This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Summary of US GAAP requirements for insurance (including changes to the Accounting for Long-Duration Insurance Contracts) and comparison with IFRS 17
Issues Paper

Objective

1 The objective of this paper is to compare the key requirements of IFRS 17 *Insurance Contracts* with the key US GAAP requirements on insurance accounting, as input to the draft endorsement advice of EFRAG. This comparison follows from the request for endorsement advice that asks "what the impact on the competitiveness of European undertakings would be taking into account the diversity of their business models vis-à-vis their major competitors outside Europe" of applying IFRS 17.

2 The DEA in this regard investigates the competitiveness:

(a) Within Europe

(i) Between European listed insurers;

(ii) Between European listed insurers and European non-listed insurers;

(iii) Between European insurers and third-country insurers;

(iv) Between insurers and other entities (banks and private equity firms)

(b) Outside Europe: US GAAP and Japanese GAAP.

3 The detailed comparison below would form part of the draft endorsement advice as the comparison between IFRS and US GAAP.

Summary of changes for Long-duration Contracts

4 In August 2018, the FASB issued an Accounting Standards Update, *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-duration Contracts.* These targeted improvements are intended to:

(a) Improve the timeliness of recognising changes in the liability for future policy benefits by requiring that updated assumptions be used to measure the liability for future policy benefits (i.e. assumptions would be unlocked) and modify the rate used to discount future cash flows;

(b) Simplify and improve the accounting for certain options or guarantees embedded in deposit (or account balance) contracts;

(c) Simplify the amortisation of deferred acquisition costs (DAC); and

(d) Improve the effectiveness of required disclosures.

Comparing the requirements

5 The US GAAP requirements for insurance contracts differ from the requirements of IFRS 17. The main differences between the two frameworks are related to the following areas:

(a) Scope;

(b) Different types of insurance contracts – overall view;

(c) Measurement of insurance contracts;

(d) Level of aggregation;

(e) Risk sharing;

(f) Recognition of onerous contracts;

(g) Reinsurance;

(h) Deferred acquisition costs;

(i) Revenue recognition;

(j) Accounting treatment of income on day one;

(k) Measurement of options and guarantees;

(l) Separation of embedded derivatives within insurance contracts; and

(m) Presentation and disclosure.

Scope

6 Unlike IFRS 17, US GAAP establishes industry-specific accounting and reporting guidance for insurance companies, as opposed to accounting for insurance contracts. For entities other than insurance companies, any contract issued that would meet the definition of an insurance contract under IFRS Standards is accounted for in accordance with other applicable US GAAP literature because the specific contract has not been issued by insurance, reinsurance, or certain financial guarantor companies.

Different types of insurance contracts - overall view

IFRS 17	US GAAP			
General model, simplified or modified for • Premium Allocation Approach • Variable Fee Approach • Investment contracts with discretionary participation features • Reinsurance contracts	Short-duration	Long-duration • Traditional • Universal Life • Participating Contracts • Guarantee benefits embedded in certain contracts	Reinsurance ceded	Financial Guarantees

7 Both IFRS 17 (through the Premium Allocation Approach) and US GAAP distinguish between short-term and long-term insurance contracts. Also, both IFRS 17 and US GAAP use modified requirements for particular subcategories of long-term insurance contracts. However, the subcategories used in both frameworks are different as shown in the table below.

Short-duration contracts

8 Under IFRS 17, an entity may use the premium allocation approach when, at inception of a group of insurance contracts:

(a) The measurement would not materially differ from the one when using the general model or the variable fee approach; or

(b) The coverage period of the insurance contracts is one year or less.

9 Under US GAAP short-duration contracts are defined as providing insurance protection for a fixed period of short duration and enabling 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 premiums charged or coverage provided.

