverage (see paragraph BC304).

BC333. Accreting interest on the remainder of the premium that is attributable to the margin would ensure consistency with the overall revenue amount because it

is the present value of the premiums received and receivable attributable to the insurance component at the time the coverage is provided. Considering the interest expense from accreting the discount on the margin together with the interest expense on the discount on the future net claims and benefits cash flows would better reflect the time value of money.

BC334. The Board acknowledges that accreting interest on the margin will increase complexity but decided that this approach would result in more useful information.

Premium Allocation Approach—Specific Considerations

Liability for Remaining Coverage

BC335. An entity should reduce the measurement of the liability for remaining coverage, gross of the qualifying acquisition costs incurred, and recognize a corresponding amount of revenue in proportion to the value of coverage that the insurer has provided. This revenue should be recognized either:

- a. On the basis of the passage of time
- b. On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

BC336. This approach would reflect the revenue recognition concept of recognizing revenue in proportion to the value of coverage that the insurer has provided. The Board noted that this approach is consistent with the existing U.S. GAAP revenue recognition model for short-term contracts. However, the Board is cognizant that there is some diversity in practice whereby even if the expected timing of incurred claims and benefits differs from the passage of time, entities recognize revenue based on the passage of time. The Board decided that explicitly stating that the revenue recognition pattern should reflect the expected timing of incurred claims will mitigate the diversity in its application.

Onerous Test

BC337. The proposed guidance would measure the insurance contract using estimates of the expected cash flows made at the end of the reporting period, even when the uncertainties affecting the reliability of those estimates are sometimes resolved by events that occur after the reporting period but before the financial statements are issued or available to be issued. The Board considered whether such types of claims should be recognized only when the insured event occurs and the liability is probable. This would generally be consistent with current practice, although the Board notes that there is some diversity.

BC338. The Board believes that recognizing an additional liability when an insured event occurs and the liability is probable would be inconsistent with the

notion of recording an additional liability when it is expected that a contract is onerous. However, the Board observed that for certain types of events such as hurricanes, the expected loss can change significantly before the damage is incurred, much of which is difficult to estimate and not necessarily based on historical data. Therefore, the Board considered whether the insured event was the formation of the hurricane and whether the measurement of that event should be updated through the date on which the financial statements are issued. However, the Board concluded that the event is when the policyholder is adversely affected, which is when the hurricane damages the insured property. In addition, the Board observed that updating the measurement would be inconsistent with other areas of U.S. GAAP, specifically financial instruments that are not revalued as of the reporting date for new information (that is, the change in value) that becomes known after the reporting date. The Board also was concerned with setting parameters for the types of claims that should be subject to this exception, that is, how long after the reporting date the event occurs. In addition, the Board was concerned that an entity affected by the hurricane would recognize different liabilities depending on when the entity reports results. However, this is an issue for any insured event that happens just before a reporting period.

BC339. The Board ultimately concluded that when uncertainties affecting the reliability of estimates are resolved by events that occur after the reporting period, the requirements of Topic 855, Subsequent Events, should be applied. Thus, an insured event that was possible at the end of the reporting period does not constitute evidence of a condition that existed at the end of the reporting period when the event occurs or does not occur after that date. Any information obtained after the reporting date and before the financial statements are issued should be considered a nonadjusting subsequent event and should be disclosed.

BC340. The Board considered whether expected cash flows should be discounted (a) in performing the onerous test to identify an onerous contract and (b) for measuring the amount of the additional liability. Some Board members noted that if the cash flows are undiscounted, using an undiscounted approach should be applied consistently in identifying and measuring an onerous contract. However, other Board members stated that identifying onerous contracts on an undiscounted basis might result in recognizing an onerous liability at contract inception even if the contract itself is not onerous, since the expected investment income is taken into consideration when pricing the contract, although not for all types of contracts measured using the premium allocation approach.

BC341. The Board determined that the onerous contract test should be performed on a consistent basis with the measurement of the liability for claims incurred for that portfolio of contracts. Therefore, the test should be performed on a discounted basis, except for a portfolio of contracts for which management elected not to discount the liability for incurred claims (only if the claims are expected to be paid within one year of the date incurred or discounting would be immaterial). In addition, an entity cannot consider expected investment income in

the test. This is a change from existing U.S. GAAP, which allows an entity to consider expected investment income in the onerous test; however, the onerous test under existing U.S. GAAP is not performed on a discounted basis. The Board noted that the requirement to include discounted cash flows may offset the entity's inability to include expected investment income in performing the onerous test and that, therefore, the change to existing U.S. GAAP would be immaterial. The Board decided that requiring the test to be performed on the same basis as the measurement of the liability for incurred claims for that portfolio of contracts would be the most effective approach because the additional liability required to be recognized would be based on the test as opposed to requiring entities to subsequently calculate that amount based on failing the test.

Liability for Incurred Claims

BC342. The Board decided that an entity should measure the liability for incurred claims as the present value of expected fulfillment cash flows.

BC343. The Board considered including a margin in the measurement of the liability for incurred claims, thereby recognizing some profit over the settlement period instead of all the expected profit over the coverage period. Unlike contracts accounted for using the building block approach in which the exposure to risk is most significant before the insured event occurs, most of the contracts that would apply the premium allocation approach expose an entity to significant risk after the insured event has occurred. That is because the entity would estimate the number of claims and severity of claims based on historical data, actuarial expectations, and updated trends. A significant amount of the liability recognized is typically for incurred but not reported claims for which there is no actual information known. In addition, estimates of claims costs often change in the post-coverage period through the final settlement of claims.

BC344. The Board acknowledged the potential uncertainty in cash flows in the settlement period. However, it decided that changes in the expected cash flows recognized in net income, without margin offsets during the settlement period, would better reflect the economics of the circumstances for the types of contracts that are most likely to be accounted for using the premium allocation approach. The Board noted that this accounting is more consistent with the traditional premium revenue and claims costs approach, with expected profit being recognized in net income by the end of the coverage period.

Time value of money

BC345. The Board considered whether to discount the liability for incurred claims in the premium allocation approach. It recognized that, under existing U.S. GAAP, the expected fulfillment costs for most contracts that are likely to be accounted for using the premium allocation approach are not discounted. Many

insurance entities follow the guidance prescribed by the Securities and Exchange Commission (SEC) under Staff Accounting Bulletin Topic 5N, *Discounting by Property-Casualty Insurance Companies*, to determine which liabilities to discount and the rate to use for discounting. That guidance would allow an entity to discount the liability for incurred claims when the payment pattern and ultimate costs are fixed and determinable on an individual claim basis, and the discount rate used is reasonable based on the facts and circumstances applicable to the registrant at the time the claims are settled. Under U.S. GAAP, nonlife insurers discount only those insurance liabilities that meet this criterion, such as workers' compensation indemnity claims, structured settlements, and medical malpractice settlements. However, that guidance indicated that it was temporary pending authoritative guidance resulting from efforts by the accounting profession to assess circumstances under which discounting may be appropriate in financial statements.

BC346. The Board also considered the following arguments, among others, against discounting the liability for incurred claims:

- a. Discounting adds more subjectivity (for example, discount rate selection and payment pattern estimation) to amounts already requiring substantial estimation and judgment. The Board decided that uncertainty about the measurement of some claims (for example, long-tail claims in which the amount and timing of payments are uncertain) should not preclude discounting of the liability for incurred claims. The uncertainty of an insured event occurring and the amount at which an insured event is settled is the nature of insurance. This uncertainty, however, does not relate to including the time value of money in the measurement of the liability for incurred claims.
- b. Discounting adds complexity without increasing the usefulness of the information. The Board acknowledged that discounting adds complexity. However, it observed that other industries also are required to reflect the time value of money in the measurement of their liabilities. The Board decided that an exception should not be made for a sector of the insurance industry, especially if the effect of discounting could be more material than in other industries.
- c. Discounting does not align with certain insurers' (predominantly property and casualty and short-term health insurance) business model. Specifically, asset-liability management is not necessarily performed, and some argue that investment income is not a significant factor in determining the premium (pricing) of contracts. The Board was not persuaded that the business model should drive the liability measurement or that these entities do not consider investment income, especially since some of these entities emphasize that they "play the float" for the time period between when the cash is received from the policyholders and when the entity is required to pay cash to policyholders.

- d. Some users do not discount the liability for incurred claims in their analyses, and others discount the claim liabilities independently, using rates they believe are appropriate, and do not want to attempt to unwind the discount applied by entities issuing insurance contracts. For those users that do apply discounting in their analyses, the timing of the expected payouts could be more accurate if provided by the entity. In addition, the Board determined that the extent of users' preference for not discounting the liability for incurred claims is potentially influenced by the interest rate environment in which an insurer operates. Some Board members believe that preparers and users are interested in the information that is provided by discounting in a high-interest-rate environment. Furthermore, even with a low interest rate environment, the effect of discounting could be material on an aggregated basis.

BC347. The primary basis for the Board's decision is expressed in the axiom that the Board adopted: money has a time value and an entity more faithfully represents its position when it measures its liabilities in a way that reflects the time value of money. In addition, as noted, the Board decided that uncertainty about the measurement of some claims (for example, long-tail claims in which the amount and timing of payments are uncertain) should not preclude discounting of the insurance contract liability. Some Board members think that reporting the liability for incurred claims on an undiscounted basis is, in effect, recognizing an implicit margin and that there will be more transparency regarding an entity's reserve adequacy and changes in expected fulfillment costs if the liability for incurred claims is measured on a discounted basis.

BC348. The Board noted that, under existing guidance, entities consider expected investment income in determining whether a portfolio of contracts is onerous, which essentially results in considering the effect of discounting as described in paragraph BC341. The Board also noted that insurers discount the liability for incurred claims for U.S. tax purposes, albeit using an Internal Revenue Service (IRS) prescribed discount rate or discounting factors and in determining whether there is significant risk transfer when entering into reinsurance contracts. The Board also observes that under SEC guidance, entities are allowed to discount the liability for incurred claims when the payment pattern and costs are fixed and determinable on an individual claim basis; the proposed guidance extends discounting to all claims.

BC349. The Board spent a considerable amount of time and effort reviewing analyses, deliberating, and performing outreach on whether discounting should be required under the premium allocation approach. The Board understands that many preparers and users agree with the arguments set forth in paragraph BC346. However, the Board decided that requiring discounting of the liability for incurred claims, if material, would more faithfully reflect the value of the insurance liability, especially in circumstances in which the expected claims settlement (payment) period may extend for many years.

BC350. The Board noted that, for some of the contracts that will apply the premium allocation approach, the period between the occurrence of an adverse event (when the liability for incurred claims is first recognized) and its settlement (when the liability is extinguished) is likely to be short. The Board decided that discounting should not be required for incurred claims that are expected to be paid within one year of the claim occurrence date. The Board decided that removing the requirement to discount the liability for incurred claims in those cases would reduce the complexity and costs for some contracts to which the insurer applies the premium allocation approach.

BC351. The Board considered whether the interest accretion rates should be based on the current rates when the claim is recognized or the initial rates when the portfolio of contracts was recognized. The Board noted that using the discount rates at inception would be consistent with the building block approach, as well as the rates used for the liability for remaining coverage when the premium allocation approach is applied. In addition, although the Board views the insurance liability as two components (that is, the liability for remaining coverage and the liability for incurred claims), they observed that the inception date of the contract is still the start of the coverage period, not the date that the claim is incurred.

BC352. The Board considered that using the rates at the date the claim is incurred may report a more useful claim expense because the claim expense is determined using a discount rate that reflects the market conditions at that time. In addition, most nonlife insurers, for which the premium allocation approach will be most applicable, maintain data on an accident-year basis (as opposed to an underwriting-year basis). Maintaining data on an accident-year basis means that many insurers do not track the rates at the inception of the contract.

BC353. However, the Board recognized that if the rates when the claim is incurred are used, movements in the discount rates would result in an entity recognizing different claims expense in the different reporting periods and different interest expense in the future when assumptions about the underwriting results have not changed. This is because using the rates at the date the claim is incurred is more analogous to discounting on an individual claim basis. Using this approach, the entity would need to track multiple base rates, each of which would need to be compared with the current rates used to record the liability for incurred claims in the statement of financial position. Adding to the complexity when claims are paid, insurers need to know how to match the payment with when the liability for incurred claims was recognized, which may fall within different quarters for the same claim. This may require insurers to track the liability at a lower level (for example, by contract, by claim, and potentially by each additional reserve strengthening for a claim) than current practice. This could possibly present substantial systems changes and tracking issues.

BC354. The Board also determined that it would be more complex to disaggregate the effect of discounting from underwriting results using the rates at

the date the claim is incurred than it would be if one yield curve (the rates at inception) for the portfolio of contracts was used.

BC355. On the basis of these considerations, the Board decided that the interest accretion rates should be based on the initial rates when the portfolio of contracts was recognized. The Board decided that using the discount rates at inception of the contracts would be more consistent with the portfolio notion because one yield curve would apply to a group of contracts. It also would allow an annual contract to be one interest rate “block” instead of at a minimum four as would be required if the rates were updated each quarter. In addition, presenting interest expense in profit or loss using the rates at inception of the contract would be consistent with the presentation under the building block approach of interest expense and, hence, with the amounts in net income. However, the Board recognizes that using the initial rates when the portfolio of contracts are recognized may result in a catch-up adjustment to be recognized in other comprehensive income to reflect the effect of changes in discount rates between the initial recognition of the contracts and when the claims are incurred (see paragraphs 834-10-55-118 through 834-10-55-122).

Reinsurance

Recognizing the Margin—Retroactive Reinsurance Contracts

BC356. The Board decided that for retroactive reinsurance contracts, a cedant should recognize the margin over the remaining settlement period to avoid recognizing a day-one gain. Unlike prospective reinsurance, a retroactive reinsurance contract does not provide protection over the coverage period. That period is past, and any protection provided by retroactive reinsurance relates to the remaining settlement period. The Board noted that the nature of the risks assumed by the reinsurer is fundamentally different when an insured event has already occurred. The uncertainty that is being reinsured is the estimation of the liabilities relating to those past events. Therefore, the Board noted that recognizing the margin over the remaining settlement period is appropriate because the uncertainty will be reduced over that period of time.

Contract Modifications and Derecognition

Modifications

BC357. A contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished (that is, the obligations are discharged, cancelled, or expired). However, in some cases, an entity may modify the terms of an existing contract.

BC358. Some contract modifications are not considered substantial. However, the modification may provide policyholders with additional benefits, often for an additional premium. The Board decided that the provision of those additional benefits should be treated as a new contract, with no effect on the measurement of the original contract. Accordingly, an entity would determine the margin for the new contract by reference to the additional premium charged using the discount rates and interest accretion rates on the original contract. The Board considered whether the additional premium benefits and margin should be determined using discount rates as of the date of the modification. However, this could result in an entity (a) splitting the contract into multiple portfolios applying different yield curves to portions of the contract, and (b) upon any derecognition of a portion of the contract, arbitrarily allocating the reduction in benefits and margin to the separate portions of the contract. Considering that the decision impacts only nonsubstantial modifications, the Board concluded that the complexities and related costs to use the discount rates at the modification date would not outweigh the benefits. Similarly, a modification may reduce the entity's obligation to provide some of the benefits that the contract would previously have required it to provide. Typically, this reduction in benefits results in a return of premium. The Board decided that an entity should derecognize that portion of its obligation, including any related portion of the margin.

