



Current GAAP Issues: Life & Annuity

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Overview

- Recent Guidance
- Discussion of GAAP Impacts During Financial Crisis
- Proposed GAAP Guidance Affecting Life Insurance Contracts
- IFRS

Recent GAAP Guidance

- SOP 05-1 (effective 2007)
 - Treatment of Internal Replacements; 2007
- FAS 157, Fair Value Measurements (eff 2008)
 - FSP FAS 157-1, 157-2, 157-3, 157-4
- FAS 159 (effective 2008)
 - Fair Value Option for Financial Assets and Financial Liabilities
- FAS 141, Business Combinations
- Many more (latest FAS 168 – GAAP hierarchy)

Recent GAAP Guidance (cont.)

- OTTI: “Other than Temporary Impairment”
 - First defined in EITF Issue No. 03-1
 - Definition superceded by FSP No. FAS 115-1 and FAS 124-1 (effective 2006)
 - Guidance defines when is an asset impaired and when impairment is “other than temporary”
 - Further clarified by FSP FAS 115-2 and FAS 124-2 (effective 2009)

Financial Crisis: GAAP Impacts

- Investment Losses due to Credit Spreads
 - Hedging programs not working as expected
 - Material DAC Impacts
- Investment Losses due to OTTI
 - Often late entries requiring manual DAC adj
- Losses due to VA Guarantees
- Loss Recognition/Recoverability Issues led to DAC Write-downs
 - VA: Decreased AV on which to earn fees
 - VA: Riders “in-the-money” – higher benefits

Financial Crisis: GAAP Impacts

- Goodwill Impairment
- DAC Caps
 - DAC Capped at Accumulated Deferrals
 - Negative amortization on fixed annuities (neg spreads)
- Assumptions Revisited
 - Long term default and spread assumption
 - Default assumption made explicit if previously implicit in spread
- Reinsurance deals to free up capital
 - Internal and external
 - Creating new subsidiaries
 - Moving business offshore

Financial Crisis: GAAP Impacts

- Valuation system conversions / enhancements
 - FAS 157
 - FAS 159
 - Dealing with OTTI
- Earnings difficult to explain
 - Old “normal” doesn’t explain results any more
- SOX Issues (“Significant Deficiency” or “Material Weakness”)

Financial Crisis: Actuaries in Financial Reporting

- More work because of:
 - Implementing new guidance
 - Modifying valuation processes
 - Accounting for new reinsurance deals
 - Spending more time explaining results
- Reductions in staffing to offset lower earnings

Proposed GAAP Guidance

- EITF 09-G – Acquisition Costs
- Other EITF Projects:
 - Topic 220: Comprehensive Income
 - Presentation only
 - Accounting for financial instruments and derivatives
 - Proposed Concept Statements
 - Discussion Papers

EITF 09-G (Proposed)

- “Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts”
- Modifies definition of deferrable expenses
- Draft released December, 2009
- Comment period through February, 2010
- Discussed by EITF March 18, 2010
- Effective yrs beginning after December 15, 2010

EITF 09-G (Proposed)

- Project began as a review of treatment of advertising costs
- Existing guidance on deferrals:
 - “Costs that vary with and are primarily related to the acquisition of insurance contracts”
- Proposed guidance on deferrals:
 - “Incremental direct costs of contract acquisition”
 - Costs directly related to issue, underwriting, medical and inspection, contract selling

EITF 09-G (Proposed)

- Expenses which cannot be deferred:
 - Unsuccessful acquisition or renewal efforts
 - Internal costs for issue and u/w that are not employee compensation or payroll-related fringe benefits
 - Costs of soliciting potential customers
 - Market research
 - Training
 - Administration
 - Product Development

EITF 09-G (Proposed)