10 The US GAAP definition is perceived to be broader than the one under IFRS 17. In addition, short-duration contracts are adjusted to reflect changes in assumptions while this is not the case for the PAA. However, the carrying amount of PAA contracts is adjusted to reflect the time value of money and the effect of financial risk when these contracts have a significant financing component.

Measurement of insurance contracts

	IFRS 17	**US GAAP**		
		Short-duration	Long-duration (Traditional life)	Long-duration (Universal life)
Cash flows	Required to fulfil the contracts	Same as IFRS	Same as IFRS	Same as IFRS
Assumptions	Updated	Updated	Updated	Updated
Discount rates	To reflect the characteristics of the cash flows arising from the insurance contracts	Typically not discounted (except for some contracts for which the settlement of claims may take many years)	Upper-medium grade (low credit risk) fixed-income instrument yield that maximises the use of current market observable inputs. Also for Limited-Payment Long-Duration Contracts	Contract rate or upper-medium grade (low credit risk) fixed-income instrument yield
Risk margin	Explicit risk margin	Risk margin is not applicable (implicit)	Risk margin is not applicable (implicit)	Risk margin is not applicable (implicit)

11 The*Targeted Improvements to the Accounting for Long-duration Contracts* require that an insurance entity measure all market risk benefits associated with deposit (or account balance) contracts at fair value. The portion of any change in fair value attributable to a change in the instrument specific credit risk is required to be recognized in other comprehensive income.

Cash flows

12 For insurance contracts that do not include complex features such as options and guarantees, both frameworks use expected cash flows required to fulfil the insurance contracts in the liability measurement. For insurance contracts that include complex features such as options and guarantees, please refer to paragraph 55.

Assumptions

13 In accordance with IFRS 17, assumptions used in measuring the insurance liability are updated. For short-duration, traditional life and universal life long-duration contracts under US GAAP, an insurance entity has to review and if necessary, update the assumptions used to measure future cash flows at least annually. For traditional and limited-payment contracts, cash flow assumptions are reviewed—and if there is a change, updated—on an annual basis, or in interim reporting periods if evidence suggests that cash flow assumptions should be revised; however, an insurance entity may make an entity-wide election not to update the expense assumption. The discount rate assumption is updated for each reporting period, as of the reporting date.

Discount rates

14 IFRS 17 requires discount rates used to reflect the characteristics of the cash flows arising from the insurance contracts.

15 Under IFRS 17, investment returns are not included in the cash flows used in measuring the insurance liability. Investments are recognised, measured and presented separately. Consequently, in order to avoid double counting or omissions, cash flows that do not vary based on the returns on any underlying items shall be discounted at rates that do not reflect any such variability. Cash flows that vary based on the returns on any underlying items are discounted using rates that reflect that variability or are adjusted for the effect of that variability and discounted at a rate that reflects the adjustment.

16 Under US GAAP, for short-duration contracts, liabilities for unpaid claims and claim adjustment expenses can be discounted at the same rate used to report the same claims liabilities to State regulatory authorities or discounting liabilities with respect to settled claims under the following circumstances: (i) if the payment pattern and ultimate cost are fixed and determinable on an individual claim basis, and (ii) the discount rate used is reasonable on the facts and circumstances applicable to the registrant at the time the claims are settled.

17 For traditional, limited-payment and universal life contracts, US GAAP requires the use of a current upper-medium grade (low credit risk) fixed-income instrument yield that reflects the duration characteristics for those contracts. The effect of updating the discount rate assumption is to be recognised immediately in other comprehensive income. The discount rate assumption is locked for purposes of determining the interest accretion rate (or interest expense).

Risk margin

18 The general requirements in IFRS 17 prescribe the recognition of a risk adjustment in order to address uncertainty in non-financial risk. The risk adjustment is also applied to investment contracts[1] but has a zero value as these contracts have no significant insurance risk.

19 The *Targeted Improvements to the Accounting for Long-duration Contracts* have eliminated the provision for risk of adverse deviation.

