Working Draft

Targeted Improvements to Long-Duration Contracts Implementation Paper

Issue #4D: Market risk benefits – Retrospective adoption of market risk benefits guidance and the effect on purchase accounting.

Wording to be Included in the Audit and Accounting Guide: Life and Health Insurance Entities.

Market Risk Benefits – Transition

Please note that the six paragraphs immediately below are from finalized paper #4AB, included in paragraphs 25 – 30 of Appendix G: FASB ASU No. 2018-12: Financial Services — Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts, Accounting Implementation Papers, in the AICPA Audit and Accounting Guide: Life and Health Insurance Entities. The paragraphs are included below for completeness as the Guide will include the final versions of both papers #4AB and #4D, integrated in this format. Content currently out for informal comment within Issue #4D starts in numbered paragraph 1.

FASB ASC 944-40-65-2 states,

> The following represents the transition and effective date information related to Accounting Standards Update No. 2018-12, Financial Services – Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts, No. 2019-09, Financial Services—Insurance (Topic 944): Effective Date, and No. 2020-11, Financial Services—Insurance (Topic 944): Effective Date and Early Application:
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> f. At the transition date, an insurance entity shall apply the pending content that links to this paragraph on market risk benefits by means of retrospective application to all prior periods. An insurance entity shall maximize the use of relevant observable information as of contract inception and minimize the use of unobservable information in determining the market risk benefits balance at the transition date. If retrospective application requires assumptions in the prior period that are unobservable or otherwise unavailable and cannot be independently substantiated, the insurance entity may use hindsight in determining those assumptions. The transition adjustment shall be recognized as follows:
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> 1. The cumulative effect of changes in the instrument-specific credit risk between contract issue date and transition date shall

be recognized in accumulated other comprehensive income as of the transition date.

2. The difference between fair value and carrying value at the transition date, excluding the amount in (f)(1), shall be recognized as an adjustment to the opening balance of retained earnings as of the transition date.

Upon adoption of FASB ASU 2018-12, at the transition date entities are required to apply the recognition and measurement guidance for market risk benefits on a retrospective basis to all prior periods. FASB ASC 944-40-30-19C states "a market risk benefit shall be measured at fair value". Fair value is defined in FASB ASC 820-10-20 and FASB ASC 944-20-20 glossaries as "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." To comply with this definition, entities should apply the FASB ASC 820 fair value framework to the initial and subsequent measurement of market risk benefits at fair value.

In accordance with the fair value hierarchy established in FASB ASC 820-10-35, in determining fair value the highest priority should be to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs), then Level 2 inputs that are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, and the lowest priority to unobservable inputs (Level 3 inputs). FinREC believes that maximizing the use of "observable information" as stated in FASB ASC 944-40-65-2(f) means identifying historical information which would have been used in determining assumptions at contract issuance had the entity been measuring the market risk benefits under a FASB ASC 820 fair value framework. Thus, it would be inappropriate for an entity to use actual historical experience as a single or deterministic scenario when determining the assumption(s) used to measure a market risk benefit in a retrospective period.

FinREC believes that before implementing the use of hindsight, entities should make reasonable efforts to determine whether retrospective information is available from any number of other sources, such as market sources, pricing, other models (e.g., previous embedded derivative valuations or Enterprise Risk Management) or other projections (e.g., regulatory capital calculations) to the extent they represent market participant assumptions. If entities are unable to obtain the necessary information through reasonable efforts, or the information would require assumptions about management's intent at contract inception (i.e., unable to be independently substantiated without contemporaneous documentation), entities would then be permitted to use hindsight in determining the assumptions.

FinREC believes that in determining the level of effort implied by the terms "otherwise unavailable" and "cannot be independently substantiated" in FASB ASC 944-40-65-2(f), an insurance entity should, similar to the guidance in the impracticability framework in FASB ASC 250, Accounting Changes and Error Corrections, make every reasonable effort to determine its assumptions without the use of hindsight. FinREC believes that an insurance entity may, in various scenarios, conclude that, after making every reasonable effort, certain information is "otherwise unavailable" and "cannot be independently substantiated" and therefore that the use of hindsight is necessary for at least certain assumptions and certain prior periods.

FinREC believes an entity's determination whether the use of hindsight is required should be made separately for each assumption and input. This evaluation approach is consistent with

FASB ASC 944-40-65-2(f) that requires that an entity "maximize the use of relevant observable information". For example, in some scenarios an entity may obtain observable capital market information sufficient for purposes of determining retrospective capital market assumptions, but are unable to obtain the information needed to determine retrospective policyholder behavior assumptions (e.g., lapses). In this instance, the entity should only use hindsight when determining the retrospective policyholder behavior assumptions.

1. When entities apply the recognition and measurement guidance for market risk benefits on a retrospective basis to a historical period that includes a previous business combination, it would generally affect the acquirer's allocation of the overall fair value of the acquired contracts to its various components.

2. FASB ASC 944-805-25-3 states:

   > The acquirer shall recognize the assets and liabilities arising from the rights and obligations of the insurance and reinsurance contracts acquired in the business combination.

