

# *IFRS, IFRS Phase 2, IASB, FASB and insurance standard*

*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 Meetings

27 April 2011

## **Highlights**

The IASB and FASB held a joint Board meeting on 27 April 2011 where they discussed the modified measurement approach for short duration contracts. In the meeting it was clear that the two Boards had different views on whether the modified approach for short duration contracts was a simplification of the building blocks approach or whether it was a different measurement model. The FASB is of the view that the modified approach is a different measurement model. The majority of the IASB is of the view that the modified approach is only a simplification and a proxy for the building blocks approach and not a separate measurement model. As a result, the IASB views the modified approach as a liability measurement model whereas the FASB views the modified approach to be in line with the revenue recognition proposals. The FASB and IASB would not require discounting of future premiums as long as the financing element in a contract was not significant.

The FASB was in favour of accounting for acquisition costs in accordance with the requirements in the revenue recognition project (incremental at contract level) and recognising the acquisition costs as a separate deferred acquisition cost (DAC) asset. The IASB reconfirmed that an insurer should deduct from the pre-claims obligation measurement the amount of acquisition costs as previously tentatively decided by the respective boards for other insurance contracts.

Both Boards agreed that the pre-claims liability should be reduced in line with the requirements as contained in the IASB exposure draft (ED) on the basis of time or the basis of expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time. Both Boards agreed to use qualitative factors as indicators to consider whether a liability adequacy test would have to be performed and not to require a liability adequacy test to be performed at each reporting period.

Due to the different positions on the modified approach, the staff did not ask the Boards to discuss whether the modified approach should be required or optional. The staff will bring the objective and the eligibility criteria of the modified measurement approach back to the Boards for discussion at a future meeting.

### Detailed discussions

The staff recommended that an insurer be permitted, but not required to apply the modified approach to contracts that (i) do not include a significant financing element, and (ii) do not contain embedded options or other derivatives that significantly affect the variability of the cash flows, after unbundling any embedded derivatives. Under the staff proposals a contract does not include a significant financing element if (i) the time between the receipt of premium and the provision of coverage is insignificant and (ii) the amount of premium charged is not substantially different if the policyholder paid at the beginning of the coverage period. As a practical expedient, a contract is not considered to include a significant financing element if the coverage period is one year or less.

For insurance contracts to which the modified approach is applied, the staff proposed that an insurer measure its pre-claims obligation at initial recognition as (i) the premium, if any, received at initial recognition, plus the undiscounted value of expected future premiums, if any, that are within the boundary of the existing contract; less (ii) the acquisition costs as tentatively decided by the FASB and IASB respective boards (additional alternatives are provided in the analysis below). Subsequently, the insurer would reduce the pre-claims obligation as the insurer provides insurance coverage (i) on the basis of time, but (ii) on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

The staff proposed that an insurer should assess if the present value of the expected cash outflows exceeds the carrying amount of the pre-claims obligation if the following factors indicate that a contract may be onerous:

- (i) the combined loss ratio exceeds 100%,
- (ii) there is a significant increase in the severity or frequency of claims, or
- (iii) there is a change in the characteristics of the risk profile.

If, on that assessment, the present value of the expected cash outflows exceeds the carrying amount of the pre-claims obligation, the insurer shall recognise an additional liability for that excess.

### Eligibility criteria

The Boards first discussed the eligibility criteria for the modified approach. A FASB member questioned why the staff proposed that the modified approach should be

permitted but not required. The staff noted that it would allow for the comparability and consistency of accounting for insurance contracts within a single reporting entity but would however not result in consistency between different reporting entities. However the staff was of the view that if the building blocks approach was followed that comparability could be achieved through disclosure.

There was much debate on the eligibility criteria to be applied to determine whether the modified approach should/may be used with some FASB members supporting the criteria proposed by respondents and not the criteria as proposed by the staff. These suggestions included criteria which focus on (a) the significance of the investment income potential over the coverage period to the business model, (b) the significance of the period of time between premium receipt and date of loss and (c) the nature of the contract which is primarily based on risk protection and therefore focuses on underwriting results as opposed to investment management.

Many FASB members noted their confusion with the staff's proposed criteria that contracts should not include a significant financing element. The Board members do not consider a difference in timing between the inflow of premiums and the payment of claims as a financing element.

A FASB member expressed his view that the proposal for the modified measurement approach was not a simplification of the building blocks approach but instead a different/second measurement model. The IASB chair asked the staff whether they see the modified approach as a different measurement model or as a proxy for the building blocks approach. The FASB staff noted that they view the modified approach as a different approach for the measurement of the pre-claims liability indicating that modelling performed indicates that the contract measurement could be notably different when using the modified approach instead of the building blocks approach.

An IASB member noted that as long as the difference in the measurement result between the modified and building blocks approach is not significantly different the modified approach could still be considered a proxy for the building blocks approach. He emphasised the importance to agree on the objective of the modified approach and noted his disagreement with the unstated objective of having two different measurement models. He noted the importance of considering the variability in the cash flows of the pre-claims liability and, consistent with the proposed treatment for embedded derivatives, if there could be variability in the cash flows of the pre-claims liability, the building blocks approach should be required.

An IASB member observed that he did not agree with the criteria proposed by respondents as referred to

above and noted that the main driver for the proposals was to avoid discounting of short duration contracts to be in line with current requirements for such contracts in the US. Many IASB members agreed with the view that the modified approach for short duration contracts was a proxy for the building blocks approach and not a different measurement model applied to these contracts.

