

Insurance alert

IASB/FASB Board Meetings and Education Sessions

June 12-14, 2012

Since a variety of viewpoints are discussed at FASB and IASB meetings, and it is often difficult to characterize the FASB and IASB's tentative conclusions, these minutes may differ in some respects from the actions published in the FASB's Action Alert and IASB Observer notes. In addition, tentative conclusions may be changed or modified at future FASB and IASB meetings. Decisions of the FASB and IASB become final only after completion of a formal ballot to issue a final standard.

Highlights

PwC summary of meetings:

- *IASB / FASB Education session on 'Exploring a method of measuring earned premiums'*
- *Unbundling: Allocation of cash flows*
- *Presentation of acquisition costs (IASB only)*

In an education session on 'Exploring a method of measuring earned premiums' the IASB and FASB boards discussed different methods of presenting a revenue type figure for premium in the statement of comprehensive income. Operational challenges were discussed and the models were explained using numerical examples. There were split views on whether such a presentation is useful after all and whether the summarized margin approach in the exposure draft with footnote disclosures on volume would be more appropriate. The staff took comments away to discuss this at the Insurance Working Group with preparers and users. No decisions were made.

The FASB and IASB discussed the allocation of cash flows to the unbundled components of an insurance contract. The boards voted for measuring the investment component on a stand-alone basis and allocating the residual

consideration to any remaining insurance and goods/services components in line with the proposals of the revenue recognition exposure draft. In addition, cash outflows such as acquisition costs and fulfillment expenses would be attributed or allocated on a rational and consistent basis.

The IASB also met to follow up its discussions on presentation of acquisition costs. The IASB considered the implications of the premium approaches for the presentation of acquisition cost expenses and related premiums. No decisions were made at this meeting. However the board gave a general leaning for a preference to recognize acquisition costs over the life of the contract and directed the staff to develop this approach further.

IASB / FASB Education session on 'Exploring a method of measuring earned premiums'

The education session focused on the 'earned premium' presentation with the specific purpose to increase the understanding of this presentation approach. The staff solicited board members' views on the usefulness of this presentation, specific matters that should be explored further with the Insurance Working Group that meets later in June and whether there is any other information needed for the boards to reach a decision on presentation in a later meeting.

The exposure draft recommended a summarized margin presentation but in the October 2011 meeting the boards tentatively decided that an insurer applying the building block approach (BBA) should present premiums, claims, benefits and gross underwriting margin in the statement of comprehensive income (SOCI). This was in response to feedback received that volume information in the SOCI would be useful as it makes contracts under the premium allocation approach (PAA) more comparable to BBA contracts. In addition, a revenue like premium figure in the income statement would make the insurance sector and other industries more comparable.

The staff introduced the earned premium (a revenue like measure for premiums) method as well as two other measures, being the premium due method and the premium written method. Under the earned premium method, premiums would be recognized as revenue based on when claims are expected to be incurred and based on the release of margin (and the risk adjustment in the IASB model).

The staff confirmed that in all methods, any investment component is first unbundled.

An IASB board member noted that as the PAA uses the premium earned approach there would be a strong argument to favor this approach for consistency. If the premium due approach were used for the BBA there may need to be two sections in the income statement or a conversion from premiums earned in the PAA to premiums due.

A FASB board member noted that the premiums written approach was more of an activity type approach as it discloses the premiums written (i.e. volume) at recognition rather than a revenue type approach.

A number of board members from both boards noted that the difference between the premiums earned and the premiums due models is that the premiums earned model tries to allocate premiums across the life of the contract in line with incurred claims. Contrary to that the premiums due approach would fix the premiums as the actual premiums due at the time of invoicing and a calculation to estimate the claims and benefits in proportion to the premiums invoiced. It was noted that the total underwriting result would be the same in both cases.

A FASB board member noted that the earned premium model made sense but as presented it did not include any explanation as to how acquisition costs would be treated. The board member expressed concern that the boards must be careful about the treatment of such costs in the modeling to avoid including such costs as a trigger for revenue recognition. If they were to flow through into revenue on day 1 then there could be incentives to increase costs in order to increase revenue. This would not be meaningful.

A FASB board member also supported an additional roll forward disclosure as suggested by the staff that reconciles the insurance liability at the start of the period and at the end of the period showing premiums received, interest accreted, claims, experience adjustments and release of the risk margin (IASB only) and single and residual margin.

The staff then explained that the earned premium model has operational consequences because to allocate earned premiums over the coverage period, an insurer applying the BBA would need to separate the liability for remaining coverage from the liability for incurred claims.

