May 21, 2015

FASB Understanding Costs and Benefits

ASU: Financial Services—Insurance (Topic 944)

Summary

This document summarizes how the Financial Accounting Standards Board (FASB) assessed the expected costs and benefits of its new Accounting Standards Update (ASU) No. 2015-09, *Financial Services—Insurance (Topic 944): Disclosures about Short-Duration Contracts*. The document also outlines the process that led the FASB to conclude that the expected benefits of the amendments in the ASU justify the anticipated costs.[1]

The FASB issues new financial accounting and reporting standards only when the benefits of a standard—improvements in the relevance and reliability of reported financial information—justify the net costs it imposes on financial statement preparers (to implement the new standard), and on financial statement users (to consider and interpret the new information).

The FASB concluded that the expected benefits of the amendments in this ASU justify the anticipated costs.

The FASB determined that the application of the ASU will provide more meaningful information to users by:

- Increasing the transparency of management's estimates in determining claim liabilities for short-duration insurance contracts
- Providing additional insight into an insurance company's ability to underwrite and anticipate costs associated with claims
- Enhancing comparability among insurance companies by requiring consistent disclosure of information.

The FASB also understands that insurance companies that issue short-duration contracts may incur additional costs as a result of the amendments in the ASU. Such costs include:

- Information Technology (IT) costs for new systems, processes, and controls used to aggregate data
- Personnel costs to modify processes, develop internal controls, comply with requirements, and prepare disclosures
- Incremental auditor costs to audit new financial statement disclosures and enhanced internal controls

The Board notes that a significant amount of the data needed to prepare these disclosures should be readily available to insurance companies because of statutory reporting requirements, which mitigates the costs of implementing the guidance in this ASU.

As a result, the FASB concluded that the expected benefits of the amendments in this ASU justify the anticipated costs.

Background

The FASB, with the International Accounting Standards Board (IASB), undertook a project intended to comprehensively improve the accounting for insurance contracts, both long-duration (life insurance and annuities) and short-duration (auto and home insurance), for all public and private companies.

In June 2013, the FASB issued proposed ASU, *Insurance Contracts (Topic 834)*, which introduced new accounting models and qualitative and quantitative disclosures to help users of financial statements understand the amount, timing, and uncertainty of future insurance contract cash flows.

The IASB at the same time issued a proposal for insurance contracts that also introduced new accounting models and qualitative and quantitative disclosures. Although the objective of the joint project was to develop common guidance, the amendments proposed by the FASB and the IASB differed in several important aspects.

Stakeholders said that the existing accounting model for short-duration contracts works well and should continue to apply only to insurance companies. They said changes to the guidance should be limited to improvements to required disclosures.

The feedback received from stakeholders on the FASB's proposal overwhelmingly supported retaining current recognition and measurement guidance for short-duration contracts under Generally Accepted Accounting Principles (GAAP). Stakeholders said that the existing accounting model for short-duration contracts works well and should continue to apply only to insurance companies. They said changes to the guidance should be limited to improvements to required disclosures.

The FASB considered this feedback and determined it would develop and issue an ASU that makes targeted improvements to enhance disclosures for short-duration insurance contracts, because the benefits of a new comprehensive accounting model did not justify the costs.

The FASB also decided to more comprehensively address accounting and disclosures for long-duration insurance contracts for insurance companies by making targeted improvements. The Board decided to separate that work into a separate project.

Outreach with Stakeholders after issuance of 2013 Proposed Update

The FASB received significant input from stakeholders on the operability and usefulness of the proposed guidance. This input included 214 comment letters in response to the 2013 proposed Update, a number of which specifically addressed the proposed disclosure requirements.

Since the 2013 proposed Update was issued, 61 outreach meetings were held with stakeholders operating within the insurance industry—specifically, preparers, practitioners, industry groups, regulators, and users of financial statements.

Stakeholder Outreach Summary

	Comment Letters	Outreach Meetings	Total
Industry Groups	14	6	20
Practitioners	8	12	20
Preparers	136	20	156
Regulators	8	10	18
Standard Setters	2	0	2
Users	46	13	59
Grand Total	**214**	**61**	**275**

The FASB considered the feedback from those stakeholders during its redeliberations at seven public Board meetings held during 2014 and 2015. The amendments in the ASU are a result of those Board meetings and redeliberations.