Level of aggregation

20 IFRS 17 subdivides each portfolio into groups of (i) contracts onerous at initial recognition, if any, (ii) contracts at initial recognition having no significant possibility of becoming onerous subsequently, if any and (iii) remaining contracts in the

[1] This refers to investment contracts with discretionary participation features that are within the scope of IFRS 17.

portfolio, if any. Contracts issued more than one year apart shall not be included in the same group.

21 For non-traditional products US GAAP indicates that insurance contracts shall be grouped consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists. For traditional, limited-payment and universal life contracts, contracts from different issue years should not be grouped together, but contracts issued within a single issue year may be grouped together when determining the level of aggregation for measuring the liability for future policy benefits.

Risk sharing

22 Under IFRS 17, entities should consider whether the cash flows of insurance contracts in one group affect the cash flows to policyholders of contracts in another group. This is to determine whether they result in policyholders subordinating their claims or cash flows to those of other policyholders, thereby reducing the direct exposure of the entity to a collective risk. This factor, sometimes referred to as 'mutualisation between contracts', is considered in the measurement of the fulfilment cash flows.

23 US GAAP does not include the concept of risk sharing amongst groups for cash flows that affect the cash flows to policyholders in another group.

Recognition of onerous contracts

24 US GAAP does not prohibit (and, in fact, requires) accrual of a net loss (that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated. A probable loss on insurance contracts exists if there is a premium deficiency relating to short-duration or long-duration contracts.

Short-duration contracts

25 A premium deficiency is recognised if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortised acquisition costs, and maintenance costs exceeds related unearned premiums. A premium deficiency shall first be recognised by expensing any unamortised acquisition costs to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortised acquisition costs, a liability is accrued for the excess deficiency.

Long-duration contracts

26 For traditional and limited-payment contracts, no premium deficiency testing is required because the liability is updated for current assumptions, but loss recognition testing is retained for universal life-type contracts. For all long duration contracts deferred acquisition costs are not subject to impairment testing as they are considered debt issuance costs and effects of interest expenses.

27 Actual experience with respect to investment yields, mortality, morbidity, terminations, or expenses may indicate that existing contract liabilities, together with the present value of future gross premiums, will not be sufficient to both:

(a) Cover the present value of future benefits to be paid to or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts; and

(b) Recover unamortised present value of future profits.

28 The premium deficiency is recognised by a charge to income and either of the following:

(a) A reduction of unamortised present value of future profits; or

(b) An increase in the liability for future policy benefits.

29 A premium deficiency, at a minimum, shall be recognised if the aggregate liability on an entire line of business is deficient. In some instances, the liability on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits would be recognised in early years and losses in later years. In those situations, the liability shall be increased by an amount necessary to offset losses that would be recognised in later years.

30 Under IFRS 17, an entity shall recognise onerous contracts:

(a) At initial recognition: an entity shall recognise a loss in profit or loss if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract are a net outflow; and

(b) On subsequent measurement: insurance contracts can become onerous when adjustments to the contractual service margin exceed the amount of the contractual service margin ('CSM'). Such excess is recognised immediately in profit or loss. The losses are allocated to a loss component of the liability for remaining coverage for an onerous group.

31 Another (more theoretical than practical) difference between US GAAP and IFRS Standards lies in the definition of "probable" which is used to determine whether a contingent loss or provision should be recognised. Paragraph 23 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines probable as "more likely than not to occur" (i.e., "the probability that the event will occur is greater than the probability that it will not"). ASC 450 *Contingencies* subsection 450-20-20 defines "probable" as "likely to occur."

Reinsurance

32 Under US GAAP, reinsurance contracts do not result in immediate recognition of gains unless the reinsurance contract is a legal replacement of one insurer by another and thereby extinguishes the ceding entity's liability to the policyholder. Reinsurance recoverables shall be recognised in a manner consistent with the liabilities relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities.

