

# ***IASB/FASB***

## ***Board meeting***

### Insurance contracts

*Since a variety of viewpoints are discussed at FASB and IASB meetings, and it is often difficult to characterise 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.*

PwC Summary of Meeting

29 March 2011

#### **Highlights**

The IASB and FASB held a joint Board meeting on 29 March 2011 where the staff provided background information to the Boards for their future consideration as to whether the residual or composite margin should be locked in at inception or unlocked over the life of the contract. The staff expressed a leaning toward unlocking prospectively for favourable and unfavourable changes in non-financial inputs relating to future estimate changes. While the staff had noted at the start that no vote would be taken, the IASB chair asked IASB members to indicate how many would potentially support the direction the staff was moving toward. The IASB seemed to support the general direction, but agreed that they needed to see the whole picture before concluding. The FASB was not prepared to vote, but the chair reiterated that she was very concerned with a deferral mechanism, given that this was a current value model with current estimates, and struggled with the idea of finding ways to support smoothing income. It should be noted that the latest IASB work plan published this week has the insurance contracts standard balloted in June but not published until the second half of 2011.

#### **Unlocking the margin**

The purpose of the meeting was to provide background information to the Boards for their future consideration as to whether the residual or composite margin should be locked in at inception, as proposed in the IASB exposure draft (the "ED") and the FASB discussion paper (the "DP"), or unlocked over the life of the contract. The staff noted at the beginning of the meeting that they were not asking for conclusions at this meeting.

The staff noted that some constituents were against the lock in principle for the residual or composite margin, noting that it was inconsistent with the requirement to remeasure all other components of the model (the building block, risk adjustment and discount rate). In addition, commentators noted that it did not make sense to record losses currently due to unfavourable changes in estimates and then continue to amortise the residual or composite margin in the future.

The staff pointed out that the Boards made decisions in February and March to include more acquisition costs in cash flows and include all costs the insurer incurs that are directly attributable to acquiring and fulfilling contracts. As a result, the size of the residual or composite margin would decrease, potentially significantly, and the remainder would include other costs priced into the premium, such as general business risk and other overheads not easily identifiable. The staff suggested this as a reason why the residual or composite margin could not easily be remeasured subsequent to inception as had been suggested as an alternative to lock in by some constituents. They also noted that since there is no transaction price subsequent to inception, there is no way to truly remeasure the margin (which by definition is a function of transaction price.)

Therefore, the latest staff paper concentrated instead on unlocking the margin by either (1) consuming the margin (meaning to reduce it for unfavourable changes in the carrying amount of the liability) or (2) floating the margin (meaning adjusting it for changes, both favourable and unfavourable in the value of the other building blocks without limiting it to the amount initially recognised).

The staff noted that if unlocking is eventually chosen by the Boards (either by consuming or floating the margin), other considerations would include:

- whether the margin should be used for changes in only non-financial variables, only financial variables, or both;
- whether the changes should be those related only to changes in future estimates, or also to changes between current period actual activity and estimates; and
- whether such adjustment to the margin should be made retrospectively or prospectively.

The staff noted that those who view the margin as an allocation of profit would tend to view unlocking as **sensible, while those who view it more as a “plug”** in a liability model would see it as a mechanism to smooth income. They noted that input from the Insurance Working Group in the prior week was mixed, but that some supported a floating form of unlocking (with the majority supporting unlocking for non-financial inputs) and noted that retrospective adjustment would be complex and burdensome to implement. The staff expressed a leaning toward unlocking prospectively for favourable and unfavourable changes in non-financial inputs relating to future estimate changes.

In response to a question by an IASB Board member, the staff noted that Australia uses the “floating” method, unlocking the composite margin on its life business for non-financial changes, adjusting the margin on a

prospective basis. An Australian representative on the Insurance Working Group believes that this unlocking is well understood and does not present issues in terms of practical application.

In response to an IASB member's question on the staff paper which indicated that unlocking of the margin for only non-financial inputs would avoid accounting mismatches, the staff responded that their point was that if assets are recorded at fair value through income, less mismatch would result if changes in the discount rate on the liability were also taken through income rather than adjusting the margin. On the other hand, if assets were recorded at amortised cost, less of a mismatch would result if the change in discount rate were taken against the margin.

An IASB member remarked that he did not understand the connection between asset changes and the margin on insurance contracts. He also asked why the staff analysis did not distinguish between the residual and composite margin, as the two differ, and he would find it easier to accept unlocking for the residual margin than for the composite margin.

The staff noted that a separate staff paper will bring the residual and composite margin approaches closer together. The staff understands that the decision on unlocking may depend on whether there is an explicit risk adjustment or not, and recognise that any input they receive from the Boards now will be preliminary, pending reaching conclusions on this and other issues.

A FASB member asked whether it was operational to distinguish between various components of changes in estimate, and between current and future period effects. In addition, she asked how the current paper would dovetail with the staff's future paper that would potentially propose putting certain financial input changes through other comprehensive income. If the margin absorbs changes in non-financial variables, and other comprehensive income is used for financial variables such as changes in the interest rate, what would be left to be recognised in the income statement? If the insurance business is subject to volatility, and the model they have built is a current value model, does it make sense to recognise all changes outside the income statement?

Other IASB and FASB members agreed that further discussion and consideration of the FASB member's points were warranted before taking a final view on this issue. A FASB member commented that they needed to decide what they wanted to portray in the performance statement, and whether it necessarily needed to show the results of all changes to the liability measurement as portrayed in the balance sheet within the current period performance statement.

An IASB member noted that if it is appropriate to unlock the risk adjustment, perhaps it is also appropriate to unlock the residual margin. Another IASB member remarked that he could live with lock in or unlocking. He noted that on insurance company earnings calls he has heard, analysts are typically interested in understanding changes to non-financial inputs and their impact on income, and thus such information would need to be presented somewhere in the financial statements.

A number of IASB Board members expressed hesitancy with the staff proposal to unlock, noting concerns with complexity, and noting that the margin was just a plug to the transaction price (and implicitly covered items such as overhead and other future costs), and so remeasuring that at a future date seemed inappropriate. There was a general sentiment that further study of the calculations (and other issues such as use of other comprehensive income) was needed before a decision could be made.

An IASB member remarked that at a prior meeting, someone raised the idea that unlocking would lessen the distinction between the explicit risk adjustment and the composite margin methods, but he was not clear on how this would be so. It appeared the staff was working on a further explanation of this, but in the meantime was looking for direction from the Boards.

While the staff had indicated at the start that no vote would be taken, the IASB chair asked IASB members how many would potentially support the direction the staff was moving toward (unlocking). Nine of 13 seemed to support the general direction, but agreed that they needed to see the whole picture before concluding.

The FASB was not prepared to vote, but the chair reiterated that she was very concerned with a deferral mechanism, given that this was a current value model with current estimates, and struggled with the idea of finding ways to support smoothing income. The IASB chair agreed with her comments.

### **Summary from Insurance Working Group meeting**

In a brief summary of the prior week's Insurance Working Group meeting, the staff noted that generally the group was in favour of bringing the project to a close after 14 years. They were interested in an approach that would record at least a portion of the change in the discount rate in other comprehensive income. In terms of presentation, they seemed interested in some sort of expanded margin approach combined with the ability to disaggregate various components of the insurance liability. Concern was expressed with the potential complexity of the model; the Boards should try to keep it simple.

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