Stakeholder Concerns

Feedback received from users, preparers, and practitioners on the 2013 proposed Update overwhelmingly supported retaining the existing accounting and reporting guidance for short-duration insurance contracts in GAAP for insurance companies.

Stakeholders noted that the existing accounting model for short-duration insurance contracts is operational and well understood, and that changes to the accounting model would provide trivial benefits relative to the significant costs required to implement a new accounting model.

To address the following stakeholder concerns, the Board decided that the final ASU should focus on making targeted improvements to enhance existing disclosure requirements for short-duration contracts.

- **Liability for unpaid claims and claim adjustment expenses.** Current GAAP contains limited disclosures for short-duration insurance contracts about the liability for unpaid claims and claim adjustment expenses. Certain companies have been increasing disclosures about the liability for unpaid claims and claim adjustment expenses in both management's discussion and analysis (MD&A) and financial statement footnotes. However, those disclosures typically do not provide enough detail to be useful and are not presented consistently across companies.

Financial statement users also indicated that they obtain information about the liability for unpaid claims and claim adjustment expenses from the regulatory insurance filings, which insurance companies provide to the state insurance regulators that grant licenses to issue contracts in those states.

However, the regulatory framework often results in complicated organizational structures for insurance companies and the creation of numerous legal entities. That, in turn, can result in data that is incomplete and inconsistent from company to company, because the data is required and available only for legal entities located in the U.S.

Practitioners and preparers also expressed concern that the requirement to disclose claims development tables (which would span many years) in the audited financial statement footnotes may be operationally difficult in the event a change in auditor occurred or was contemplated during the years for which the tables are presented.

To issue an audit report on the financial statements (which include the footnotes), an auditor must be independent of the information for all years presented.

The Board decided that the final ASU should focus on making targeted improvements to enhance existing disclosure requirements for short-duration contracts.

The FASB considered these concerns along with the views from users about the location of the information and decided that the ASU would specify that all years presented in the claims development tables that precede the most recent reporting period should be considered supplementary information, which addresses the auditor independence issue. That approach would be less costly to preparers while still providing the relevant information to users.

- **Disclosure about claim counts (cumulative number of claims incurred).** Stakeholders explained that claim count information may not always be relevant or useful for users, and for certain product types, this information may not be available.

  To address this concern, the proposed requirement to disclose claim counts was replaced with a disclosure objective of providing information about claim frequency along with a description of methodologies for determining claim frequency, unless it is impracticable to do so.

- **Disclosure about incurred-but-not-reported (IBNR) liabilities.** Stakeholders noted that insurance companies generally do not make separate estimates for IBNR and, therefore, the disclosure of IBNR on its own would require new processes in order to estimate the amount. These new processes could be both operationally challenging and costly.

  In response to this concern, the FASB decided to require insurance companies to disclose the amount of the total of IBNR liabilities plus expected development on reported claims for each accident year presented in the claims development table. This results in a reported amount which is well understood by users and preparers, avoids costs associated with introducing a new IBNR metric, and more closely aligns the IBNR disclosures with statutory reporting.

Targeted Improvements

- Incurred and paid claims development tables
- Disclosure about claim counts (cumulative number of claims incurred)
- Disclosure about incurred-but-not-reported (IBNR) liabilities

Costs: Applying the New ASU

The FASB understands that insurance companies that issue short-duration contracts may incur additional costs as a result of the amendments in the ASU.

The magnitude of the costs will vary based on the extent of an insurance company's international operations and the diversity of its product offerings. For example, an insurance company that only issues automobile insurance in the U.S. will incur far fewer costs than an insurance company that issues a wide variety of short-duration insurance contracts both in the U.S. and in other countries.