Short-duration contracts

33 Under US GAAP, amounts paid for prospective reinsurance shall be reported as prepaid reinsurance premiums and amortised over the remaining contract period in proportion to the amount of insurance protection provided.

34 Amounts paid for retroactive reinsurance that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred. The deferred gain shall be amortised over the estimated remaining settlement period.

Long-duration contracts

35 Under US GAAP, the amortisation of the estimated cost of reinsurance of long-duration contracts that meets the conditions for reinsurance accounting depends on whether the reinsurance contract is long-duration or short-duration. The cost shall be amortised over the remaining life of the underlying reinsured contracts if the reinsurance contract is a long-duration contract, or over the contract period of the reinsurance if the reinsurance contract is a short-duration contract. The

assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts.

36 The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortised.

37 Similar to US GAAP, IFRS 17 utilises consistent assumptions as the underlying insurance contracts for measuring the estimates of the present value of future cash flows for a group of reinsurance contracts held. However, under IFRS 17, the effect of any risk of non-performance by the reinsurer, including the effects of collateral and losses from disputes, is considered when determining such estimates. In US GAAP the cost of non-performance is considered as part of expected credit losses.

38 The difference between the amount paid for the reinsurance cover and the expected risk-adjusted present value of the cash flows generated by the reinsurance contracts held, represents the contractual service margin which is recognised over the reinsurance coverage period.

Deferred acquisition costs

39 Differences may occur between deferred acquisition costs as defined under IFRS 17 and in accordance with US GAAP.

40 IFRS 17 defines insurance acquisition cash flows as cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are *directly attributable* to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

41 US GAAP defines acquisition costs as those that are related directly to the successful acquisition of new or renewal insurance contracts. In addition, US GAAP provides detailed guidance about how to identify costs that directly relate to the *successful* acquisition of new or renewal insurance contracts.

42 Under IFRS 17, the IASB has proposed that insurers would be required to allocate part of the insurance acquisition costs directly attributable to newly issued contracts to expected contract renewals. Under US GAAP, for long-duration contracts, acquisition costs are deferred and amortised on a constant basis over the expected life of the related contracts. Deferred acquisition costs would be written off for unexpected contract terminations but would not be subject to impairment testing.

Revenue recognition

43 Under IFRS 17, entities are required to report as insurance revenue the consideration for services on an earned basis. As a result, when applying IFRS 17, insurance revenue will exclude deposit components which represent policyholders' investments that are not consideration for services. The said revenue is then recognised as described in paragraph 49 below.

44 US GAAP has different methods of premium revenue recognition: short-duration contracts, three methods of long-duration contract accounting: traditional, universal life and participating contracts, foreign property and liability reinsurance contracts and financial guarantee insurance contracts.

45 For short-duration contracts, premiums are recognised over the period of the contract in proportion to the amount of insurance protection provided. For few types of contracts where the period of risk differs significantly from the contract period, premiums are recognised as revenue over the period of risk in proportion to the amount of insurance protection provided.

46 For long-duration contracts, premiums are recognised as revenue over the premium-paying periods of the contracts when due from policyholders.

(a) Traditional long-duration contracts: Premiums are recognised as revenue over the premium-paying periods of the contracts when due from policyholders;

(b) Limited-payment contracts: Any gross premium received in excess of the premium is deferred and recognised in income in a constant relationship with insurance in force (life insurance) or with the amount of expected future benefit payments (annuities);

(c) Universal life type contracts: Premiums collected are not reported as revenue. Revenue from those contracts represents fees charged to policyholders and is reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period. Amounts assessed that represent compensation to the insurance entity for services to be provided in future periods are not earned in the period assessed. Such amounts are recognised as unearned revenue and recognised in income over the period benefited using the same assumptions and factors used to amortise capitalised acquisition costs.

47 For foreign property and liability reinsurance contracts: depending on the circumstances, either the periodic method or the open year method are to be used.