BC359. Treating the contract modification as a new contract or extinguishment of a portion of a contract would result in symmetrical accounting for contract modifications that adds rights and obligations and for contract modifications that eliminates rights and obligations. The Board decided that this would reduce the potential for accounting arbitrage through contract modification.

BC360. In some cases, an entity may modify the terms of an existing contract in a way that significantly changes the economics of the contract (a substantial modification). The Board considered the issue of when an amendment or modification (including riders) to a contract is substantial and should result in an extinguishment of the initial fulfillment cash flows and recognition of the fulfillment cash flows based on the modification with an adjustment to the margin.

BC361. The Board decided that modifications that affect the economic substance of a contract are substantial. Paragraph 834-10-55-170 includes criteria that the Board decided are important in determining whether a modification is substantial. A substantial modification differs from derecognition of a contract in that the entity has a continuing obligation to the policyholder. Because of that continuing obligation, the Board decided that it would be inappropriate for an entity to recognize the remaining margin on the initial contract in net income and record additional margin on the modified contract that subsequently would be recognized in net income. The Board noted that this could result in manipulation of earnings.

BC362. Therefore, the Board concluded that when an existing contract is derecognized and a new contract is recognized using the modified terms, an

entity should use the entity-specific hypothetical value as the implicit premium. The entity-specific hypothetical price is the price the entity would charge if it had sold a contract with the equivalent remaining terms on the date of modification. That implicit premium determines:

- a. The gain or loss on derecognition of the existing contract
- b. The amount of the margin for the new contract.

BC363. The Board considered the view that the implicit premium should be the fair value of the existing contract because it would be less subjective than the entity-specific hypothetical price. Fair value of consideration received also is used to measure gains and losses for extinguishment of financial liabilities and other extinguishments (for example, sales of assets). If that approach were adopted, the gain or loss on derecognition of the existing contract would be consistent with the accounting for other extinguishments. However, the Board concluded that the subjectivity of an entity-specific hypothetical price should not be a determining factor because the fair value of a contract with the equivalent terms on the date of modification is not observable and would be measured applying level 3 of the fair value hierarchy (see Topic 820, Fair Value Measurement).

BC364. Instead, the Board placed more weight on the conclusion that the use of fair value will impair the comparability between the liability for the amended insurance contract and other insurance contract liabilities. Consistent with the measurement of insurance contracts generally, the entity-specific hypothetical value is based on entity-specific assumptions about cash flows and the margin the entity would require.

BC365. The Board believes this proposed guidance will (a) reduce diversity in practice, (b) ensure that modified insurance contracts are accounted for in accordance with the accounting model considered to best reflect the economics of the contract, and (c) prevent the opportunity for circumventing (by way of contract modification after the assessment date) the accounting prescribed for the contract or its specific features.

Derecognition

BC366. The proposed guidance states that an entity should remove an insurance contract liability (or part of an insurance contract liability) from its statement of financial position when, and only when, it is extinguished, that is, when the obligation specified in the insurance contract is discharged or cancelled or expires.

BC367. The Board considered concerns that an entity might not know precisely whether a liability has been extinguished because claims are sometimes reported many years after the end of the coverage period. Those with that concern suggested that an entity might be unable to derecognize those contracts, which

in some cases might result in accounting that is unreasonable and unduly burdensome. However, the Board decided that it would not be a faithful representation of an entity's financial position to ignore contractual obligations that remain in existence and can generate valid claims. Also, an entity would not measure the liability at a material amount if it has no information that a possible claim exists. Accordingly, there may be little practical difference between recognizing an insurance liability measured at an immaterial amount and derecognizing the liability.

Commutations

BC368. The Board considered whether commutations (contract terminations) should be presented on a gross or net basis in net income. The Board determined that for the portion of the coverage period that has expired, a net adjustment to claims and benefits was more appropriate than grossing up premiums and claims or benefits. To gross up the premiums and claims or benefits would reflect the notion that the commutation is the undoing of the original contract. However, the Board determined that the net presentation reflects the transaction in a manner consistent with a settlement of claims. However, an adjustment should be recognized to premiums for the portion of a commutation of insurance contracts that provides future coverage, given that no claims or benefits have yet to be incurred on that portion and therefore there is no settlement of those claims or benefits.

Presentation

Statement of Financial Position

Building Block Approach

BC369. The guidance in this proposed Update states that, for contracts measured using the building block approach, the fulfillment cash flows arising from an insurance contract are a combination of rights and obligations and should be presented as a single insurance contract asset or liability in the statement of financial position. The right to receive premiums from a policyholder depends on the entity's performance, and the entity will only perform if the policyholder pays premiums. The Board noted that the right to receive premiums, the performance obligation, and the obligation to pay benefits and claims in an insurance contract constitute a single unit of account for measurement purposes. Therefore, the Board concluded that net presentation of an entity's rights and obligations would most faithfully represent the level of interdependence between those rights and obligations. The Board noted that reporting the net presentation of the rights and obligations associated with a long-duration insurance contract,

which would be the majority of contracts that would apply the building block approach, is consistent with existing U.S. GAAP. This also is consistent with Topic 606.

BC370. The Board also decided that any unconditional right to premiums or other consideration should be presented in the statement of financial position as a receivable separately from the insurance contract asset or liability and accounted for in accordance with existing guidance for receivables. The unconditional right to any premiums or other consideration represents past due premium for coverage that has been provided. Therefore, the Board determined that it would be inappropriate to include this amount in the liability for future expected cash flows. This also is consistent with Topic 606.

BC371. Additionally, the Board decided that the margin should be presented separately from the liability for fulfillment cash flows (that is, the entity's liability to policyholders). The margin (or at least a portion of it) represents deferred profit, whereas the present value of the expected cash flows represents the net right or obligation to policyholders under the insurance contract. In addition, the Board noted that the present value of the expected cash flows and the margin do not constitute a single unit of account for measurement purposes and the expected cash flows and the margin are not subject to the same initial or subsequent measurement approach. Therefore, the Board decided that greater transparency would result from disaggregating the building block components of an entity's net insurance contract asset or net insurance contract liability and the margin on the statement of financial position.

Premium Allocation Approach

BC372. For contracts measured using the premium allocation approach, the Board decided that an entity should account for the gross rights and obligations separately. Unlike the majority of the contracts accounted for under the building block approach under which the entity will pay the policyholder or its beneficiary (that is, death benefits, annuity payments, or a surrender value), many of the contracts accounted for under the premium allocation approach will not have a claim. Therefore, the right of setoff does not typically exist with respect to the premiums receivable from one policyholder and the claim reserves associated with another policyholder. The Board concluded that the net presentation of an entity's combined rights and obligations does not faithfully represent the entity's economic circumstances for many of the contracts that are accounted for under the premium allocation approach. This Board noted that this approach is consistent with existing U.S. GAAP.

BC373. The Board also decided that the liability for remaining coverage should be presented separately from the liability for incurred claims. The Board noted that the economic driver for the liability for remaining coverage is different from the economic driver for the liability for incurred claims. Specifically, the liability for

remaining coverage represents the entity's performance obligation and is measured on the basis of contractual premium within the boundary of the contract. The release of the liability for remaining coverage results in the recognition of revenue over time. The liability for incurred claims represents an obligation to pay an amount for a specified event that has been incurred and is measured on the basis of the present value of the unbiased mean of expected cash outflows to those policyholders that incur an insured event. The liability for incurred claims is reduced as the entity settles the claims. The liability for remaining coverage is therefore conceptually different from the liability for incurred claims and also is measured differently. As a result, the Board concluded that separate presentation of the liability for remaining coverage and the liability for incurred claims would increase the transparency of an entity's financial statements, because separation of the performance obligation and the obligation to pay an amount in the statement of financial position would enhance a user's ability to assess the amount, timing, and uncertainty of the entity's future cash flows. The Board did not think that presenting the liability for remaining coverage and the liability for incurred claims as one liability would faithfully represent an entity's obligations. The Board noted that this approach is consistent with that in existing U.S. GAAP.

Reinsurance

BC374. The Board determined that the net reporting of assets and liabilities related to ceded reinsurance and an entity's obligations for insurance contracts written is inconsistent with the established conditions for offsetting and does not result in a meaningful presentation in the financial statements. The Board decided that presenting reinsurance ceded with the entity's insurance contracts written may obscure the required accounting for the underlying reinsured contracts. A number of stakeholders indicated that reporting insurance net of reinsurance activity is consistent with the way entities view and manage their reinsurance contracts. Those stakeholders maintained that reporting the net exposure from the reinsured contracts appropriately reflects the role of reinsurance in mitigating risk. However, the existence of a reinsurance contract does not alter the measurement of the liabilities that should be recognized on the underlying reinsured contracts. Therefore, the Board concluded that separate reporting of reinsurance receivables or payables and the related underlying liabilities will provide a more relevant and representationally faithful presentation of the effects of reinsurance.

BC375. Several balances may arise between the ceding and assuming enterprise in a reinsurance contract, including funds withheld on ceded premiums, commissions, and unsettled claims and funds advanced by the assuming enterprise. The Board noted that those items may qualify for offsetting and need to be evaluated by the entity.

Statement of Comprehensive Income

BC376. The Board considered whether to present insurance contract revenue separately for contracts measured using the building block approach and the premium allocation approach. Conceptually, because the Board decided that an earned premium method should be used for contracts using the building block approach, arguably insurance contract revenue could be combined for the two approaches because the premium allocation approach also uses an earned premium method. However, users of insurance entity financial statements have indicated that they will analyze the contracts separately (for contracts measured using the building block approach as opposed to the premium allocation approach) because the underlying economics of the contracts are different. The Board also noted that the liabilities for the different approaches are shown separately in the statement of financial position and that insurance contract revenue related to the premium allocation approach would link with the liability for remaining coverage. Therefore, the Board concluded that revenue should be separately presented for contracts measured using the building block approach and for contracts measured using the premium allocation approach.

BC377. Likewise, the Board decided that benefits and claims incurred should be presented separately for contracts measured using the building block and the premium allocation approaches.

BC378. The Board also considered whether to present insurance contract revenue and benefits and claims expense separately for reinsurance contracts assumed and ceded. The Board drew a distinction between these two types of cash flows. Premium for assumed contracts reflects a cash inflow related to taking on insurance risk, and benefits and claims expense reflects a cash outflow related to settling the entity's obligation. The Board decided that assumed reinsurance contracts are economically similar to the direct contracts written by the insurer even though the assuming entity is secondarily liable. As such, the Board concluded that an entity should present premiums and claims and benefits expense for assumed contracts together with the insurance contract revenue and claims and benefits expense with the direct contracts written for either the building block approach or the premium allocation approach. Premium ceded reflects a cash outflow that an entity pays to transfer risk to a reinsurer (perhaps better phrased as *ceded reinsurance contract expense*), and reinsurance recoverable for benefits and claims expense incurred reflects a cash inflow related to an assuming company settling its obligation with the entity. Existing U.S. GAAP allows entities either to report the effects of ceded reinsurance on earned premiums and claim costs (that is, the amount by which earned premiums are reduced by amounts paid or payable to reinsurers, and the amount by which claim costs are reduced by amounts received or receivable from reinsurers) as separate line items within net income or to disclose that information in the notes. The Board disagreed with this presentation and determined that amounts paid to reinsurers and reinsurance recoveries should be reported gross of the related earned premiums and incurred claim costs in net

income. This will provide consistency with the statement of financial position and recognizes that the existence of a reinsurance contract does not alter the revenue and expenses that should be recognized on the underlying reinsured contracts. The Board also concluded that separate reporting of reinsurance revenue and expenses will provide a more relevant and representationally faithful presentation of the effects of reinsurance.

BC379. The Board determined, consistent with its reasoning to present revenue and claims and benefits expenses for directly written insurance contracts separately for contracts measured using the building block and premium allocation approaches, that it would be appropriate to present ceded reinsurance consideration and reinsurance recoverable for benefits and claims expense incurred separately for the building block and the premium allocation approaches.

BC380. For contracts measured using the building block approach, the Board considered whether to disaggregate the insurance contract revenue on the statement of comprehensive income into its components, namely the revenue for the expected policyholder benefits and nonclaims fulfillment expenses and the release of the margin. The Board acknowledged that these components are measured differently and may be earned using different patterns; however, both components are used to derive the insurance contract revenue and therefore the Board decided that presenting the components separately would be unnecessarily complicated and could be confusing to users of financial statements.

BC381. The Board's reasoning for presenting interest accretion on the expected cash outflows as part of interest expense in net income is to pair the interest accretion with the investment income on the assets that back the insurance contract liability. The interest accretion on the cash inflows is included with the respective insurance contract revenue line items so that the total revenue recognized in a period reflects the "cash selling price" of the underlying insurance service transferred. The Board acknowledged that the interest accretion on the cash inflows and cash outflows is important information and decided that rather than cluttering the financial statements with additional line items, those components should be disclosed in accordance with paragraph 834-10-50-14 if not separately presented in the statement of comprehensive income.

BC382. In segregated fund arrangements all investment performance, net of contract fees and assessments, is passed through to the individual policyholders. Existing U.S. GAAP nets the investment income and the pass through of that income to policyholders to zero in net income. However, the Board decided that investment income generated from the assets in the qualifying segregated fund arrangements and the interest credited to policyholders as a pass through of that investment income should be presented as part of investment income and interest expense, respectively, in net income. The Board noted that although the investment income passes through to the policyholder, it is first allocated to the

assets of the entity; the entity then allocates the performance to the policyholder's account balance, typically based on units in the segregated fund arrangement. Furthermore, the Board determined that the investment income information is useful in determining how well an insurer manages its assets, a measure that is reported to the policyholder. The Board acknowledged that in most cases the policyholder chooses its investment strategy; however, the entity is responsible for either actually managing the assets or selecting the investment manager. In addition, the Board decided that excluding the investment income for segregated assets that meet specified criteria when the assets are on an entity's statement of financial position, and not necessarily disaggregated, would result in misleading investment yields on the entity's assets. The Board also decided that including the interest credited (that is, the pass through of the investment performance) in net income would result in a better comparison to other contracts that an entity issues that have participation features that wholly or partially depend on the performance of underlying items.

Disclosure

BC383. In determining the disclosure requirements for this proposed guidance, the Board considered the existing requirements in Topic 944. In selecting the disclosure objectives, the Board considered work in other related projects and concluded that disclosures about insurance contracts should enable users of financial statements to evaluate the amount, timing, and uncertainty of cash flows arising from those contracts.