A FASB board member noted that in his view none of the options were ideal. The insurance contract model is a liability recognition model and not a revenue recognition model. For the IASB the practical expedient of the PAA should not drive the accounting for the BBA. For the FASB, as they have two models, it would be acceptable to have separate presentations. Further, if the users wanted volume information, it should be possible to move such data to the footnote.

A number of FASB and IASB board member supported this view. In one IASB board member's view, she was happy with the summarized margin model in the exposure draft with supplementary information disclosed in the footnotes. Users probably would not

compare insurance financial statements with, for example, financial statements of a goods manufacturer.

A FASB board member asked if the claims incurred line in the premium earned model would include all costs embedded in the BBA model to fulfill the contract, e.g. taxes, claims handling and administrative costs, overhead etc. The staff confirmed this. The board member then argued that it would be difficult to allocate all those costs to a period. Some would be paid up front, some over time, some delayed. The earned premium approach would somehow need to match revenue to those incurred costs as the costs are the fixed element and the revenue the calculated element in this model.

An IASB board member found that the earned premium model has merit for understanding the insurer's business. It would further be responsive to calls for a 'revenue' type figure. However, there are operational issues around it. In his view it would be either the earned premium approach or the original exposure draft suggestion. The question is how difficult is it to generate the premium earned figures.

The staff then took the boards through a number of detailed examples, a whole life contract and a term life contract.

In a case with no changes to the data, the total premium was allocated to the periods based on probabilities of future claims incurred. The highest premium was earned at the point where the highest likelihood of death was. In the example with changes, after some years, there was a change in timing of when death occurs. The probability going forward was therefore changed. Top line premium stays the same. However, any time there are changes in assumptions there is a recalculation of premium allocation, in other words the figure of premium earned per period may change going forward. Lapse assumptions and discounting were not considered in these examples.

A FASB board member noted that this method of measuring earned premiums reflected the way that the insurer provides the service of insurance coverage to the customer. The staff confirmed that the insurer priced the premiums at the start of the contract on the basis of the estimates of expected claims and benefits at the time. The amount of premiums recognized as earned in each period approximates the amount that the insurer would in theory have charged for each

period of coverage had it issued separate contracts for each period of the issuance date of the actual contract.

The staff noted another operational consequence being that the insurer has to identify reversals in changes in estimates. To do so, an insurer will need to separate the expected cash flows and risk adjustments for each future period into two components, the amount originally estimated and subsequent adjustments and track both amounts until they reverse in the future period.

In addition the staff noted a third operational consequence in that an insurer might need to treat changes in estimates differently depending on their source. Some changes might need to be treated as if they were original estimates and others as subsequent adjustments.

An IASB board member noted that it is important to get clarity on the operational aspects in order to move forward. In particular he also noted there was a question on what unit of account this would apply to. Further costs to track reversals and assumptions made a long time in the past should be considered. This needed to be taken this to the Insurance Working Group.

Another IASB board member expressed concern that even if operational issues could be solved, would the results be understandable for normal investors?

The staff summarized that they heard there is little interest in the premium due and premium written models but that there is support to continue to explore the premiums earned model. They learned that the insurance liability model might clash with the revenue recognition model and that the summarized margin model may need to be reconsidered. The staff took on board a request to build acquisition costs and non claims related cash flow expenses into the model. Lapse rates should be built in as well. The unit of account and operational costs of tracking should be considered as well in discussions with the Insurance Working Group.

An IASB board member stressed that for the Insurance Working Group in particular the cost benefit analysis should be discussed. Is the revenue figure to be generated really useful for users, will they use it, will they understand it?

Unbundling: allocation of cash flows

In previous meetings the boards voted to unbundle the investment component, embedded derivative and goods/services components from the insurance contract if specified conditions (as discussed in previous meetings) are met. This meeting addressed how the allocation of cash flows is made in such unbundling situations.

The boards supported the staff proposal on the allocation with clarifying changes, tentatively concluding on the following:

- a) an insurer would attribute cash flows to an investment component and to an embedded derivative on a stand-alone basis. This means that an insurer would measure an investment component or embedded derivative as if it had issued that item as a separate contract. The insurer would thus not include the effect of any cross-subsidies or discounts/supplements in the investment component.
- b) after excluding the cash flows related to unbundled investment components and embedded derivatives:
 - i. the amount of consideration and discounts/supplements would be attributed to the insurance component and/or service component in accordance with proposals in the revenue recognition exposure draft.
 - ii. cash outflows (including expenses and acquisition costs) that relate directly to one component would be attributed to that component, and those that related to more than one component would be allocated to those components on a rational and consistent basis, reflecting the costs that the insurer would expect to incur if it issued that component as a separate contract. Once cash outflows are attributed to components, the insurer would account for those costs in accordance with the recognition and measurement requirements that apply to that component.