(a) Under the periodic method, premiums are recognised as revenue over the policy term, and claims, including an estimate of claims incurred but not reported are recognised as they occur.

(b) Under the open year method, premiums, claims, commissions and related direct taxes are not reported as income, instead they are reported in the open underwriting balances to which they pertain. The underwriting balances are aggregated and kept open until sufficient information becomes available to record a reasonable estimate of earned premiums.

48 Financial guarantee insurance contracts: At inception a liability for the unearned premium revenue is recognised. The premiums from a financial guarantee insurance contracts are recognised as revenue over the period of the contract in proportion to the amount of insurance protection provided with a corresponding adjustment (decrease) in the unearned premium revenue. The premium revenue for each reporting period is determined by multiplying the insured principal amount for that period by the ratio of the following components:

(a) The total present value of the premium due or expected to be collected over the period of the contract; and

(b) The sum of all insured principal amounts outstanding during each reporting period over the period of the contract (either contract period or expected period).

Accounting treatment of income on day one

49 The accounting treatment under IFRS 17 for the unearned profit or contractual service margin (CSM) as determined on day one depends on whether the CSM arising from a primary insurance contract is in a gain or loss position or whether the entity incurred a cost or gain resulting from purchasing reinsurance coverage.

50 This can be illustrated as such:

IFRS 17: Recognition at inception	*Gain position*	*Loss making position*

IFRS 17: Recognition at inception	*Gain position*	*Loss making position*
Primary insurance contract	CSM is deferred and recognised in profit or loss over the period as services are provided.	The net loss position is recognised immediately in profit or loss at inception and if it arises subsequently for a group.
Reinsurance contract held	CSM of a group of reinsurance contracts held is adjusted and income recognised, on recognition of a loss at initial recognition of an onerous group, or on addition of onerous contracts to that group.	The net loss is not recognised immediately in profit or loss but is deferred.

51 For traditional life insurance, limited-payment, universal life and participating life insurance contracts under US GAAP, the net premium model is used to measure the liability for future policyholder benefits. The liability for future policy benefits for traditional life insurance, limited-payment, and participating life insurance contracts is calculated as the present value of estimated future policy benefits and expenses to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders and shall be accrued as premium revenue is recognised.

52 The net premiums are the portion of the gross premiums required to provide for all benefits and expenses, excluding acquisition costs or costs that are required to be charged to expense as incurred. The net premium ratio is calculated at contract inception by dividing the present value of the total policyholder benefits and expenses, excluding acquisition costs or costs that are required to be charged to expense as incurred, by the present value of total gross premiums. Therefore, the net premium ratio remains a constant percentage of the gross premium for the duration of the contract. The model results in profits being recognised as a level percentage of premiums over the entire life of the contracts.

53 Further, the unlocking of net premiums, by applying the catch-up approach is required. Under this approach, the insurance entity uses its updated net premium ratio to discount future cash flows to derive an updated liability measurement; the difference between the updated liability measurement and the previous liability measurement is referred to as the “catch-up” adjustment.

54 For reinsurance contracts under US GAAP, refer to paragraphs 34 and 36.

Measurement of options and guarantees

55 Certain contracts may be sold with contract features that provide for benefits in addition to the account balance. IFRS 17 requires an entity to include all financial options and guarantees embedded in insurance contracts in the measurement of the fulfilment cash flows, in a way that is consistent with observable market prices for such options and guarantees. However, under US GAAP, some of those features are accounted for as embedded derivatives at fair value under ASC Topic 815 *Derivatives and Hedging* (ASC 815) or as insurance liabilities under ASU 944.

56 For long-duration contracts, market risk benefits (such as guarantees embedded in variable contracts) are measured at fair value.

Separation of embedded derivatives within insurance contracts

57 Insurance contracts typically create a number of rights and obligations that together generate a package of cash inflows and cash outflows. They can include features in addition to the transfer of significant insurance risk, such as derivatives. IFRS 17 paragraph 11(a) requires an entity to apply IFRS 9 *Financial Instruments* to determine whether an embedded derivative should be accounted for separately from an insurance host contract.