Reconciliation of Opening and Closing Balances

BC384. The Board decided to include a requirement that an entity should provide a reconciliation of opening and closing balances of the liability for insurance contracts (building block approach) and the liability for incurred claims (premium allocation approach) because those reconciliations inform users of financial statements about changes to those assets and liability balances during the reporting period that they would not be able to otherwise discern by simply observing the change in the balances. The Board noted that users of financial statements indicated that these reconciliations would be one of the most useful disclosures, because much of an entity's insurance activity affects the liability balance. Furthermore, users indicated that being able to tie the disaggregated reconciliation to the manner in which the reportable segments were disclosed also would enhance the utility of the disclosure. Therefore, the Board decided that the reconciliation of opening and closing balances of the liability should not aggregate amounts from different reportable segments. However, further disaggregation should be considered if it would provide additional transparency regarding the drivers of changes to the liabilities.

BC385. Because the movements in the reinsurance recoverable balance are affected by similar transactions and assumptions to the underlying insurance

contract liabilities, the Board decided that it was logical to conclude that the reconciliation of the opening and closing balance of that amount would be equally valuable. The Board noted that the value of this disclosure would be enhanced by disaggregating it in a manner similar to the liabilities because the reinsurance recoverable economically offsets the liabilities related to the underlying contracts.

BC386. The Board also decided that a reconciliation of the opening and closing balance of the margin would be helpful because the movements in the margin are an indication of the activity that is expected to affect the entity's total profit it expects to earn as well as the profit earned in the current reporting period. That activity may include expected margin on new contracts that are written, expected acquisition costs to be incurred, and acquisition costs incurred that will reduce the entity's profit. Users have noted that having transparency on the expected profit will provide decision-useful information in assessing the performance and expected performance of an entity.

BC387. The Board also thought reconciliations that show the changes in the period of the components of the liability used in measurement are important in light of the differences between the FASB's and the IASB's models for accounting for insurance contracts. Providing reconciliations of movements in the expected cash flows separately from movements in the margin (and each of the components included in those reconciliations) would enable users of financial statements to compare the movements in the insurance liabilities of entities applying the FASB's model to the movements in the insurance liabilities of entities applying the IASB's proposed model.

BC388. The Board contemplated requiring reconciliations of the opening and closing balances of the premiums received but not yet earned for contracts measured using the building block approach. This disclosure would bridge the gap between the premium due method of earning premium as revenue under existing U.S. GAAP and the earned premium method included in this proposed guidance, because it would show premium received but not yet earned in the period. In addition, this disclosure would link a portion of the insurance contract liability with net income as well as provide users with information about the cumulative amount of premiums received but not yet earned, which has resulted in an increase in the insurance contract liability. The Board also contemplated requiring reconciliations of the opening and closing balances of the liability for remaining coverage for contracts measured using the premium allocation approach. However, the Board decided that disaggregation of particular income items and accruals could instead communicate that information to users without full reconciliations.

BC389. The Board decided that because of the manner in which premiums are earned as insurance contract revenue in the guidance in this proposed Update, users of financial statements would benefit from a disclosure of the estimated returnable amount of the fulfillment cash flows that represents the aggregate portions of the expected premiums received and claims and/or benefits that are

expected to be excluded from net income, disaggregated between those portfolios of contracts accounted for under the building block and the premium allocation approaches. This amount would indicate the difference between expected premium inflows and those amounts expected to be included in insurance contract revenue for the reporting period. In addition, the Board decided to require an entity to disclose the portion of the fulfillment cash flows paid during the current period attributable to the estimated returnable amount disaggregated between those portfolios of contracts accounted for under the building block and the premium allocation approaches. This latter amount would provide financial statement users with the information necessary to reconcile the amounts paid to policyholders with the amounts included in net income, because estimated returnable amounts will not be shown in net income.

Discount Rates, Expected Cash Flows, and Other Measurement Disclosures

BC390. Because the discount rates are an important input to measuring an insurance contract liability or asset and result in future interest expense, users have a particular interest in understanding the current rates applied as well as the interest accretion rates that will affect income in the future. Users stated that they would use these rates, along with a schedule of expected cash flows, to:

- a. Understand volatility, if any, recorded in the period due to a change in discount rates
- b. Adjust an entity's assumptions to align it with other entities for comparability or their own calculated discount rates assumptions
- c. Assess whether an entity may be approaching a loss-generating contract used for interest accretion on the portfolio (if the discount rates at the inception of the contract are significantly higher than the current discount rates).

BC391. Therefore, the Board decided to require an entity to disclose the current discount rates and the interest accretion rates by time bands that the Board believes would be relevant for the types of contracts measured using the building block approach and premium allocation approach. This disclosure would essentially show the yield curve applied to the insurance contract liability or asset. In effect, it would show a table of expected cash outflows along with the corresponding weighted-average current discount rates and weighted-average interest accretion rates. The Board considered requiring ranges of rates but decided that ranges could be too wide, thus diminishing the value of the information provided. In addition, the disclosure would be so extensive that it would be difficult to understand. The Board noted that the value of this disclosure would be enhanced by disaggregating it in a manner similar to the reconciliations of the insurance contract liabilities.

BC392. The Board considered whether this information would be considered forward looking. However, unlike expectations of some assets and liabilities, the

expectations included in this disclosure are also assumptions used in the measurement of the liabilities, which the Board believes contain relevant information to be disclosed to users of the financial statements.

Participating Contracts

BC393. The Board noted that the terms by which the participating contracts accrue benefits to policyholders would help users assess the cash flows of the entity that are unavailable to service claims or other general purposes. Once the benefits accrue to the policyholder, the liabilities are similar to other liabilities, that is, the amount accrued represents the future cash flows of the contract. However, the Board decided that disclosure of the amounts accrued during the period would be useful given that it would reflect results not necessarily related to underwriting results. Therefore, the Board decided that an entity should disclose the general criteria on which the participation features of the contracts are based and the amount during the period that accrued to the benefit of the policyholders because of those features. The Board considered whether, for contracts with participation features, an entity should disclose each of the terms of the participation features as well as the amount of the liability that is subject to the participation features. While this information may be useful, it would be an overly burdensome requirement. The Board decided that disclosing the general criteria of the participation features and the amount accrued during the period was sufficient information that would allow users to understand those features at a high level so that they can perform additional analysis if need be.

BC394. In addition, the Board decided that for contracts in which an entity's nondiscretionary obligation is contractually dependent on the performance of other assets or liabilities of the entity or the performance of the entity itself, and the contract does not qualify as a segregated fund arrangement, the entity should disclose additional information in accordance with paragraph 834-10-50-17. The Board based this on the fact that, for those contracts, an adjustment is required because the asset or liability is measured on a different basis than the obligation (that is, the amount included in the insurance contract liability is not the same measurement as in all other liabilities).

BC395. The Board also decided that an entity should disclose the amount of expected dividends to be paid to policyholders or credited to policyholders' insurance contracts that are included in the measurement of the liability but have not yet been declared. This portion of the liability is typically determined separate from the determination of the remainder of the liability, albeit affected by the expected future cash flows and by the overall results of the entity. In addition, until the dividends are declared, the entity continues to have discretion over whether or not to pay or credit the dividends. Therefore, the Board determined that disclosing the portion of the expected cash flows that is based on management's discretion would provide decision-useful information to users of financial statements.

Measurement Uncertainty

BC396. Because the measurement of the assets and liabilities under the guidance in this proposed Update would involve a degree of judgment and uncertainty, the Board decided to require disclosures analyzing measurement uncertainty. This would inform users about the extent to which the insurer might reasonably have arrived at different measurements.

Risks and Uncertainties

BC397. If an entity provides insurance, it is exposed to risks. Those risks include more than whether or not the insured event occurs or the timing of the insured event, all of which could have a significant effect on an entity's results, depending on the type of insurance contract. Therefore, the Board decided to require disclosures related to risks and uncertainties inherent in insurance contracts. In particular, the proposed guidance would require disclosures about insurance risk, concentrations, risk mitigation strategies, and market risk, including sensitivity analyses. These disclosures would provide users with insight into not only the types of risks an insurer is exposed to, but the financial effects of those risks on the entity and how the entity addresses those risks.

BC398. In addition, the Board decided to require an entity to disclose information about the effect of the insurance regulatory frameworks in which the entity operates. The proposed disclosures are for the most part consistent with existing U.S. GAAP requirements. The Board decided that information about an entity's regulatory capital, restrictions on that capital, as well as the minimum amount of capital the entity must hold, would allow users of the financial statements to understand the entity's capital adequacy and to perform a comparison across entities. In addition, the Board noted that there are situations in which entities receive an exemption from applying prescribed accounting practices from their regulators, which is referred to as a permitted practice in the United States. That permitted practice often has an effect on the regulatory capital. The Board decided that had a regulatory event been triggered if the entity had not applied a permitted practice, the disclosure of that event would provide decision-useful information.

BC399. The Board was concerned that requiring these disclosures would be unduly burdensome on entities that are subject to insurance regulators. However, the Board noted that there are similar disclosure requirements regarding capital requirements within U.S. GAAP for other financial service institutions. The Board noted that those disclosures may be useful for entities that are governed by other regulators and indicated that it will consider this in the future. However, until that time, entities within the scope of this proposed Update would be required to make the proposed disclosures.

Transition and Open Effective Date Information

General Transition Approach

BC400. The Board considered the tradeoff between verifiability and comparability of contracts that were in force at the date of transition and those that were issued after the date of transition. Accordingly, this guidance proposes that an entity should measure insurance contracts by means of retrospective application to all prior periods.

BC401. While measuring the present value of the fulfillment cash flows in accordance with this proposed guidance using current assumptions at the date of transition should be no more difficult than performing that measurement for a later date, provided an entity has sufficient lead time to set up the necessary systems, the Board recognized that determining the margin for contracts measured using the building block approach at the date of transition is more challenging. In principle, an entity would determine the remaining margin by:

- a. Estimating the fulfillment cash flows at initial recognition of the contracts
- b. Determining the margin at initial recognition of the contracts as the difference between the fulfillment cash inflows and the fulfillment cash outflows
- c. Estimating the amount of margin that would have been recognized in net income in the periods before the date of transition.

BC402. Thus, to apply this proposed guidance retrospectively, an entity would need to estimate, in addition to the direct measurement of the fulfillment cash flows at the date of transition, the expected cash inflows and outflows at the date of initial recognition of a portfolio of insurance contracts and the discount rates at the date of initial recognition.

BC403. Determining these amounts retrospectively may be burdensome and costly and would be subject to bias through the use of hindsight. As a result, for many contracts, retrospective application of this proposed guidance would often be impracticable as defined in Topic 250, Accounting Changes and Error Corrections.

BC404. In the 2010 IASB Exposure Draft, the IASB proposed that an entity should, on first applying the proposed guidance, measure its existing contracts at that date by setting the contractual service margin equal to zero. That conclusion reflected the IASB's concern that retrospective application of the proposed guidance would sometimes be impracticable and, if not impracticable, would often cause costs disproportionate to the resulting benefit for users. However, most comment letters responding to the 2010 FASB Discussion Paper and the 2010 IASB Exposure Draft criticized this approach because it would result in a significant lack of comparability between contracts that were in force at the date of transition and those that would be initially recognized after the date of

transition. The largest concern was the inconsistency in the earnings for contracts written before and after the transition date. The effects of this lack of comparability and consistency would be prevalent in the financial statements of entities issuing insurance contracts for many years to come, because of the long duration of insurance contracts.

BC405. The Board considered the proposal in the 2010 IASB Exposure Draft, but was persuaded by the arguments that there would be a lack of comparability in the measurement, both at transition and subsequently, and a lack of consistency in the earnings, of contracts that were written before and after the date of transition. In particular, the Board was persuaded that when an entity first applies new guidance, the primary focus should not be on whether the measurement of the contract is verifiable but on consistency between:

- a. The measurement of the insurance contract liability and the margin on the insurance contracts in force at the date of transition and contracts written after transition
- b. Insurance contract revenue and profit on the in-force insurance contracts at transition and on new contracts issued after transition.

BC406. The Board also considered that the benefits of the information provided in the transition application should justify the costs of providing it.

BC407. In addition, the Board considered that financial statement users have indicated that full retrospective application is desired because:

- a. It would facilitate their analyses of the margin balance and the earnings trends after a one-time effect at the transition date. Without full retrospective application, users would have to perform analysis separately for contracts written before and after the transition date.
- b. Users' projections of future earnings could be consistent for all contracts.
- c. It would enhance the users' ability to compare entities that previously used different accounting methods.

BC408. However, when full retrospective application of the proposed model would not be practicable, the Board felt that recognizing an estimate for the margin on portfolios of contracts written before the earliest period practicable to apply the proposed model retrospectively would achieve the highest amount of consistency in the measurement of the assets and liabilities and comparability of earnings for all portfolios of contracts.

BC409. In many cases, entities that issue insurance contracts will have objective, contemporaneous data about insurance contracts issued before the date of transition. Those data could include actuarial reports and regulatory filings, among other information. The Board considered whether an entity that issues insurance contracts should be permitted to use that information in estimating the margin to increase comparability between the accounting for

contracts in force at the date of transition and the accounting for contracts that are initially recognized after the date of transition. In addition, because the insurance business is in a competitive market, the estimates should not be significantly different among insurers.

BC410. Allowing insurers to determine the earliest practicable date that the guidance in this proposed Update can be applied retrospectively by portfolio of contracts would provide better consistency of the measurement of the margin and comparability in future earnings for a higher portion of the insurers' portfolios of contracts than if insurers were to be required to use a consistent date across all of its portfolios of insurance contracts. That is because an entity may have objective data going back to different periods of time for its different portfolios. Thus, requiring a consistent date for the earliest practicable date could hamper an entity's ability in developing its best estimate of the margin for certain portfolios.

BC411. As such, the Board decided to allow insurers, when impracticable to apply the insurance contracts guidance retrospectively, to estimate what the margin would have been at contract inception had the insurer been able to apply the proposed guidance retrospectively and then roll the amounts forward to the earliest period presented (that is, the transition date). In determining that estimate, insurers would be required to take into account all objective information that is reasonably available. The Board determined that using historical data to estimate the margin would result in the most comparable measurement of the margin and consistent earnings for all portfolios of contracts.

BC412. The historical data will most likely have been accumulated based on the existing definition of a portfolio. While the groupings of contracts into portfolios may remain the same after adoption of this proposed guidance, it will not necessarily be the case for all portfolios or all entities. Because regrouping the objective information used in estimating the margin may be complex, the Board determined that insurers should be able to use the objective information as currently tracked to determine the estimate of the margin on the portfolios as currently defined. In those situations, contracts written before the transition date may be grouped into separate portfolios from contracts written or substantially modified after the transition date if the entity's determination of the portfolio differs from what the portfolio would be under this proposed guidance.