- Deferral of advertising costs
 - Not deferred as part of DAC
 - Follow GAAP guidance for advertising:
 - Topic 720, Other Expenses
 - Subtopic 340-20 (SOP 93-7), Other Assets and Deferred Costs – Capitalized Advertising Costs
 - Capitalize direct-response advertising if it creates “probable future economic benefit” and aims to generate sales
 - Intended to generate consistency across industries

EITF 09-G: The Future of DAC

- FASB disclosed current position regarding the future of DAC:
 - “The Board has an ongoing project on its agenda on the accounting for insurance contracts. The Board’s current view in that project is that all acquisition costs should be expensed as incurred.”
 - Would not be effective until 2014 or later

EITF 09-G: Comment Letters

- Deferred expenses should be considered as part of larger joint project on insurance
- Entirely GAAP accounting model expected to be effective in 2014
 - Retroactive restatement to 2011
- Narrower definition of deferred expenses not appropriate
- Perceived problem of inconsistent definition of deferrable expenses from company to company is not material

EITF Meeting March 18, 2010

- Affirmed that acquisition costs should include only those directly related to the acquisition or renewal of insurance contracts
- Affirmed that costs related to unsuccessful acquisition efforts should be expensed as incurred
- Affirmed that advertising costs should only be capitalized if criteria in Topic 340 are met
- Discussed impact on loss recognition testing of excluding advertising costs from DAC asset

IFRS – The GAAP of the Future?

- Accounting bodies working together
- SEC reaffirmed commitment to single set of global standards (Feb 24 2010)
- FASB and IASB working together to develop standards
- Could have entirely new “GAAP” in 2014

Joint FASB/IASB Projects

- Fair Value (4/2/10)
- Financial Instruments (exposure 5/26/10)
- Financial Statement Presentation (5/6/10)
- Insurance Contracts (5/6/10)
- Revenue Recognition (5/18/10)
- Statement of Other Comprehensive Income
 - Exposure draft 5/26/10

<http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220137074>

FASB/IASB Joint Project

- Calendar:

- Lots of activity in 2010
- Expect final documents Q1 2011
- Effective 2014?
- Restatement to 2011?

FASB/IASB Joint Project Revenue Recognition

- Single model (not industry specific)
- Revenue recognizes as goods and services are transferred to customer
 - Identify contract
 - Identify performance obligations
 - Determine transaction price
 - Allocate price to performance obligations
 - Recognize Revenue when obligation satisfied

FASB/IASB Joint Project Insurance Contracts: Goal

- Improve and simplify the financial reporting requirements for ins contracts
- Eliminate numerous pieces of current US Accounting literature re ins contracts
- Provide investors with more decision useful information

FASB/IASB Joint Project Insurance: Measurement

- Building blocks:
 - Unbiased, probability-weighted average of future cash flows
 - Time value of money
 - Risk adjustment
 - Updated each reporting period
 - Amount that eliminates any gain at issue
 - BUT NOT LOSS AT ISSUE!

FASB/IASB Joint Project Insurance: Day 1 Differences

- Initial recognition of insurance contract should not result in profit
- If $PV(\text{outflows}) > PV(\text{inflows})$, on risk-adjusted basis, recognize loss at inception
- Any gain at inception eliminated by including a “residual margin”

FASB/IASB Joint Project Insurance: Other Decisions

- Unbundling Insurance vs Investment?
 - IASB/FASB differences of opinion
- Deposit Floor on Liability?
 - No
- Policyholder Behavior
 - Reflect policyholder options as well as options, forwards, and guarantees related to existing coverage
- Participating Features
 - IASB/FASB differences of opinion

FASB/IASB Joint Project Insurance: Other Decisions

- DAC

- An insurer should expense all acquisition costs when incurred and should not recognize any revenue (or income) to offset those costs incurred.

- Revenue Recognition

- Not Premiums
- Recognize revenue as insurer performs under the contract
- Separate FASB/IASB project on revenue recognition

Closing Thought

- Change is inevitable - except from a vending machine.

Robert C. Gallagher