3. FASB ASC 944-805-30-1 states:

   > The acquirer shall measure at fair value the assets and liabilities recognized under paragraph 944-805-25-3. However, the acquirer shall recognize that fair value in components as follows:
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   > a. Assets and liabilities measured in accordance with the acquirer's accounting policies for insurance and reinsurance contracts that it issues or holds. For example, the contractual assets acquired could include a reinsurance recoverable and the liabilities assumed could include a liability to pay future contract claims and claims expenses on the unexpired portion of the acquired contracts and a liability to pay incurred contract claims and claims expenses. However, those assets acquired and liabilities assumed would not include the acquiree's deferred acquisition costs and unearned premiums that do not represent future cash flows.
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   > b. An intangible asset (or occasionally another liability), representing the difference between the following:
   >   1. The fair value of the contractual insurance and reinsurance assets acquired and liabilities assumed
   >   2. The amount described in (a).

4. In accordance with FASB ASC 944-805-30-1, acquiring entities often record an intangible asset (or liability) related to the acquisition of insurance and reinsurance contracts. Such insurance contract intangible balances represent the difference between the carrying amounts of insurance and reinsurance contracts and the contracts' fair value as of the acquisition date. These insurance contract intangible balances are commonly referred to as the present value of future profits (PVFP), or alternatively the value of business acquired.

5. Upon adoption of ASU 2018-12, some of the benefit features within the acquired insurance and reinsurance contracts will be retrospectively recognized as market risk benefits and measured at fair value as required by FASB ASC 944.

6. Adoption of ASU 2018-12 guidance does not impact the acquisition date fair values of the insurance and reinsurance contracts at the purchase date of the business combination. However, FinREC believes that application of the provisions of ASU 2018-12 to market risk benefits on a

retrospective basis will require entities to adjust the *allocation* of the acquisition date fair value of the contracts to their related components (e.g., the allocation among PVFP, host contract account values, additional liabilities, and MRBs) to reflect changes in the measurement of the contracts in accordance with ASC 944-805-30-1(a). That is, acquiring entities should retrospectively adjust carrying amounts of the acquired contracts (i.e. contracts or contracts features that now meet the definition of market risk benefits) and redetermine the initial measurement of the components of the contracts acquired in the business combination but should not change the fair value of the group of contracts.

7. FinREC believes that if an entity adjusts the PVFP in accordance with paragraph 6, the entity should use an amortization method for any revised PVFP amount consistent with the entity's accounting policy before adoption of ASU 2018-12 to determine amortization from the date of the business combination through the transition date.

8. Consider the following example:

Schedule 1 illustrates a scenario where at the time of the business combination, the acquiring entity estimated a $80 total fair value of the insurance contracts acquired. At the time of the business combination, the carrying amount of the insurance contracts under FASB ASC 944 as determined by the acquirer was $90. Thus, the acquirer recorded PVFP of $10 which was initially measured as the difference between the fair value and carrying amount of the acquired insurance contracts.

Schedule 1 – Original Business Combination
(prior to adoption of ASU 2018-12)

Total fair value of insurance contracts acquired	$	80
Less: carrying amount of insurance contracts acquired		(90)
PVFP – initial measurement	$	10

Now consider the acquirer adopts the market risk benefits guidance on a retrospective basis as required by ASC 944-40-65-2f. In adopting the new guidance, the carrying amount of the acquired insurance contracts at the time of the business combination increased from $90 to $100 (The change of $10 represents the adjustment to the carrying amount of those acquired insurance contracts that meet the definition of market risk benefits). Retrospectively adjusting the carrying amount of the insurance contracts acquired from $90 to $100 results in a corresponding increase in the PVFP at the date of the business combination from $10 to $20. Schedule 2 illustrates how the acquirer would revise the initial measurement of the PVFP related to the business combination. The entity would then determine amortization between the date of the business combination and the transition date using an amortization method for any revised PVFP amount consistent with the entity's accounting policy before adoption of ASU 2018-12.

Schedule 2 – Revised Accounting for Business Combination
(subsequent to adoption of ASU 2018-12)

Total fair value of insurance contracts acquired	$	80
Less: carrying amount of insurance contracts acquired		(100)
PVFP– initial measurement	$	20

9. FinREC believes entities should also follow the principles of paragraphs 6 and 7 when applying the transition guidance to ceded reinsurance arrangements with MRB provisions not accounted for as part of a business combination. Adoption of ASU 2018-12 guidance does not change the total consideration of the reinsurance arrangement, and the ceding insurer should determine the revised cost of reinsurance asset or liability based on the recalculated measurement of the market risk benefit features within the contracts and determine amortization from the date of the reinsurance contract through the transition date using an amortization method consistent with the entity's accounting policy before adoption of ASU 2018-12.

10. As discussed in LDTI Implementation Paper #11EF: *Reinsurance Contracts that Include Market Risk Benefits*, if a reinsurance arrangement includes a contract or contract feature that provides for potential benefits in addition to the account balance, FinREC believes each entity should determine the classification of the reinsurance arrangement as an investment contract or as an insurance contract at the inception of the reinsurance arrangement by assessing the significance of mortality and morbidity risk within the reinsurance arrangement. FinREC believes that the reallocation of the total consideration for the reinsurance arrangement resulting from application of the provisions of ASU 2018-12 to market risk benefits on a retrospective basis does not result in reassessment of contract classification.

Comments should be received by July 29, 2021, and sent by electronic mail to Kim Kushmerick at kim.kushmerick@aicpa-cima.com, or you can send them by mail to attention: Kim Kushmerick, 1345 Avenue of the Americas, New York, N.Y., 10105.