Determining the Discount Rates at Transition

BC413. To estimate the margin for contracts measured using the building block approach and to determine the interest accretion rates on all contracts, an entity will need to determine the discount rates that would have been applied at initial recognition of the contracts in accordance with the guidance in this proposed Update. The Board acknowledged that insurers may find it operably challenging to determine the initial discount rates because the data may not be available and, if available, would be difficult to determine without using hindsight. As such, the

Board decided that insurers should determine the discount rates using the proposed guidance for a minimum of three consecutive years before the effective date. The Board recognizes that the years used may differ by entity and possibly by portfolios. However, the Board did not want to hamper an entity's ability to implement the proposed guidance and to determine the effects of adoption earlier than proposed by requiring the three years to be the three years immediately preceding the effective date. The Board felt that this may be too late for many entities but did not want to require the three years to be the three years immediately preceding the transition date because that may be too early for many entities. In addition, the Board was cognizant that in the latter case, the earliest of the three years may be before this proposed guidance is issued as final. Those rates would be compared to an observable market for those respective years to determine the best corresponding rates. Using that observable market, the discount rates to be applied to the expected cash flows would be the equivalent rates for each of the years in which the insurer applies the guidance in this proposed Update retrospectively.

BC414. An argument against this approach is that the rates applied may not be identical to the rates that would be used if the insurer determined the discount rates in accordance with the guidance in this proposed Update for each year in the retrospective period. However, the Board concluded that it is a valid proxy. Because the yield chosen for the practical expedient is based on an equivalent yield (or nearest proxy) to that which is determined by applying this proposed guidance, the Board determined that there is support for the rates that would be used in the retrospective period. The Board further concluded that while using only one year as a reference could be considered an anomaly, requiring three years could be considered a trend without becoming unduly burdensome or impractical.

BC415. The Board realized that in some jurisdictions there may not be observable market rates that are equivalent to the discount rates determined by applying this proposed guidance. In those situations, the Board determined that it would be reasonable for an entity to calculate a spread between the calculated discount rates and the observable market rates and to apply that spread to the observable market rates for the retrospective periods.

BC416. The Board also considered requiring an entity to use the current rates at transition or the discount rates that are applied under current accounting guidance. However, the Board concluded that using either of those rates would not achieve consistency in the measurement of the margin or the interest accretion for contracts in force at the date of transition and contracts written after transition.

BC417. For portfolios of contracts for which the initially determined interest accretion rates are adjusted in accordance with this proposed guidance, the Board concluded that a practical expedient to determine the interest accretion rates would be to apply a ratio between the calculated interest accretion rates in

accordance with this proposed guidance and the observable rates averaged over a minimum of three consecutive years before the effective date. The Board believes that is consistent with the guidance to determine the interest accretion rates when those rates are not adjusted, and that this provides a reasonable proxy for the adjustments that would be made to the initial discount rates as required in paragraph 834-10-35-25. In determining the observable rates, an entity should use the same methods it will use to apply the proposed guidance on an ongoing basis. That is, if an entity determines changes in interest accretion rates are based on a percentage of a specific bond curve, then that method should be applied. However, if an entity determines changes in interest accretion rates are based on the movement of a rolling average of a specific bond curve, then that method should be applied.

Alternative Approaches Considered for Determining the Margin for Contracts Measured Using the Building Block Approach

BC418. The Board considered whether an entity should determine the margin at the date of transition as the difference between the present value of fulfillment cash flows and another measure of the insurance contract at the date of transition, for example, fair value, a hypothetical entity-specific fulfillment value, or the carrying amount under existing U.S. GAAP. However, the Board observed that those other measures would not aim to provide comparability between contracts in force at the date of transition and contracts that are initially recognized after the date of transition. In addition, the Board concluded that fair value and a hypothetical entity-specific fulfillment value would not exclude the use of hindsight and could be just as complex and costly to determine as applying this proposed guidance retrospectively with the practical expedients.

BC419. Furthermore, those measures would not provide the information needed to determine insurance contracts revenue and also would require the Board to specify practical expedients. Therefore, the Board concluded that there would be minimal benefit in applying a different measure of the insurance contract at the date of transition.

Transition for Insurance Contract Revenue for Contracts Measured Using the Building Block Approach

BC420. In addition to the release of the margin, insurance contract revenue includes the recognition of the revenue attributed to the fulfillment cash outflows. This proposed guidance would recognize the revenue attributed to the fulfillment cash outflows over the coverage period in proportion to the value of coverage and any other services that the insurer has provided. Therefore, at transition, an entity should determine the remaining value of coverage and other services that are expected to be provided.

BC421. To estimate the amount of the remaining value of coverage and other services that are expected to be provided, an entity would need to separately identify the amount of the liability related to changes in assumptions between inception of the contracts and the earliest period presented and, if there were any losses on initial recognition, the portion of those losses that remains to be reversed. The Board determined that for the contracts in which retrospective application was applied to estimate the margin, an entity should have the data to objectively determine those amounts.

BC422. However, for contracts for which retrospective application is not practicable to determine the margin, the Board recognized that it would be just as impracticable to retrospectively determine the revenue remaining to be earned. This is because an entity would likely not have data to estimate how much of the liability for remaining coverage is related to changes in assumptions and day one losses. Therefore, as a practical expedient, the Board decided to allow an entity to set the insurance contract revenue remaining to be earned equal to the portion of the insurance contract liability for which an insured event has not occurred, which is analogous to the amount of the liability for remaining coverage (excluding any estimated returnable amounts) recognized at the date of transition. This presumes that any losses on initial recognition of the contracts and all changes in expected cash flows recognized before transition relate to past coverage provided, which may not always be the case. However, in making this decision, the Board noted that the amounts to be recognized in future periods would solely affect the presentation in net income and would not affect the measurement of the insurance contract liability, an insurer's equity, or an insurer's net income. To alleviate concerns that the future revenue to be recognized could exceed the consideration received or expected to be received from policyholders, the Board decided to limit the remaining insurance contract revenue to be earned to the total expected cumulative consideration for in-force policies in the portfolio less receipts for the estimated returnable amounts.

Prior Business Combinations

BC423. Current U.S. GAAP recognizes an "intangible asset," which is sometimes referred to as the value of business acquired or the present value of future profit, for the excess of the fair value of the insurance contracts acquired and the liability measured in accordance with the acquirer's accounting policies. Because the Board decided to measure the present value of the fulfillment cash flows using current estimates at the date of transition and to apply the guidance retrospectively, an entity would be required to go back to purchase accounting allocations and determine at that date the margin and the interest accretion rates. This decision has no effect on the allocation of the purchase price consideration to the insurance contract liability; however, it will result in the elimination of any previously recognized intangible asset.

BC424. Some Board members are concerned that entities may not have the data to perform this reallocation and, therefore, considered whether the

intangible asset at the transition date should be carried forward as the margin. However, that amount was initially calculated differently than the margin is calculated in this proposed guidance. In addition, the previous amortization of the intangible is not consistent with the recognition of the margin in this proposed guidance. Therefore, the amount of the intangible immediately before the transition date would not be comparable to the margin on the insurance contracts directly issued by the entity.

Redesignation of Financial Assets

BC425. Absent any special transition provisions, any redesignation of an entity's classification of its financial instruments would be expected to be rare or infrequent and would require support indicating a significant change that affects the entity. However, the Board concluded that it would be plausible that an insurer could reach different conclusions about classification when the relevant financial instruments guidance is first applied than it would in reassessing the existing classification of financial assets upon comprehensive changes in the accounting for insurance contracts. That could be the case if an insurer changes its investment and/or asset-liability management strategy. While the asset-liability management is focused on the economics of the assets and liabilities rather than the accounting, if the accounting change results in an accounting mismatch, management may change its intent or business strategy. Because asset-liability management is a fundamental aspect of an insurer's business, the Board recognized that allowing for increased comparability of the integral relationship between insurance contract liabilities and related assets would enhance the decision usefulness of the asset and liability measurements. Absent such an alignment, the perceived integrity of any relationships between the financial assets and insurance contract liabilities might impair trend analysis and minimize transparency as to the effectiveness of the asset-liability management activity.

BC426. As a result, the Board concluded that upon adoption of the guidance in this proposed Update, an entity would be permitted to redesignate its classification of financial assets using the same transitional options that are available under the transitional provisions of the relevant financial instruments guidance in effect at that time.

BC427. However, the Board does not believe it would be appropriate for an entity that operates in multiple industries, including banking, manufacturing, and services, and issues some insurance contracts to be able to redesignate its entire financial asset portfolio. Therefore, the Board decided to limit this one-time reclassification to an entity's financial assets that are designated to its insurance business by legal entity or internal designation and related to funding of insurance contracts that are newly determined to be insurance. The Board concluded that this approach would properly limit the redesignation of an entity's classification of its financial assets to those that are used to back the entity's obligation for its insurance contracts.

Disclosures

BC428. The Board decided not to require an entity that would adopt the guidance in this proposed Update to disclose certain requirements in Topic 250 on accounting changes. Specifically, the Board does not believe that disclosing the nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable, would be meaningful given that entities will be required to adopt the proposed guidance. In addition, the Board decided that an entity should not be required to disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the period in its annual or interim financial statements in which this proposed Update is effective. In the Board's view, the cost of providing this disclosure, which would include the running of parallel systems, would outweigh the benefits.

BC429. In addition, the Board decided to exempt an entity from disclosing more than five years of claims development information if it had not previously disclosed that information. The Board determined that requiring an entity to go back more than five years to prepare this disclosure, which requires a significant amount of data, could be unduly burdensome.

Benefits and Costs

BC430. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, cost is a pervasive constraint on the information that financial reporting can provide; the benefits of providing information that helps to achieve that objective should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by the preparer and, by extension, the preparer's investors. The Board's assessment of the costs and benefits likely to result from issuing new guidance is unavoidably more qualitative than quantitative. Neither objective measurement of the costs to implement new guidance nor quantification of the value of improved information in financial statements is possible.

BC431. Throughout its deliberations that led to the guidance in this proposed Update, the Board considered whether the expected improvement in the usefulness of the information—improvements in its relevance and the extent to which it faithfully represents what it purports to represent—justifies the costs that stakeholders are likely to incur to prepare and use that information. The Board believes that the proposed guidance would improve financial reporting by

establishing a consistent, comprehensive framework for measuring and presenting financial statement information about insurance contracts that an entity issues and reinsurance contracts that an entity holds. The Board also concluded that the expected improvement in financial reporting would be achieved at an acceptable cost. The reasons for the Board's decisions on benefits and costs, including the expected effect on the complexity of financial reporting, are discussed in the following paragraphs.

Gathering Information about Benefits and Costs

BC432. As part of its due process that led to the proposed guidance, the Board conducted extensive outreach activities with investors, regulators, and other users as well as preparers, actuaries, and auditors of financial statements to obtain information about specific areas for improvement in the existing accounting guidance for insurance contracts. These outreach activities conducted include roundtables, workshops, question-and-answer sessions, participation in conferences, and meetings with insurance industry trade groups, preparers, auditors, and users. Nonpublic entities also were included as part of the outreach efforts with users and preparers. Educational sessions and roundtables (both joint with the IASB and FASB only) also have been a large part of the staff's outreach efforts, as well as meetings with various advisory groups. The Board also conducted field visits for the purposes of discussing the different dynamics of the proposed model, mainly with preparers. The Board's outreach activities also included varying amounts of discussion about the potential costs and feasibility of implementing the Board's proposals for improving the accounting for insurance contracts.

Expected Benefits of the Proposed Guidance

BC433. The Board believes that the proposed guidance would provide relevant, transparent, and comparable information that faithfully represents the effects of a reporting entity's obligation for insurance contracts it issued and reinsurance protection it purchased on its financial position and financial performance. As a result, the information provided about an entity's exposure to insurance contracts would be more decision useful than the information provided under current accounting guidance.

BC434. The Board believes that the most significant increases in decision usefulness would result from the following provisions:

- a. Replace existing product-specific guidance with principles-based guidance for measuring insurance contracts, which reduces complexity for preparers, auditors, and regulators.
- b. Include within the measurement of insurance contract liabilities all costs that arise from the contract (that are not separately accounted for under revenue recognition or financial instruments guidance), including any from guarantees and options comprising part of insurance contracts.

- c. Disaggregate the estimated future cash flows and the remaining deferred profit for long-duration contracts within the financial statement presentation, thereby increasing transparency.
- d. Update the assumptions used in the measurement of traditional long-duration contract policyholder benefits each reporting period to reflect all available information.
- e. Segregate the effects of underwriting performance from investment performance.
- f. More faithfully represent time value for short-duration insurance contracts by measuring the liabilities on a discounted basis.
- g. Present revenue in a manner more consistent between long-duration and short-duration insurance contracts as well as with other industries, including the exclusion of estimated returnable amounts from revenue and the repayment of those amounts from expenses.
- h. Provide more information about assumptions (for example, estimated timing of cash flows) and effects of assumptions in the financial statements, increasing the transparency of the measurement of insurance contracts.

BC435. The following aspects of the proposed guidance also would make significant contributions to improve decision usefulness:

- a. Enhance comparability by requiring contracts that transfer significant insurance risk to be accounted for in a similar manner, regardless of the type of entity issuing the contracts (for example, many contracts currently accounted for under Topic 460 on guarantees).
- b. Mitigate estimation bias and enhance consistency and comparability of the liability for incurred claims by measuring it based on the probability-weighted mean rather than a best estimate of future cash outflows.
- c. More faithfully represent time value for long-duration insurance contracts by measuring the fulfillment cash flows, other than those that are contractually linked to the performance of an underlying item, with discount rates that reflect the characteristics of the liability rather than the invested assets related to those liabilities.
- d. Enhance comparability of recognition of acquisition costs in net income by requiring them to be recognized in the same pattern as the margin for contracts measured using the building block approach and by removing the requirement to reflect changes in the estimated gross margin by retrospectively adjusting the deferred acquisition cost balance and amortization of that balance.
- e. Enhance comparability of similar transactions by establishing criteria for when the premium allocation approach should be applied that focuses on economic characteristics of the contract other than only the length of the coverage period.
- f. Simplify and enhance comparability in the presentation of the liability for remaining coverage and premiums receivable by clarifying that for

contracts reported under the premium allocation approach, an insurer would not include expectations of future changes in coverage (for example, policyholder cancellations) in the cash flows for purposes of measuring the liability for remaining coverage or the premium receivable.