Costs of Applying the New ASU

- IT costs for new systems, processes, and controls used to aggregate data
- Personnel costs to modify processes, develop internal controls, comply with requirements, prepare disclosures
- Incremental auditor costs to audit new financial statement disclosures and enhanced internal controls

Insurance companies are expected to incur the following costs to apply the new ASU:

- Information technology transition costs to change existing systems or develop new systems to obtain the disclosure information. These costs may include software and hardware acquisition costs, as well as internal personnel or external consulting costs to configure, install, and maintain these new systems
- Personnel costs at transition to develop processes for compiling and synthesizing the information required for disclosure, as well as ongoing costs to prepare the disclosures on a periodic basis
- Incremental auditor costs to audit the new financial statement disclosures and related internal control enhancements

However, the FASB understands that insurance companies will be able to leverage existing processes and data currently used for statutory reporting to prepare the financial statement footnote disclosures required by this ASU, which mitigates the costs of applying the new guidance.

Benefits: Applying the New ASU

The FASB observed that the targeted improvements from the new ASU will benefit users of financial statements by providing more relevant, useful, and comparable information.

The liability for unpaid claims and claim adjustment expenses represents an insurance company's estimate of the ultimate cost of settling claims. However, under current GAAP, there are limited disclosure requirements related to this liability.

The ASU will require all insurance companies that issue short-duration insurance contracts to disclose incurred and paid claims development tables that include information for the number of years for which incurred claims typically remain outstanding, but the disclosure need not go back beyond 10 years, including the most recent reporting period presented.

Financial statement users have indicated that today, the information they receive is incomplete and requires significant effort to compile from regulatory filings to render it useful.

The introduction of these tables will increase the transparency of the liability for unpaid claims and claim adjustment expenses by facilitating an analysis of initial liability estimates and subsequent adjustments to those estimates.

Overall, the new ASU increases the transparency of liabilities that arise from short-duration insurance contracts by providing enhanced disclosure of:

- Incurred and paid claims development information by accident year
- Reconciliation of incurred and paid claims development information to the aggregate amount of the liability for unpaid claims and claim adjustment expenses displayed on the balance sheet
- Total of IBNR liabilities plus expected development on reported claims included in the liability for unpaid claims and claim adjustment expenses for each accident year presented, accompanied by a description of reserving methodologies (as well

as any changes to those methodologies)

- Quantitative information about claim frequency (unless it is impracticable to do so) accompanied by a qualitative description of methodologies used for determining claim frequency information (as well as any changes to these methodologies) for each accident year of incurred claims development information presented
- Average annual percentage payout of incurred claims by age (that is, history of claims duration) for all claims except health insurance claims
- Rollforward of the liability for unpaid claims and claim adjustment expenses for annual and interim periods

These disclosures will provide a more transparent view of management's significant estimates by:

- Including information for the entire company, not only U.S. legal entities.
- Providing users with consistent and comparable information by year so that they can analyze an insurance company's ability to underwrite and anticipate costs associated with claims.
- Providing disclosures of incurred and paid claims development information by accident year that are consistent with management's analysis of information regarding the liability for unpaid claims and claim adjustment expenses.
- Enabling users to calculate average severity of reported claims based on the claim frequency information and the claims development information.

As a whole, the amendments in the ASU will result in more meaningful financial reporting for users of the financial statements by providing financial information that better explains the financial position and performance of the reporting organization and a better basis for assessing the prospects for the nature, amount, and timing of future cash flows.

Benefits of Disclosures

- Includes information for the entire company, not only U.S. legal entities
- Helps users analyze an insurance company's ability to underwrite and anticipate costs associated with claims
- Provides incurred and paid claims development information by accident year
- Enables users to calculate average severity of reported claims

Conclusion

The Board's assessment of the costs and benefits of issuing the ASU is unavoidably more qualitative than quantitative because there is no identified method to objectively quantify all of the costs and benefits of implementing new guidance.

Overall, the Board concluded that the expected benefits of the amendments in the ASU justify the perceived costs.

More information on the ASU, including a press release and a *FASB In Focus*, can be found on the FASB website.

More information on how the FASB conducts its cost-benefit analysis can be found here.

[1]For a detailed explanation of the FASB's consideration of costs and benefits refer to the basis for conclusions in ASU 2015-09.

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