An IASB member questioned whether a modified approach was needed as a practical expedient if the pre-claims period had to be of short duration (and hence one would not expect much variability in the pre-claims obligation cash flows). She also noted that one of the main differences between the building blocks model and the modified approach was presentation. Under the building blocks approach a single contract position was presented whereas under the modified approach a pre-claims liability and a contract receivable were presented. Another IASB member noted that the proposal in the ED was for a single measurement model and noted that one of the main reasons for including the modified approach for short duration contracts was to keep the presentation of certain key performance metrics intact that are used today by many users. He noted his agreement with the observations of other IASB members with regards to the variability in the cash flows and noted that for many contracts there would not be variability in the cash flows if the coverage period was approximately one year and hence he would continue to support the eligibility criteria as proposed in the ED.

A staff member noted the overwhelming support by respondents for the continued use of the unearned premium approach as used by many insurers today. He noted that the focus should not be on whether the modified approach is a separate model or a proxy for the building blocks approach and suggested that the eligibility criteria and the proposed measurement model should be considered in tandem. He noted that the building blocks approach works well for contracts with a number of different contract elements such as insurance coverage and investment management services indicating that all elements are treated consistently in the building blocks model. He observed that the proposed modified approach is similar to the treatment of service contracts under the proposals in the revenue recognition project and noted that this treatment works well for those contracts that do not include a number of different contract elements.

A FASB member voiced his agreement with some of the IASB members that the Boards should decide whether they are developing a single measurement model or two different models. He noted that the FASB is of the view that the modified approach is a different model and hence is developing two different models whereas the IASB views it as a single model with the modified approach being a proxy for the building blocks model. He noted that for many non-life contracts the underwriting results were far more volatile than for life contracts and noted that a distinguishing difference is

the fact that for life contracts asset returns are needed over time to accumulate the required funds to be able to pay the fixed contractual benefit. For non-life contracts the adequacy of premium income to pay claims is more important. Another FASB member noted the tension between a liability measurement model (building blocks approach) and a model in line with the proposals in the revenue recognition project (modified approach). The staff later emphasised that for many non-life contracts (especially motor business in Europe), very little underwriting profit is achieved and insurers rely on the investment returns generated during the contract term and so using this as a distinguishing feature would be difficult.

The FASB chair noted in summary that the FASB was of the view that there should be a simplified model for some contracts and that the FASB saw the building blocks model and the modified approach as two different measurement models. The IASB chair summarised the IASB position that the modified approach is a simplification of and a proxy for the building blocks approach and not a different measurement model. The staff will bring the objective and the eligibility criteria of the modified measurement approach back to the Boards for discussion at a future meeting.

### *Time value of money*

The Boards next discussed whether the expected future premiums should be discounted in determining the pre-claims liability. A FASB member noted that he would not require discounting for contracts with a coverage period of 12 months or less. He also noted that if the cash paid on contracts with an upfront premium is different compared to the total cash amount when the premium is paid monthly, he would also require discounting of the premium. Another FASB member noted that he would support using the three factors as tentatively agreed in the revenue recognition project of when a contract contains a financing element that would require the discounting of the contract. The IASB chair noted that most of the IASB members would be in favour of not requiring discounting if the financing element in a contract was insignificant using the guidance as developed for the revenue recognition project. A majority of FASB members appeared to have a similar view.

### *Acquisition costs*

The Boards next discussed the treatment of acquisition cost in the modified approach. A FASB member noted that if the modified approach is more in line with the requirements in the revenue recognition project (as it is currently proposed), he would support applying the revenue recognition project's principles to acquisition costs (incremental cost at contract level). He noted that if the principles in the revenue recognition project do not work for insurance contracts, the Boards should reconsider the appropriateness of these principles in the

revenue recognition project. However, if the measurement for short duration contracts is a liability measurement model, he would support the tentative decision for acquisition costs for other insurance contracts. Most FASB members were in favour of accounting for acquisition costs in accordance with the requirements in the revenue recognition project and recognising the acquisition costs as a separate deferred acquisition cost (DAC) asset. The FASB chair noted that the Boards should consider the appropriateness and consistency of their decisions on acquisition cost in different projects when considering sweep issues (leases, revenue recognition and insurance contracts).

An IASB member noted his strong disagreement with the FASB view to recognise the acquisition costs on these contracts as a DAC asset. He noted that the Boards previously agreed that acquisition costs were a contract cash flow and questioned how the DAC could be supported as an asset for contracts where the premium is paid up front. Nine of the ten IASB members reconfirmed that an insurer should deduct from the pre-claims obligation measurement the amount of acquisition costs as previously tentatively decided by the respective boards for other insurance contracts.

#### ***Amortisation of the pre-claims obligation***

Both Boards agreed with the principle that the pre-claims liability should be reduced in line with the requirements as contained in the ED (on the basis of time or the basis of expected timing of incurred claims and benefits if that pattern differs significant from the passage of time).

#### ***Onerous contract***

The Boards next discussed the proposals for an onerous contract test. A FASB member noted that the Boards should not develop a new liability adequacy test and that insurers would have priced their expectation of insurance losses into the premium that is charged on contracts. He also indicated that if the modified measurement approach is in line with the revenue recognition model, no risk adjustment should be included to be consistent with the revenue recognition project. Other FASB members noted that they would support the use of qualitative factors to consider whether a liability adequacy test is required to be performed, consistent with the impairment requirement in other standards. Both Boards generally agreed with using qualitative factors to consider whether a liability adequacy test would be required. An IASB member noted that for short tail contracts, retrospective indicators might be appropriate but for long tail business, more weight should be placed on indicators that are prospective in nature.

Due to the different position on the objective of the modified approach, the Boards did not discuss whether the modified approach should be required or optional but will consider it when the Boards discuss the objective of the modified approach at a future meeting.

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