- g. Enhance comparability of revenue and claims expense for economically similar contracts by (1) treating any other cash flows resulting from contractual features affecting the amount of premiums that are contingent on claims or benefits experience (often referred to as *loss sensitive features*) as part of the claims and benefits cash flows (rather than as part of the premiums) and (2) treating any ceding commissions and other fees expected to be received from the assuming entity that are not contingent on claims and benefits experience as a reduction of the premium ceded to the reinsurer.
- h. Enhance comparability with economically similar noninsurance transactions by separately measuring services (for example, the title search in a title insurance contract and claims processing services that are distinct from the entity's obligation under an insurance contract) and investment components of an insurance contract that are distinct from the insurance coverage, in accordance with revenue recognition and financial instruments guidance, respectively, if specified criteria are met.
- i. Enhance presentation and measurement comparability and consistency of segregated fund arrangements, regardless of jurisdictional-specific legal isolation rules.
- j. Provide transparency to the implicit cost of financing the insurance contracts' cash flows by presenting together with investment income, rather than in underwriting income, an explicit amount of interest expense associated with the unwind of the discount of insurance contract liabilities.
- k. Enhance comparability and consistency of day one-loss recognition for contracts acquired in a business combination and contracts issued or assumed outside of a business combination.

Expected Costs of Implementation, Including Effects on Complexity

BC436. The Board expects that most of the direct costs of applying the proposed guidance are likely to be the costs of the systems changes incurred to implement the guidance (at the effective date of the final guidance). These will likely include both new systems (for example, administrative, actuarial valuation, forecasting, and reporting tools) and system changes to capture and transmit data in new ways. Due to the age of many in-force contracts (that is, some that will have been issued decades ago), entities might reasonably face challenges in accumulating the necessary data, especially if there was no perceived need to store the data historically or if the systems used to store the data have since

been retired. Some of those challenges should be mitigated by the availability of various practical expedients included in the transition guidance.

BC437. Many entities also will incur initial costs to educate employees about how to comply with the new requirements, as well as explain the effects of the changes in accounting for insurance contracts on the entity's financial statements to analysts who follow the company and other users of its financial statements. Other costs may include those associated with consequences of adopting the proposed guidance, such as reengineering processes, internal controls and risk management, contract redesign and pricing, modification of investment and hedging strategies, and auditing fees in the period of adoption.

BC438. Once those systems and other changes are made and the related education and explanation has been accomplished, the Board believes that for most entities the incremental, ongoing costs of providing the information that the proposed guidance would require are less likely to be significant compared with the costs of initially implementing the guidance. For some, the ongoing costs may be less than the cost of complying with current requirements, mainly because of the replacement of product-specific guidance with one of two accounting models. However, many entities will incur incremental costs in comparison to the costs of complying with existing U.S. GAAP for enhanced processes and controls around updating assumptions each period, several of which are new assumptions not previously required to be determined (for example, determining the estimated returnable amounts, determining the amount of revenue to be recognized each period for contracts measured using the building block approach, and discounting for contracts measured using the premium allocation approach, among others) and for disclosures.

BC439. The Board recognizes that the initial costs of preparing to comply with the guidance in this proposed Update are likely to be significant for many entities, including noninsurance companies. For some entities, depending on their individual situations and the complexity of their products, the ongoing costs may be somewhat higher than the costs of complying with current U.S. GAAP. These costs will include the additional costs for employees, actuaries, and auditors resulting from more frequent updating of assumptions and additional processes and controls to deal with the significant judgments.

Expected Effects on Complexity of Financial Reporting about Insurance Contracts

BC440. Financial reporting complexity also contributes to the cost to prepare, audit, and use financial reporting information. Throughout its deliberations, the Board considered the potential effects on complexity in financial reporting about insurance contracts. In addition, after reaching tentative decisions on all of those issues, the Board conducted an analysis of the cumulative effect of the resulting proposed guidance on the complexity of financial reporting about insurance

contracts. The Board discussed that analysis in a public Board meeting before issuing this proposed Update.

BC441. The Board observes that the accounting for insurance contracts, including the different features that are included in some insurance contracts, is inherently complex. In general, the guidance in this proposed Update increases comparability among entities and reduces some complexity in existing U.S. GAAP. However, additional complexity is inevitable based on some of the Board's decisions that change existing U.S. GAAP, for example, discounting is more complex than not discounting. The Board's view of how the guidance in this proposed Update would affect the complexity of financial reporting is discussed in the following paragraphs in the context of the specific features of accounting guidance that often result in complexity.

Different Accounting for Economically Similar Transactions or Events

BC442. The guidance in this proposed Update would require contracts that transfer significant insurance risk to be accounted for in a similar manner, regardless of the type of entity issuing the contracts. However, in contemplating the consequences of expanding the scope of insurance contract guidance to contracts issued by noninsurance companies, a number of scope exceptions have been introduced. Most of those scope exceptions result in continuing application of accounting treatments that exist under current U.S. GAAP, which are considered to provide sufficient decision-useful information to users. Others, including leases and revenue recognition, are the subject of other projects on the Board's agenda. Although, due to the scope exceptions, alternative accounting treatments for contracts that meet the definition of an insurance contract will continue to be used should the guidance in this proposed Update become final. However, on balance, the scope of this proposed Update enhances rather than reduces comparability and consistency compared with current U.S. GAAP.

BC443. In developing the insurance contracts guidance in this proposed Update, the Board considered the applicability of tentative decisions reached in other ongoing projects, including revenue recognition and financial instruments. A few notable differences between the proposed insurance contracts guidance and decisions reached on the revenue recognition project include the scope of eligible acquisition costs to be deferred (that is, revenue recognition requires each cost to be incremental) and the proposed guidance's requirement for an entity to estimate income for future fees expected to be charged for investment management and other services and expected surrenders. Each of those differences was arrived at on the basis of perceived distinctions between the insurance industry and other industries. The acquisition costs decision for insurance contracts was based on a business model for insurance under which insurers manage their business and related costs on a portfolio basis, while the decision to incorporate future fees into the measurement was based on

prioritizing consistency in measurement of other insurance contract cash flows over the recognition and measurement of comparable cash flows from the investment management industry.

BC444. Under current U.S. GAAP, multiple accounting models exist depending on the nature of the insurance contract. The guidance in this proposed Update includes two broad models for accounting for insurance contracts, which would represent a reduction in the use of alternative accounting treatments for economically similar transactions. Although some view the premium allocation approach as a simplification of the building block approach, the Board believes the two models—building block approach and premium allocation approach—are representative of the fundamental differences in the types of contracts that would apply each approach and that the results produced by the two approaches will be representationally faithful of the unique characteristics of the contracts. Although many aspects of the premium allocation approach and the building block approach are the same, the Board decided on different measurements between the two approaches for some aspects, which will produce different results. In practice, most analysts focus either on life insurance business (expected to be mostly accounted for under the building block approach) or on nonlife insurance business (expected to be mostly accounted for under the premium allocation approach), or if they focus on both, they separately analyze the results and, therefore, the differences between the two models would likely not affect their analyses.

BC445. Another example of alternative accounting treatments for contracts accounted for under the proposed guidance is some inconsistencies in the treatment of gains and losses depending on whether an insurance contract provides retroactive coverage, prospective coverage accounted for under the premium allocation approach, or prospective coverage accounted for under the building block approach. Specifically, the margin attributable to any gains (that is, the excess of expected cash inflows over expected cash outflows) is released over a period extending through the settlement period for retroactive insurance contracts and for prospective insurance contracts accounted for under the building block approach but is fully released over the coverage period for prospective coverage for insurance contracts accounted for under the premium allocation approach. This different basis for accounting for those transactions is based, in part, on a view of some that the premium allocation approach and the building block approach represent two distinct models for two economically distinct classes of contracts. Additionally, any losses (that is, excess of expected cash outflows over expected cash inflows) are recognized immediately for any written or assumed coverage and for any purchased retroactive reinsurance coverage but are deferred and recognized over the coverage period for any purchased reinsurance protection. The Board's decisions are based, in part, on the views that (a) the nature of the risks ceded and assumed are fundamentally different depending on whether the coverage relates to an insured event that has already occurred or not occurred and (b) only the amounts paid for purchased

prospective reinsurance coverage are equivalent to prepaid insurance premiums that should be recognized over the coverage period as the cost of reinsurance. While this view may seem complex, it is generally consistent with existing U.S. GAAP and therefore is not adding complexity to the models.

BC446. The guidance in this proposed Update would allow an entity to apply a number of practical expedients (for example, to avoid discounting or to determine the time value of money). Each of those practical expedients introduces some opportunity for reduced comparability and consistency. However, each was individually considered by the Board, which concluded that the reduction in cost and complexity resulting from those expedients exceeded the reduction in benefits that resulted from introducing the exceptions.

Bright-Line or Percentage Tests

BC447. The guidance in this proposed Update would place limited dependence on bright-line or percentage tests. Instances within the proposed guidance with such a test include:

- a. For contracts measured using the building block approach, the use of a threshold for unlocking the margin and recognizing the margin immediately as income when the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance contracts exceeds the expected cash inflows
- b. For contracts with a coverage period of one year or less, the requirement to apply the premium allocation approach and a practical expedient for recognizing all costs of acquiring a portfolio of insurance contracts as an expense when incurred
- c. For contracts measured using the premium allocation approach in which the time period between when the policyholder pays all or substantially all of the premium and when the entity provides the corresponding part of the coverage is one year or less, a practical expedient to not require entities to adjust the liability for remaining coverage to reflect the time value of money
- d. For contracts measured using the premium allocation approach, liabilities for incurred claims that are expected to be paid within one year of the occurrence date, a practical expedient to not discount
- e. For liabilities for incurred claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year, a practical expedient for not disclosing information about the development of claims.

BC448. The introduction of these bright-line tests was based on balancing the costs of a more detailed analysis with the perceived limited incremental decision-useful information of applying the corresponding guidance in these situations. On balance, the Board decided that those limited uses of bright-line tests would reduce the complexity and cost of preparing financial statements.

BC449. Although there are various references to the term *significant* throughout the proposed guidance and the Board is aware that, in practice, the evaluation of the term *significant* often times evolves into a bright-line test, the Board does not intend the use of this term to imply its advocacy for a bright-line threshold in those instances. For example, for a reinsurance contract to qualify for accounting as an insurance contract under existing U.S. GAAP, there must be a reasonable possibility the insurer suffers a significant loss. Although the guidance in this proposed Update would retain the concept of significance, it would remove the reasonable possibility criterion, which should reduce the complexity of the accounting guidance for insurance contracts.

Insufficient or Overly Detailed Implementation Guidance

BC450. In developing the implementation guidance in this proposed Update, the Board sought to strike an appropriate balance between:

- a. Insufficient guidance that might result in differing judgments in similar circumstances, thereby reducing comparability (or consistency) and making it more difficult for users to make meaningful comparisons
- b. Overly detailed implementation guidance that can contribute to complexity by making the requirements more difficult to understand or by becoming a set of de facto rules that preclude an entity from using its judgment to apply the requirements in ways that best represent the transaction or event.

BC451. The proposed implementation guidance explains how the measurement, presentation, and disclosure principles lead to decisions about how to account for specific aspects of insurance contracts in specified situations, which will help stakeholders apply those principles. Considered on an overall basis, the Board believes that the proposed implementation guidance would contribute to a reduction in complexity.

Excessive or Overly Prescriptive Presentation or Disclosure Requirements

BC452. The guidance in this proposed Update would require an entity to separately present on the face of the statement of financial position insurance contract liabilities/assets measured under the building block approach from contracts measured under the premium allocation approach. In addition, those liabilities/assets would be separately presented for written/assumed contracts and reinsurance ceded contracts. Additional disaggregation also is required, the specifics of which are dependent on whether a contract is measured under the building block approach or the premium allocation approach. Similarly, for direct/assumed contracts and reinsurance ceded contracts, revenue from and expenses for contracts measured under the two measurement approaches would be disaggregated on the statement of comprehensive income. Although the presentation requirements result in increased disaggregation and details in the

face statements, the Board decided that those proposed presentation requirements would reduce complexity for users of the financial statements, making it unnecessary for them to search through the notes to understand how an entity measures its insurance contracts (at a high level) without increasing complexity for preparers of financial statements. The Board observes that, in practice, the majority of these items are disaggregated under current U.S. GAAP.

BC453. The proposed disclosures are more robust than the disclosure requirements in existing standards, while eliminating some required disclosures that were perceived not to provide decision-useful information. The proposed disclosures should result in an entity disclosing additional information to users about its assumptions used in the measurement of the insurance contract liabilities and changes in those assumptions. Users have indicated that the proposed disclosures would provide more transparency into the exposures of an entity and the drivers of the results. The Board noted that each of the proposed disclosures would provide useful information to users of financial statements if that information disclosed is material to understanding an entity's financial position, performance, and cash flows.

Other Complexities of the Model

BC454. The insurance contracts project's early focus was on liability measurement and the project initially contemplated a summarized margin presentation, which essentially treated all cash inflows associated with an insurance contract as deposits and limited revenue to the margin. In response to users' emphasis on the importance of including volume information in the statement of comprehensive income and the resulting deliberations of the most appropriate measure to present on the statement of comprehensive income, the Board decided that an entity should recognize revenue for the fulfillment of cash flows over the coverage period in proportion to the value of coverage and any other services that the insurer has provided. Because of the blend of insurance coverage, investment management, and other services in many contracts, the Board concluded that excluding cash inflows related to an amount that the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs from revenue is important to enhance comparability between entities issuing insurance contracts and financial type contracts. Additionally, consistent with principles included within the broader proposed revenue recognition standard, the Board concluded that revenue for the fulfillment of cash flows should include interest accretion on the premiums received for the insurance component and other services related to the fulfillment of cash flows to reflect the time value of money for the period of time between when the entity receives premium and its provision of the corresponding coverage. Each of these requirements—recognizing revenue in proportion to the value of coverage and other services, estimating an amount that is expected to be returned to policyholders or their beneficiaries, and accreting interest on the revenue—are individually complex and would likely increase the cost of

preparing financial statement information relative to existing U.S. GAAP because it introduces the need for some additional calculations and tracking of data that would not otherwise be required. Notwithstanding the increased cost, the Board decided that the principles it has proposed are the appropriate principles that should be followed if a revenue-like volume indicator is to be included in the statement of comprehensive income.

BC455. A consequence of updating each of the assumptions each period, especially for longer duration contracts, is that a relatively minor change in interest rates can have a significant effect on the liability measurement. In response to concerns raised by many stakeholders that gains and losses from underwriting and investing activities would be obscured by more volatile, potentially larger, gains and losses that arise when there are changes in the discount rates applied to the cash flows that arise from insurance contracts, the Board decided that the effect of changes in the discount rates would be recognized in other comprehensive income. In order to calculate the appropriate amounts to record to interest expense and other comprehensive income, an entity would likely need to track its issuance date discount rates by contract or portfolio and separately calculate the insurance contract liability under both the locked-in interest accretion rates and the current rates required for the liability. Even though doing so will introduce additional preparer and auditor cost, the Board decided that the benefit of increased transparency would exceed this cost.