58 U.S. GAAP requires entities to first evaluate whether such contracts or contract features should be accounted for as a market risk benefit. For benefits that are not determined to be market risk benefits, an insurance entity should then determine whether such benefits should be accounted for under Derivative and Embedded Derivative guidance in ASC Topic 815. All other benefits should be accounted for under the provisions of ASC Topic 944.

Presentation and disclosure

59 In accordance with IFRS 17, the carrying amounts of portfolios of insurance contracts that are an asset and those that are liabilities are to be presented separately in the statement of financial position. The same is valid for reinsurance contracts held.

60 In the statement of financial performance, a disaggregation is to be made between the insurance service result and the insurance finance income and expenses.

61 Further, IFRS 17 requires disclosure of qualitative and quantitative information about:

(a) the amounts recognised in its financial statements from insurance contracts;

(b) the significant judgements, and changes in those judgements, made when applying IFRS 17;

(c) detailed reconciliations of opening and closing balances; and

(d) the nature and extent of the risks from contracts within the scope of IFRS 17.

62 US GAAP requires various disclosures of qualitative and quantitative information that are applicable to the different types of products. For instance, insurers are required to provide:

(a) disaggregated rollforwards of the beginning to ending balances of the liability for future policy benefits, policyholder account balances, market risk benefits, separate account liabilities, and deferred acquisition costs

(b) information about significant inputs, judgments, assumptions, and methods used in measurement, including changes in those inputs, judgments, assumptions, and methods, and the effect of those changes on the measurement.

Effective date

63 The effective date for the long-term insurance contract standard for SEC filers excluding eligible smaller reporting companies will be financial years beginning after 15 December 2021, and interim periods within those fiscal years. For all other entities, the effective date will be financial years beginning after 15 December 2023 and interim periods within the financial years thereafter.

64 The effective date of IFRS 17 is [to be completed]

EFRAG secretariat views

65 In addition to the above detailed analysis the following overarching conclusions would be included in the DEA.

66 In assessing the competition issues between US GAAP and IFRS 17, EFRAG has considered US GAAP ASU Topic 944 *Financial Services – Insurance* in addition to IFRS 17.

67 The requirements of IFRS 17 and US GAAP differ in many respects, although the US GAAP changes to the accounting for Long-Duration Insurance Contracts are more closely aligning the frameworks on a number of issues. EFRAG has considered whether any of these differences may result in European insurance entities being at a competitive disadvantage to entities reporting under US GAAP for competition for capital.

Overall

68 IFRS and US GAAP are two different frameworks resulting in different detailed accounting treatments between IFRS 17 and ASU Topic 944. In many cases, these differences balance each other out. I.e. a competitive disadvantage for European insurers in one area for a particular insurance contract type is balanced by a competitive advantage for European insurers for another insurance contract type or in another area. No quantitative estimates exist whether one difference is larger or smaller than another. Examples here are the use of discount rates or certain requirements in the area of the level of aggregation. In this latter area the very different approach relating to impairment testing between the two frameworks is to be kept in mind.

69 In other areas no competitive (dis)advantages could be identified such as the measurement of options and guarantees, presentation and disclosures and the requirements for reinsurance. For the latter issue EFRAG has been informed that the US GAAP treatment provides a competitive advantage for US insurers, but also here quantitative estimates are lacking.

70 In conclusion, the EFRAG Secretariat is of the view that IFRS 17 is not impacting the fact that the two standards are not comparable, however we don’t have evidence that IFRS 17 will impair the competitiveness vis-à-vis US competitors

Questions to TEG

71 Do TEG member have comments on the content of the comparison between IFRS 17 and US GAAP?

72 Do EFRAG TEG members agree to include the analysis of this paper? Please explain.