Despite of the general support for the staff proposal, several questions were raised by board members, some of which ultimately led to the revised wording noted above. First the staff was asked to justify why the cross-subsidies are not considered when measuring the

investment component. The staff explained that due to the nature of financial instrument measurement (at fair value upon initial recognition) the inclusion of cross-subsidies might result in day 1 gains/losses that they would like to avoid.

An IASB member asked the staff to clarify how any investment management fee would be allocated. The staff clarified that investment management fees would only be expected to be unbundled if the investment component itself were required to be unbundled (which at the prior meeting they noted would be uncommon).

Board members suggested some changes to the wording regarding the unbundled investment components: the allocation of the cash flows of the investment component should explicitly refer to cash inflows and outflows. That is, acquisition costs would also be attributed or allocated to any financial instrument component as if it were a stand-alone contract. It should also be clarified that all investment income and not only the interest should be attributed to this component. Also there should be an explicit reference that the cash flows of the embedded derivatives should be allocated to the component similarly. The staff agreed with the proposed changes.

There was an extensive discussion around the allocation of costs to unbundled goods/services and the insurance components. Several board members shared a view that the proposal for the allocation on a 'rational and consistent basis' was not clear enough. The staff noted that the term and principle are consistent with other accounting guidance, including inventory and construction contracting. An IASB member added that he could accept it as long as the allocation method is disclosed in the notes.

FASB members suggested that the guidance might require a clarification that allocation of cash outflow costs should not be assumed to be based on relative revenue, but instead should be based on the amount of costs that would be attributable to that component assuming it were offered on a standalone basis.

As a conclusion the board members suggested that the staff should add an objective or definition to the 'rational and consistent' notion. The staff replied that they felt it will require the entities to directly attribute the direct costs to the component wherever possible, and where not possible, the entity should develop an allocation method (e.g. by estimating the cost for each component). An IASB member expressed his view that

although he likes this proposal he just found it operationally challenging.

The discussion was closed with a unanimous vote in favor of the staff proposal, as revised to reflect the clarifications discussed during the meeting.

Presentation of acquisition costs (IASB only)

This discussion followed discussions at the joint IASB and FASB meeting earlier in the week, where there was a focus on an earned premium approach for determining how much premium would be recognized in each accounting period. At this meeting, the IASB considered the implication of premium approaches for the presentation of acquisition cost expenses and related premium. The staff clarified that the purpose of the meeting was not to change the measurement of the insurance contracts liability or to change the profit that the insurer would report, but to explore presentation.

The board focused its discussions on whether an insurer would recognize acquisition cost expenses and the related premium when the insurer incurs those expenses or whether it would recognize them over the life of the contract. No decisions were made at this meeting however the board gave a general leaning for a preference to recognize acquisition costs over the life of the contract and directed the staff to develop this approach further.

During the meeting the staff reminded the board that in effect, the premium charged to the policyholder covers the insurance obligation itself (including the resulting obligation to pay necessary maintenance and operating expenses and the costs of settling claims), acquisition costs, and an adequate profit. Part of the premium received is compensation for acquisition costs expected to be incurred, not compensation for the insurance obligation itself.

The board discussed the recognition of acquisition cost expenses and that the grossing up of the related premium when the insurer incurs those expenses seemed counterintuitive and against the principles within the revenue recognition exposure draft. As no performance obligations had been performed the board found it difficult to justify the recording of premium revenue in this instance. The staff noted that the FASB had voted against this approach during the joint May meeting. In addition, adverse feedback was received by users when it was suggested at a previous

stage within the project that such costs would be expensed as incurred.

When discussing the alternative approach of spreading the expense, several members noted that this would result in some form of asset on the balance sheet. Some noted that intuitively this made sense given that there is no direct relationship between the costs incurred to acquire a contract and costs incurred to fulfill the contract. The staff and another board member noted that there would not be an explicit asset but a contra within the insurance contract liability. The staff also noted that in line with previous discussions at the board, a separate presentation of the asset may subsequently open discussions as to whether the asset should be subject to impairment.

The board also very briefly touched on the IASB board's decision for costs associated with both successful and unsuccessful efforts to be included within the model. The staff noted that constituents may be viewing this decision as permitting the capitalization of costs associated with unsuccessful efforts. However the staff suggested that this should be viewed as accounting for the consideration that the insurer receives from the customer as compensation for the effort of selling.

Additional information

Questions on this summary and the FASB/IASB joint project can be directed to: Mary Saslow (860-693-4407) a Managing Director in the National Professional Services Group, who is part of both the U.S. and Global Accounting Consulting Services groups

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