BC456. For some contracts, the interest accretion rates will be periodically reset. Specifically, interest accretion rates for insurance contracts with discretionary participation features (for example, universal life contracts) would be reset upon any change in expectations of the crediting rates used to measure the insurance contract liability. The rate will be reset in a manner that recognizes any changes in estimated interest crediting and related expected cash flows on a level-yield basis over the remaining life of the contracts. The degree to which the interest accretion rates for the portfolio is adjusted would reflect the relative value of the account balances to be credited and the extent to which the change in expected interest crediting rates for the portfolio related to the changes in expected asset returns affects the present value of expected cash flows on the account balances. Accordingly, an entity will need to apply judgment to exclude any changes to the discretionary crediting rate that are not deemed to be driven by changes in expected asset returns. Because the crediting rate is discretionary, there are many factors that might influence the entity's determination of the rate including mortality, lapse, and expense experience and competition. The exact effect of changes in expected asset returns on the discretionary rate selected might not be verifiable. The basis for resetting the interest accretion rates includes the fact that some movements in interest rates affect the cash flows of asset-affected contracts, such as universal life contracts, and that presenting interest expense based on rates locked in at the inception of those contracts would be inconsistent with the variable rate nature of the amounts borrowed by the entity under the contract. These contracts have similar economic features to

floating rate interest payments on amounts borrowed by the entity. Because those payments vary with changes in interest rates, portraying the interest expense as if it resulted from fixed-rate financing would be inconsistent with the objective of recognizing in other comprehensive income changes that reverse when the contract is settled. Furthermore, the degree to which entities adjust the locked-in interest accretion rates should be reflective of the extent of change in amounts expected to be paid to the policyholder as interest, and thus should exclude any changes in cash flows attributable to underwriting activity. Notwithstanding the complexity, the Board thinks that resetting the interest accretion rates to rates that reflect the estimated remaining interest expense is necessary to ensure that the total interest expense recognized over the life of the contract is accurately portrayed.

Differential Reporting for Nonpublic Entities

BC457. Different reporting requirements for nonpublic entities than for public entities sometimes are necessary to meet the informational needs of users of nonpublic entity financial statements or to reduce the cost of application in light of the perceived benefits of the reported information. Although those differences potentially benefit users, preparers, or both, they also can increase the cost of application if they make the overall guidance more difficult to read and understand.

BC458. The amendments in this proposed Update would result in some different disclosure requirements for nonpublic entities. Specifically, a nonpublic entity would be exempt from the requirement to provide specified disclosures at a minimum by reportable segment and would not be required to provide the insurance disclosures required for interim periods. Because those disclosure differences are based on broader existing requirements for nonpublic companies related to segment and interim reporting, they should decrease costs and complexity for nonpublic entities.

Differences between U.S. GAAP and IFRS

BC459. The proposed guidance would improve convergence of U.S. GAAP and IFRS (based on the 2013 IASB revised Exposure Draft) by reducing differences in the accounting for insurance contracts, as a result of joint deliberations between the FASB and the IASB. Acknowledging that some differences are unresolved, the Board notes that both models have the same fundamentals, for example, updated estimates and assumptions that are, to the extent applicable, consistent with prices in financial markets. In addition, some of the disclosures that would be required would allow users to reconcile the amounts reported under both models. The FASB decided that the remaining differences are necessary to achieve appropriate accounting in the pertinent areas as well as to provide adequate guidance to help entities transition to the proposed guidance when finalized. The Board believes that, considered on an overall basis, the improved convergence of U.S. GAAP and IFRS would decrease complexity.

Alternative Views

BC460. Two FASB members disagree with the issuance of the guidance in this proposed Update.

BC461. Mr. Buck disagrees with issuing the proposed guidance. Because insurance is a global industry with many U.S. insurers having a significant global presence, the Board originally decided to undertake this project to be actively involved with the IASB in the development of an international accounting standard for insurance transactions, while simultaneously improving U.S. GAAP. Unfortunately, the Boards have not achieved a converged improvement, which is evidenced by the list of significant differences between the FASB's decisions and the IASB's decisions in several key areas (see the Summary section and Appendix B of this proposed Update). Absent convergence, Mr. Buck does not believe that the guidance in this proposed Update yields a sufficient overall improvement in decision-useful information to investors and other users of financial statements to justify the significant overall costs and complexity it will add.

BC462. Mr. Buck acknowledges the merits of several individual aspects of the proposal, when considered in isolation. However, when considered in totality and in conjunction with overall feedback from users, Mr. Buck believes that the magnitude of the costs and complexity that the models would add (for example, by requiring entities using the proposed premium allocation approach to measure claims liabilities using expected values and to discount those claims liabilities before the amounts of the claims have become fixed and determinable) is not justified. Therefore, until either a converged proposal or a less costly and less complex targeted proposal is developed, Mr. Buck prefers to retain the current recognition and measurement models for insurance contracts.

BC463. Mr. Buck believes that financial statement users have expressed a strong desire to retain the current model for short-duration insurance contracts under U.S. GAAP instead of replacing it with the proposed premium allocation approach. In general, Mr. Buck believes that contracts to which the proposed premium allocation approach would apply (for example, property-casualty insurance) are fundamentally different than contracts to which the proposed building block approach would apply (for example, life insurance). Investors analyze the respective financial statements of entities issuing these two types of contracts differently.

BC464. Mr. Buck believes that those differences are distinct enough to justify a greater degree of differentiation in the accounting for contracts under the two approaches than the Board is proposing. Thus, Mr. Buck believes that the Board should consider the two approaches separately to facilitate the development of more appropriately tailored improvements in accounting for each of those respective types of insurance contracts.

BC465. Mr. Linsmeier disagrees with issuing the proposed guidance for three primary reasons. First, under the building block approach, items are included in fulfillment cash flows at contract inception that do not represent present rights or present obligations under the insurance contract. As a result, he believes net insurance contract assets or liabilities that would be recognized under the building block approach are inconsistent with the definitions of assets and liabilities in the conceptual framework and, therefore, generally are inconsistent with other assets and liabilities recognized under U.S. GAAP. Second, because under the building block approach revenue would be recognized in proportion to value of the fulfillment cash outflows incurred during each reporting period, the inclusion of certain period costs (identified later) within the fulfillment cash outflows would result in a less volatile pattern of revenue and expense recognition than generally is the outcome from applying other Topics in U.S. GAAP. Other Topics in U.S. GAAP require recognition of period costs as incurred without any consideration of whether the revenue being recognized is proportionate to the costs incurred. Finally, under the building block approach, a margin would be separately recognized as a liability and measured at inception of the contract as the excess of the fulfillment cash inflows over the fulfillment cash outflows reduced by qualifying acquisition costs incurred to obtain or renew the contract. Those contract acquisition costs would not be recognized when incurred as an asset or expense but, rather, would be amortized and recognized as expenses over the coverage and settlement periods in the same pattern that the remainder of the margin is recognized in income. Both the separate recognition of a margin at contract inception and the failure to recognize contract acquisition costs when incurred either as an asset or as an expense create additional differences between the accounting under the building block approach and the accounting for similar items in U.S. GAAP.

BC466. Each of the differences identified in the preceding paragraph between the building block approach and other U.S. GAAP Topics serve to retain the unique and very specialized nature of current insurance accounting. The current, highly specialized nature of accounting for insurance contracts has resulted in only a narrow set of user specialists being able to understand and evaluate the accounting, which has hindered the comparison of the financial reports of insurance entities with other entities, limiting the decision usefulness of reported information. Mr. Linsmeier believes that to make a real improvement to insurance accounting, any differences between the accounting for insurance and other revenue-generating contracts should be minimized to facilitate comparisons between insurance and other entities and to enhance the efficient allocation of capital.

BC467. Under Mr. Linsmeier's preferred approach to accounting for insurance contracts, fulfillment cash flows under the building block approach would be limited to those that represent present rights and obligations under the insurance contract at its inception, thereby excluding future payments to or from policyholders that are unrelated to present rights or obligations under the contract

at inception (which also would exclude most period costs from fulfillment cash flows). Under that approach, fulfillment cash flows generally would be limited to (a) premium cash inflows to be paid by the policyholder associated with present rights or obligations of the insurer under the insurance contract (including expected cash inflows relating to renewal options) and (b) cash outflows required under the insurance contract relating to the compensation to the policyholder linked to present obligations under that contract. Excluded from fulfillment cash flows under this approach would be future separate payments under the contract expected but not required to be paid by the policyholder for investment management or other services and dividends expected to be paid to the policyholder that have not yet been declared. Also excluded from the fulfillment cash flows would be many period costs, including policy administration and maintenance costs and claims handling costs that (a) represent future costs of doing business and (b) are not obligations to be paid to the policyholder under the insurance contract. Under Mr. Linsmeier's preferred approach, each of the items would be accounted for consistent with other Topics in U.S. GAAP. In addition, under Mr. Linsmeier's preferred approach, direct contract acquisition costs would be accounted for consistent with other Topics in U.S. GAAP and, therefore, either capitalized as an asset or expensed when incurred consistent with the soon to be issued final guidance on revenue recognition for contracts with customers.

BC468. Mr. Linsmeier also notes that none of the issues identified in this alternative view relating to the measurement of fulfillment cash flows under the building block approach exist under the premium allocation approach in the proposed guidance. That is because under the premium allocation approach, recognized assets and liabilities generally meet the definition of assets and liabilities in the conceptual framework and the incurrence of period costs do not affect the pattern of revenue recognition. Mr. Linsmeier, therefore, does not raise similar issues with the premium allocation approach. In addition, if the building block approach were modified as he suggests, it would significantly reduce the differences between the financial reporting outcomes relating to the recognition and measurement of separate amounts reported as revenues and expenses under the revised building block approach and the premium allocation approach, enhancing the comparability of the two insurance models and facilitating comparability with the general accounting model. Finally, under his preferred approach, Mr. Linsmeier would conform the accounting for acquisition costs across all models, including the premium allocation approach.

BC469. Mr. Linsmeier notes that there are both similarities and differences between this alternative view and his recent alternative view on the proposed FASB Accounting Standards Update, *Leases (Topic 842)*. The similarity is that in both alternative views he generally prefers an accounting model in which the whole contract is the unit of account and, therefore, includes in the measurement of the assets and liabilities all cash flows or costs that are associated with present rights and obligations under the contract. Mr. Linsmeier's alternative view

on the proposed leasing guidance criticizes that proposed model for excluding some costs relating to present rights and obligations of the two parties to the contract from the measurement of the lessee's asset and liability (for example, bundled services and contingent rents). In this alternative view, Mr. Linsmeier disapproves of the guidance in this proposed Update that includes in the measurement of the net insurance contract asset or liability cash flows that are not related to present rights or obligations of the counterparties to the contract (for example, claims handling costs and contract administrative and maintenance costs).

BC470. The primary difference in the two alternative views relates to Mr. Linsmeier's recommended treatment of renewal options. Mr. Linsmeier recommends including the cash flows relating to renewal option rights and obligations within the measures of net insurance contract assets and liabilities in the guidance in this proposed Update; however, he recommends excluding them from the measures of the lessee's assets and liabilities under the proposed leasing guidance. Mr. Linsmeier discusses the reason why there is no conceptually pure approach to the recognition of renewal options in contract assets and liabilities in his alternative view on the proposed leases guidance and indicates, therefore, that an arbitrary decision must be made to either include or exclude the cash flows relating to renewal options in the measures of assets and liabilities under the contract. That conceptual recognition issue is even more complicated for insurance contracts because the insurer's present obligation relating to a policyholder's option to renew generally yields net cash inflows to the insurer under the contract. The difference in Mr. Linsmeier's recommendations about renewal options in the two alternative views is based primarily on differences in the reliability of the measures of renewal option assets/liabilities across the two types of contracts with the cost of insurance options generally being reliably included and measured in the total premiums charged under an insurance contract. In contrast, renewal options in lease contracts are more difficult to estimate because the probability of exercise and amounts to be paid to renew the contract are not embedded in fixed payments required under the lease contract and are subject to greater uncertainty that generally cannot be resolved until close to the renewal date.

Amendments to the XBRL Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require changes to the U.S. GAAP Financial Reporting Taxonomy (UGT). We welcome comments on these proposed changes to the UGT at [ASU Taxonomy Changes](#) provided at www.fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, proposed amendments to the UGT will be made available for public comment at www.fasb.org and finalized as part of the annual release process.

Appendix A: Comparison of Existing U.S. GAAP Guidance and the Guidance in This Proposed Update

A1. This table provides a high-level comparison of existing U.S. GAAP and the guidance in this proposed Update for an insurance entity that is currently applying Topic 944 to its insurance contracts. It is intended to highlight the more significant changes between existing U.S. GAAP and the proposed Update.

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
Significant insurance risk	If it is reasonably possible that an insurance entity may realize a significant loss.	An entity is exposed to a significant loss in any reasonable scenario.
Definition of portfolio	Contracts should be grouped to be consistent with the insurer's manner of acquiring, servicing, and measuring the profitability of its insurance contracts when considering whether a portfolio of contracts is onerous.	A group of insurance contracts that: - Are subject to similar risks and priced similarly relative to the risk taken on - Have similar duration and similar expected patterns of release from risk (that is, reduction in variability in cash flows).
Determining which measurement model to apply: short-duration or long-duration (Determination of the model)	Contracts are accounted for using the short-duration model if the contracts provide insurance protection for a fixed period of short duration and enable the insurer to cancel the contracts or to adjust the provisions of the contracts at the end of the contract period. Contracts are accounted for	An entity should apply the building block approach unless either of the following characteristics are present, in which case, apply the premium allocation approach: - The coverage period of the insurance contract is one year or less, or - At contract inception, it is unlikely that during the period before a claim is

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
	using the long-duration model generally if the contract is not subject to unilateral changes in its provisions and requires the performance of various functions and services for an extended period. Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity (that is, investment contracts) and long-duration insurance contracts with terms that are not fixed and guaranteed (that is, universal life-type contracts) are accounted for using a different model than other long-duration contracts. Financial guarantee, mortgage guaranty and title insurance are typically accounted for using a hybrid of the short-duration and long-duration models.	incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract. (It is presumed that the building block approach will be used to measure most contracts that are accounted for using the long-duration model and that the premium allocation approach will be used to measure most contracts that are accounted for using the short-duration model under existing U.S. GAAP.)
Traditional long-duration insurance contracts (Liability for future policy benefits) (For contracts measured using the	An entity should measure the liability for future policy benefits as the present value of estimated future policy benefits and related expenses (including a provision for adverse deviation) less the present value of estimated future net premiums. The discount rate is based on	An entity should measure and present an insurance contract as: 1. The fulfillment cash flows that represent the expected present value of future cash outflows less the expected present value of future cash inflows. In general, these will be determined similarly to the current

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
building block approach in the proposed Update)	the estimated pretax investment yields (which contains a provision for adverse deviation), net of related expenses, expected at the contract issuance date on the basis of actual yields, trends in yields, and portfolio mix and maturities. The rate typically is adjusted for defaults and reinvestment risks. Interest expense for the accretion on the discounted liability is presented with changes in the liability. The assumptions for measuring traditional life insurance benefit liabilities are locked in at inception unless the portfolio is determined to be in a loss position, at which time the assumptions are reset as of that date. The implicit gain, adjusted for changes in assumptions, is released over time as the liability is released.	process but, where based on historical experience, will need to reflect projections for fluctuations in historical rates and not include adjustments for parameter risks and pandemics, which should be reflected in the probability-weighted estimates. 2. A margin when the fulfillment cash inflows are greater than the cash outflows; a loss when the fulfillment cash inflows are less than the cash outflows. Unconditional premium receivables should be recognized as a separate asset. The discount rates should reflect the characteristics of the insurance liability. The fulfillment cash flows should reflect all available information at the end of the reporting period, that is, updated each reporting period. Changes in the fulfillment cash flows, except for the effects from changes in discount rates, should be recognized in net income. Changes in the fulfillment cash

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
		flows due to changes in the discount rates should be recognized in other comprehensive income, unless related to certain participating features (see participation features). Interest expense, to reflect accretion on the insurance-related balances, should be recognized based on the discount rates at the inception of the contracts or adjusted rates that reflect changes in estimated interest crediting and related ultimate expected cash flows. Interest credited, if applicable, and interest expense that reflects the accretion of the discounted liability should be presented with net investment income. If a portfolio of contracts is expected to generate a loss (that is, if the expected cash outflows including qualifying acquisition costs are expected to exceed the expected cash inflows), an entity should immediately recognize the remaining margin.
Universal life-type contracts, deferred annuities, and variable and equity-based life and annuity	The liability is equal to the account balance and, if applicable, an additional liability (see below). A profit margin is embedded in the account value (and in the unearned revenue liability	These contracts are accounted for the same as all other insurance contracts measured using the building block approach. That is, the liability is measured as the fulfillment cash flows,

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
products (Policyholder account balances and separate account liabilities) (For contracts measured using the building block approach in the proposed Update)	when amounts have been assessed for future periods service) and is recognized over time as fees are withdrawn from the account balance (and based on a pattern of estimated gross profits for amounts previously assessed for future periods) and recognized as income. Interest credited to policyholder account balances is generally presented as a separate line item with other insurance contract expenses. Where an insurance benefit feature results in an expectation of profits in the early years followed by losses in the later years from that feature, an additional liability (typically included in the liability for future policy benefits) is recognized for the expected benefits in excess of expected assessments and the related policyholder account balance determined by a formulaic calculation. Any benefit in excess of the account balance (for example, death benefit) is included in the measurement of the liability for future policy benefits.	discounted using rates that reflect the characteristics of the insurance liability, plus a margin. See section on liability for future policyholder benefits. The fulfillment cash flows should include the following that are not considered in existing U.S. GAAP for universal life-type contracts, deferred annuities, and variable and equity-based life and annuity products: 1. Expected surrenders and surrender charges 2. Expected fees (cost of insurance, mortality and expense, and asset management fees) 3. Expected value of all option and guarantee features within the contract that are not accounted for as embedded derivatives, measured based on the expected cash flows (includes guarantees and options not recognized under existing U.S. GAAP until the option is exercised or the guarantee is in the money and guarantees and options measured using a formulaic calculation under existing U.S. GAAP).

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
Separate account assets (Segregated fund arrangements in the proposed Update)	To apply specialized accounting: 1. The separate account is recognized legally. 2. The separate account assets supporting the contract liabilities are insulated legally from the general account liabilities of the insurance entity. 3. The entity must invest the policyholder's funds (as directed by the policyholder) in designated investment alternatives or in accordance with specific investment objectives or policies. 4. All investment performance, net of contract fees and assessments, must be passed through to the individual policyholder. The portion of separate account assets representing contract holder funds is measured at fair value initially and subsequently. Assets underlying an insurance entity's proportionate interest in a separate account (seed money or other investment) should be classified and measured as if the assets were held directly by the general account rather than	To apply specialized accounting: 1. The entity must invest the policyholder's funds (as directed by the policyholder) in designated investment alternatives or in accordance with specific investment objectives or policies. 2. All investment performance, net of contract fees and assessments, must be passed through to the individual policyholder. All assets held in segregated fund arrangements, including insurers' proportionate interests, should be recognized at fair value with changes recognized in net income. Segregated asset and liability balances should be presented with the appropriate category of financial instruments (although could be identified and presented separately) and with the insurance liability, respectively. Investment income on segregated assets should be included in net income separate from investment expense (that is, pass-through of results).

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
	through the separate account structure; if certain criteria are met, the assets can be measured using the held-for-sale accounting for the respective assets. Separate account assets and the related liability are presented separately on the statement of financial position. Investment income on separate account assets and the investment expense representing the pass-through of the investment income are reported net in net income.	If not presented separately, segregated fund assets and the related investment income/expense should be disclosed.
Participation features	Contractual income-based dividend provisions for participating contracts are based on income that includes adjustments between general purpose and statutory-basis financial statements that will reverse and enter into future calculations of the dividend provision. To the extent that unrealized holding gains or losses from securities classified as available-for-sale would result in adjustments of policyholder liabilities, those balance sheet amounts are adjusted with corresponding credits or charges reported	If a participation feature contractually depends wholly or partly on the performance of an underlying item: 1. As measured in accordance with U.S. GAAP, the measurement of the liability should reflect the measurement of the underlying item. 2. Based on something other than the measurement in accordance with U.S. GAAP and the difference: a. Reflects a timing difference that will reverse and enter into future calculations of participating benefits, the measurement of the liability should be

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
	directly to other comprehensive income. When there are no restrictions on the amount of dividends to pay, the expected dividends, sometimes determined using dividend scales, are accrued over the life of the contract, typically as the premium is earned or paid.	adjusted if necessary to reflect the measurement of the underlying items in accordance with U.S. GAAP. b. Does not reflect such a timing difference, the measurement of the liability should be based on the contractual feature (for example, at fair value, if the contractual feature passes through to the policyholder the fair value of the underlying). Changes in the measurement of the liability for participation features that contractually depend wholly or partly on the performance of an underlying item should be presented in the same manner as the changes in the underlying item (that is, in net income or other comprehensive income) except in 2(b) above, in which case the changes should be recognized in net income. Noncontractual or discretionary participation features should be included in the measurement of the fulfillment cash flows on the basis of expected cash flows from these features.

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
Revenue and expense recognition for long-duration contracts (For contracts measured using the building block approach in the proposed Update)	For traditional insurance contracts, revenue is generally recognized when premium is due (and for the amount due), and an expense is recognized for the change in the liability (that is, the reduction in the future premium results in an expense and an increase in the liability). For universal life-type contracts, deferred annuities, and variable and equity-based life and annuity products, revenue is recognized for amounts assessed against policyholders in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the entity for services to be provided over more than one period, in which case revenue should be recognized over that period. Expenses are recognized for the benefits/claims in excess of the related policyholder account balances and amounts credited to policyholders.	Exclude from revenue the amounts that are estimated to be returned to the policyholder or its beneficiary regardless of the occurrence of an insured event. See section on estimated returnable amounts. Recognize revenue for the fulfillment of cash flows (including accretion of interest) over the coverage period in proportion to the value of coverage and any other services. Immediately recognize changes in expected future net cash flows in net income. Recognize claims, benefits, and related expenses (in excess of the repayment of estimated returnable amounts) when the claims are incurred and other nonclaims fulfillment costs when those costs are incurred and recognize reversals of previously recognized amounts. Changes in the margin are recognized as revenue over the coverage and settlement periods as the entity satisfies its performance obligation to the policyholder (that is, as it is released from exposure to risk as evidenced by a reduction in the variability of cash outflows). The margin should not be adjusted to offset

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
		changes in expected cash flows, but in determining its release from risk an entity should consider changes in actual and expected cash flows. The total insurance contract revenue (revenue for the fulfillment of cash flows plus the release of the margin) over the life of a contract should represent the consideration received plus accretion of interest (less any estimated returnable amounts).
Unearned premium reserve (The liability for remaining coverage for contracts measured using the premium allocation approach in the proposed Update)	Unearned premium reserve is recorded for the amount of premium related to the unexpired period of the contract (or unexpired proportion of risk). A receivable is recognized for the expected future premiums. For some health insurers, unearned premium reserves are not recorded.	A liability for remaining coverage is recorded for the amount of premium related to the unexpired period (or unexpired proportion of risk) of the contract. A receivable is recognized for the expected future premiums. Expectations of future changes in coverage, such as endorsements or reductions of coverage, should not be considered. The liability for remaining coverage and any premiums receivable should be adjusted to reflect the time value of money if the contract has a financing component that is significant as defined by Topic 606 on revenue recognition. However, if the entity expects,

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
		at contract inception, that the time period between when the policyholder pays all or substantially all of the premium and when the entity provides the corresponding part of the coverage is one year or less, the time value of money need not be reflected. When the time value of money is reflected, the discount rates should be based on the discount rates determined at inception of the contracts and not updated.
Revenue recognition— unearned premium reserve (The liability for remaining coverage for contracts measured using the premium allocation approach in the proposed Update)	The unearned premium reserve is reduced, and premium revenue is recognized for the corresponding amount over the coverage period in proportion to the amount of insurance protection provided.	The liability for remaining coverage should be recognized: 1. On the basis of passage of time, but 2. On the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time. A corresponding amount of premium revenue should be recognized. The total premiums earned over the life of a contract should represent the consideration received plus accretion of interest, if applicable (less any estimated returnable amounts).

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
Premium deficiency reserve (Onerous contract liability for contracts measured using the premium allocation approach in the proposed Update)	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 (and expected investment income if elected to consider), then unamortized acquisition costs are expensed, and any additional deficiency is recorded as an additional liability. Although required to be considered in the premium deficiency test, liabilities for catastrophic events are not typically recognized until an event or events have occurred, the event adversely affects the policyholder, and the loss can be reasonably estimated.	When facts and circumstances indicate that a portfolio of contracts may be onerous, perform an onerous contract test and recognize an additional onerous contract liability and a corresponding expense for the excess of the fulfillment cash flows relating to future claims and expenses over the premiums, net of acquisition costs. The onerous contract test should be performed and the liability should be measured on a basis that is consistent with the measurement of the liability for incurred claims for that portfolio of insurance contracts. That is, either on a discounted or undiscounted basis. The test and the measurement of the additional liability should not consider expected investment income. Liabilities for catastrophic events should be considered in the onerous contract test which should include the expected cash flows as of the reporting date.
Reserves (or liability for unpaid claims) (The liability for incurred claims for contracts)	A liability for unpaid claims, including incurred but not reported claims and related claim adjustment expenses, is recognized as an expense, and a liability should be accrued when the insured	The liability for incurred claims, including incurred but not reported claims and related claim adjustment expenses, should be recognized as an expense, and a liability should be

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
measured using the premium allocation approach in the proposed Update)	event occurs. Changes in assumptions are recognized in net income each reporting period. The recorded reserves are based on management's best estimate, which includes the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using historical experience adjusted for current trends, and any other factors that would modify experience. The determination of the best estimate sometimes starts with the actuarial central estimate, the objective of which is to determine the mean of the expected value over a range of reasonably possible outcomes using multiple estimation methods. Reserves are measured on a discounted basis when the payment pattern and ultimate costs are fixed and reliably determinable on an individual claim basis. As such, most reserves are measured on an undiscounted basis, except workers' compensation indemnity claims, structured settlements, and medical malpractice settlements.	accrued when the insured event occurs. Changes in assumptions are recognized in net income each reporting period. The liability for incurred claims should be measured as the present value of the unbiased, probability-weighted estimate of expected fulfillment cash flows, the objective of which is to recognize the statistical mean of possible scenarios that incorporate all relevant information. The liability for incurred claims should be discounted using discount rates that reflect the characteristics of the liability. However, an entity need not apply discounting when the effects are immaterial or when the incurred claims are expected to be paid within 12 months of the occurrence of the insured event. Changes in the fulfillment cash flows due to changes in the discount rates should be recognized in other comprehensive income. Interest expense to reflect accretion on the insurance related balances generally should be recognized based on the discount rates at the inception of the contracts.

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
		Interest expense that reflects the accretion of the discounted liability should be presented with net investment income.
Acquisition costs	Acquisition costs that relate directly to the successful acquisition of new or renewal insurance contracts are capitalized and presented separately on the statement of financial position as an asset. The measurement of the liability for future policyholder benefits for traditional long-duration insurance contracts includes net premiums, which approximates the gross premiums less expected acquisition costs. Expected acquisition costs are not included in the short-duration model or the liability for nontraditional long-duration insurance contracts. For contracts accounted for under the short-duration model and traditional long-duration insurance contracts, deferred acquisition costs are amortized in proportion to the premium revenue recognized. For other long-duration insurance contracts, deferred acquisition costs are	Acquisition costs that are directly related to the entity's selling efforts that result in obtaining the contracts in a portfolio should be included in the expected acquisition costs to be incurred. Direct-response advertising costs should be expensed as incurred. When acquisition costs are incurred, the margin for contracts measured using the building block approach and the liability for remaining coverage for contracts measured using the premium allocation approach should be reduced. Acquisition costs should be recognized as an expense in the same pattern as the margin for contracts measured using the building block approach or the liability for remaining coverage for contracts measured using the premium allocation approach is recognized.

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
	amortized based on the pattern in which the estimated gross profit is expected to be recognized over the life of a portfolio of contracts. The deferred acquisition cost balance and the prior amortization is adjusted for favorable and unfavorable changes, retrospectively with a cumulative catch-up adjustment recognized in net income. Certain direct response advertising costs are included in deferred acquisition costs.	
Estimated returnable amount (In the proposed Update applicable to contracts measured using both the building block approach and the premium allocation approach)	For universal life-type contracts, deferred annuities, and variable and equity-based life and annuity products, premium that is allocated to the policyholders account balance is not recognized as revenue, and the return of the account balance is not recognized as an expense.	If a feature of an insurance contract requires an entity to pay amounts to policyholders or their beneficiaries regardless of whether an insured event occurs (estimated returnable amount), an entity should: 1. Exclude from revenue the amounts that have been received from the policyholder for those repayments 2. Exclude those repayments from the expenses for claims and benefits when incurred.
Reinsurance ceded	Expected gains (that is, recoveries are expected to exceed the premiums paid) from reinsurance contracts	Expected gains (that is, recoveries are expected to exceed the premiums paid) from prospective reinsurance

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
	are deferred and recognized over the coverage period, settlement period, or life of the underlying reinsurance contracts, as applicable (if prospective reinsurance) or settlement periods (if retroactive reinsurance, which typically only applies to short-duration contracts). The premiums paid in excess of expected recoveries from reinsurance contracts for prospective events are recognized over the coverage period (that is, as the cost of purchasing reinsurance) and are recognized immediately in net income for events that occurred before entering into the reinsurance contract (that is, as expected losses). The reinsurance recoverable reflects the assumptions consistent with those used in measuring the underlying insurance contract liabilities. Ceded reinsurance recoverables and payables are recognized separately from the underlying insurance contract liabilities in the statement of financial position. The measurement of the reinsurance recoverable should consider counterparty	contracts should be deferred and recognized over the coverage period if measured using the premium allocation approach and over the coverage and settlement periods if measured using the building block approach. Expected gains from retroactive reinsurance contracts should be deferred and recognized over the settlement period. Expected losses (that is, premiums paid are expected to exceed recoveries) from reinsurance contracts for prospective events should be recognized over the coverage period, and expected losses for events that occurred before entering into the reinsurance contract should be recognized immediately. The reinsurance recoverable should reflect the fulfillment cash flows using assumptions consistent with those used to measure the corresponding part of the fulfillment cash flows of the underlying insurance contracts without reference to the margin on the underlying contracts, if applicable, and should be presented in the same manner (that is, in net income or other comprehensive income).

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
	credit losses. Premiums ceded and recoveries recognized under ceded reinsurance contracts are required to be reported in net income, as separate line items or parenthetically, or disclosed. Often, those amounts are disclosed. Proceeds that represent recovery of acquisition costs (for example, ceding commissions) are recognized as a reduction in the related deferred acquisition costs. Cash flows affected by contingent provisions that affect the amount of premiums or ceding commissions upon the occurrence of a triggering event or events (that is claims or benefits experience, often referred to as <i>loss sensitive features</i>) often follow the form of the adjustment. That is, the premium and/or commissions are adjusted. (Note: this also applies to directly written contracts and reinsurance assumed.)	The measurement of counterparty credit losses for the reinsurance recoverable should be measured in accordance with the financial instruments impairment guidance. Ceded reinsurance recoverables and payables should be recognized separately from the underlying insurance contract liabilities in the statement of financial position and should be disaggregated between those amounts for reinsurance contracts measured using the building block and premium allocation approaches. Premiums ceded and losses recovered from ceded reinsurance contracts should be presented separately from revenue and expenses on the underlying insurance contracts, disaggregated between those amounts for reinsurance contracts measured using the building block and premium allocation approaches. The premiums ceded should be recognized in net income in the statement of comprehensive income, net of ceding commissions and other fees expected to be received from the reinsurer that are not

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
		contingent on claims and benefits experience. An assuming entity should recognize expected cash inflows net of ceding commissions and other fees expected to be paid to the cedant that are not contingent on claims and benefits expense. Cash flows affected by contingent provisions that affect the amount of premiums or ceding commissions upon the occurrence of a triggering event or events (that is, claims or benefits experience, often referred to as <i>loss sensitive features</i>) should be presented as part of the claims and benefits cash flows rather than as an adjustment to premiums. (Note: this also applies to directly written contracts and reinsurance assumed.)
Foreign currency	For purposes of determining the exchange rate to be used in remeasurement, unearned premium reserves, deferred acquisition costs, and the amortization of those costs, except policy acquisition costs and the amortization of those costs for life insurance companies, are considered nonmonetary items. Other insurance-related balances such as the liability for future	All insurance contract related financial statement components should be classified as monetary for purposes of determining the exchange rate to be used in remeasurement.

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
	policyholder benefits and the liability for incurred claims are classified as monetary.	
Business combinations	An entity measures at fair value the assets and liabilities arising from the rights and obligations of the insurance and reinsurance contracts acquired in the business combination (in accordance with the guidance on business combinations) and presents the following components: 1. Assets and liabilities measured in accordance with the acquirer's accounting policies for insurance and reinsurance contracts that it issues or holds 2. An intangible asset (or occasionally another liability), typically referred to as the value of business acquired or present value of future profits representing the difference between the fair value of the contractual insurance and reinsurance assets acquired and liabilities assumed and the measurement of the assets and liabilities. The intangible is amortized in a manner that is consistent with the amortization of	An entity should measure at fair value the assets and liabilities arising from the rights and obligations of the insurance and reinsurance contracts acquired in the business combination (in accordance with the guidance on business combinations) and present the following components: 1. Assets and liabilities measured in accordance with the acquirer's accounting policies for insurance and reinsurance contracts that it issues or holds 2. A margin if the fair value of the contractual insurance and reinsurance assets acquired and liabilities assumed exceeds the measurement of the assets and liabilities or a loss if the measurement of the assets and liabilities exceeds the fair value of the contractual insurance and reinsurance assets acquired and liabilities assumed. The margin should be presented with the entities margin on its insurance contracts directly written and

	Existing U.S. GAAP	Amendments in the FASB's Proposed Update
	deferred acquisition costs and is subject to a loss recognition test.	recognized in the same manner (that is, as the entity is released from risk).

Appendix B: Comparison of the Guidance in This Proposed Update and in the 2013 IASB Revised Exposure Draft

B1. The table highlights some significant differences between the FASB's proposed Update and the IASB's proposed model for insurance contracts. It does not highlight all differences. For a complete description of the IASB's model, see the 2013 IASB's revised Exposure Draft, *Insurance Contracts*.

	The FASB's Proposed Update	The IASB's 2013 Revised Exposure Draft
Scope and scope exceptions	Financial guarantee contracts that meet the definition of insurance are in the scope of the proposed Update. Some charitable gift annuities and some guarantees previously accounted for under Topic 460 are explicitly excluded from the scope.	Participating investment contracts that are issued by entities that issue insurance contracts are in the scope of the IASB's model. Financial guarantee contracts are excluded from the scope unless the issuer has previously asserted explicitly that it regards those contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply IFRS 7 and IFRS 9.
Definition of portfolio	A group of insurance contracts that are: 1. Subject to similar risks and priced similarly relative to the risk taken on 2. Have similar duration and similar expected patterns of release	A group of insurance contracts that are: 1. Subject to similar risks and priced similarly relative to the risk taken on; and 2. Managed together as a single pool.

	The FASB's Proposed Update	The IASB's 2013 Revised Exposure Draft
	from risk (that is, reduction in variability in cash flows).	
Initial measurement		
Fulfillment cash flows	The measurement of the liability includes cash outflows that an entity will incur to directly fulfill its obligations to the portfolio of policyholders, or can be attributed to them on a reasonable and consistent basis. Therefore, it does not include other expenses unrelated to or only indirectly related to satisfying those specific obligations, such as commissions, transaction-based taxes (for example, premium taxes), or levies (for example, guarantee fund assessments).	The measurement of the liability includes all cash outflows that will arise as the entity fulfills the portfolio of contracts, including commissions, transaction-based taxes (for example, premium taxes), and levies (for example, guarantee fund assessments) that arise directly from existing insurance contracts or can be attributed to them on a reasonable and consistent basis.
Measurement and presentation of the present value of expected cash inflows in excess of the present value of expected cash outflows	The expected present value of cash inflows over the expected present value of cash outflows to fulfill the portfolio of policyholder contracts should be presented as a margin that represents the expected unearned profit for the portfolio of insurance contracts.	The measurement of the insurance contract liability includes an explicit risk adjustment that represents the compensation that the entity requires for bearing the uncertainty in the amount and timing in the remaining cash flows. The excess of the expected present value of cash inflows over the expected

	The FASB's Proposed Update	The IASB's 2013 Revised Exposure Draft
		present value of cash outflows to fulfill the policyholder contract plus a risk adjustment should be presented as a contractual service margin.
Acquisition costs	Limited to acquisition costs directly attributable to obtaining a portfolio of insurance contracts that are successfully obtained. Expected acquisition costs are included in determining whether an entity should recognize the remaining margin for a portfolio of contracts that are expected to be loss generating for contracts measured using the building block approach or an onerous contract liability for contracts measured using the premium allocation approach. Acquisition costs incurred reduce the margin or the liability for remaining coverage and are recognized as an expense in the same manner as the margin is recognized as revenue.	Includes all acquisition costs directly attributable to obtaining a portfolio of insurance contracts, including costs that would be attributable under the FASB's proposed Update to unsuccessful efforts. Expected acquisition costs should be included in the fulfillment cash flows and in the measurement of the amount of the contractual service margin and should be recognized as an expense in the same manner as the contractual service margin is recognized.

	The FASB's Proposed Update	The IASB's 2013 Revised Exposure Draft
Participation features	If a participation feature contractually depends wholly or partly on the performance of an underlying item: 1. As measured in accordance with U.S. GAAP, the measurement of the liability should reflect the measurement of the underlying item. 2. Based on something other than the measurement in accordance with U.S. GAAP and the difference: a. Reflects a timing difference that will reverse and enter into future calculations of participating benefits, the measurement of the liability should be adjusted if necessary to reflect the measurement of the underlying items in accordance with U.S. GAAP. b. Does not reflect such a timing difference, the measurement of the liability should be based on the	Fulfillment cash flows for all participation features specifically linked to and that are expected to vary directly with the returns on underlying items should reflect the measurement of the underlying items. For contracts without any contractual linkage to underlying items (for example, universal life or other contracts in which all the participation features are discretionary), the measurement of the feature should reflect the entity's expectations of the timing and amount of payments to policyholders. The measurement of the fulfillment cash flows for a discretionary participation feature that provides policyholders with the right to participate in the surplus of the entity should include the relevant remaining surplus of the entity. This means that there would be no profit or equity reported in any accounting period for mutual insurers (that is, companies owned entirely by their policyholders).

	The FASB's Proposed Update	The IASB's 2013 Revised Exposure Draft
	contractual feature (for example, if the contractual feature passes through to the policyholder the fair value of the underlying item). Changes in the measurement of the liability for participation features that contractually depend wholly or partly on the performance of an underlying item should be presented in the same manner as the changes in the underlying item (that is, in net income or other comprehensive income) except in 2(b) above, in which case the changes in the measurement of the liability should be presented in net income. Noncontractual or discretionary participation features should be included in the measurement of the fulfillment cash flows based on expected cash flows from these features.	
Subsequent measurement		

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Changes in estimates of fulfillment cash flows	All changes in estimates should be recognized immediately in net income and as an adjustment to the insurance liability.	Unless the contract is onerous, all changes in estimates relating to future coverage or future services should be offset against the contractual service margin.
Margin (risk adjustment and contractual service margin) release patterns	The margin should be recognized in net income as a part of revenue over the coverage and settlement periods as the entity is released from risk as evidenced by a reduction in the variability of cash outflows. Changes in actual and expected cash flows of a portfolio of contracts should be considered in determining an entity's release from risk but should not be recorded as a direct adjustment to the margin. The implicit margin in the liability for remaining coverage for contracts measured using the premium allocation approach should be recognized over the coverage period as the liability for remaining coverage is reduced and corresponding revenue is recognized.	The risk adjustment should be remeasured each reporting period with changes recognized immediately in net income. The contractual service margin should be adjusted to reflect favorable and unfavorable changes in the measurement of the expected cash flows related to future coverage and services (unless the portfolio of contracts are onerous). The contractual service margin should be recognized in net income as part of revenue over the coverage period in a systematic basis that is consistent with the pattern of transfer of services that are provided under the contract. Any adjustments to the contractual service margin should be reflected in the transfer of services and therefore recognized prospectively.

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Interest accretion rates for participating investment contracts	Upon any change in expectations of the crediting rates used to measure the insurance liability, the interest accretion rates should be reset in a manner that recognizes any changes in estimated interest crediting and the effect on the measurement of the insurance contract liability on a level-yield basis over the remaining life of the portfolio of contracts.	When an entity expects changes in the returns of underlying items to affect the expected cash flows, the interest accretion rates should be reset for the subset of cash flows that vary with returns on underlying items (and are not directly measured on the same basis as the underlying item because there is no specified link to the performance of that underlying item that the entity must hold).
Use of the premium allocation approach	The premium allocation approach is a separate model and should be applied for all contracts meeting specified criteria. Reinsurance contracts held should be accounted for using the same approach used to account for the underlying insurance contracts issued.	The premium allocation approach is a simplification to the IASB's main approach (that is, the building block approach), and may be applied for any contracts when it would produce measurements that are a reasonable approximation to those that would be produced when applying the requirements of the main approach. Reinsurance contracts held may be accounted for using a different approach than the approach applied to the underlying contracts.
Consideration of counterparty credit losses	When measuring the fulfillment cash flows for reinsurance contracts held, the risk of	The risk of nonperformance by reinsurers (for reinsurance held) and by policyholders should be

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	nonperformance by the reinsurer should be measured on an expected value basis in accordance with Subtopic 825-15 on credit losses. Because any unconditional right to premiums or other consideration should also be separately recognized as a financial instrument, the risk of nonperformance by the policyholder should also be measured on an expected value basis in accordance with Subtopic 825-15.	measured on the basis of an explicit, unbiased and probability-weighted estimate basis (that is, consistent with the measurement principle applied to cash flows in general).
Substantial modifications	The criteria to determine when a modification is a substantial modification include, among other circumstances, situations similar to those in which internal replacements are classified as substantially changed from the replaced contract on the basis of the current criteria in paragraph 944-30-35-37.	The criteria to determine when a modification is a substantial modification include, among other circumstances, situations in which the modified contract will be included in a different portfolio from the one in which it was included in at initial recognition.
Insurance contracts acquired in a business combination	If the present value of fulfillment cash flows exceeds the fair value of the insurance contract liability, the insurer should recognize an immediate	If the present value of fulfillment cash flows exceeds the fair value of the insurance contract liability, the insurer should apply the general requirements of

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	loss in net income at the acquisition date.	IFRS 3, <i>Business Combinations</i> (that is, the insurer should adjust goodwill and thus not recognize a loss in net income at the acquisition date).
Transition	When determining the margin, an entity may elect to measure the insurance contract liability and the margin using its determination of the portfolio immediately before transition. If there is not objective information that is reasonably available to retrospectively adopt the proposed standard or to estimate what the margin would have been using the practical expedient in the proposed guidance, an entity should apply the general requirements of Subtopic 250-10 that are relevant to situations in which there are limitations on retrospective application. An entity should redesignate and reclassify its financial assets that are designated to its insurance business either by legal entity or internal designation or relating to	When determining the margin at transition, an entity should determine the portfolio in accordance with the proposed definition of portfolio. If it is impracticable to apply the proposed standard retrospectively, an entity should estimate the contractual service margin, taking into account all objective information that is reasonably available and by applying specified simplified requirements. An entity may elect to (a) redesignate and classify its financial assets as measured at fair value through profit or loss if to do so would eliminate or significantly reduce a new inconsistency in the measurement or recognition that would have been created by the application of the insurance contracts standard; (b) use other comprehensive income to present changes in the fair

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	funding of insurance contracts that are newly designated to be insurance, as if it had adopted on the transition date the relevant classification and measurement guidance for financial instruments in effect.	value of some or all of the equity instruments that are not held for trading; and/or (c) revoke a previous election to use other comprehensive income to present changes in the fair value of some or all of the equity instruments that are not held for trading. An entity is required to revoke previous designations as measured at fair value through profit or loss if the initial application of the insurance contracts standard eliminates an accounting mismatch that led to that previous designation.