
IASB/FASB

Board meeting

Insurance contracts

PwC Summary of Meetings

4 May 2011

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.

Highlights

The IASB and FASB held a joint Board meeting on 4 May 2011 where they discussed the potential unbundling of two non-insurance components sometimes present in an insurance contract - goods and services and investment balances. The Boards had recently discussed another component, embedded derivatives, tentatively agreeing that they should be separated using existing "closely related" criteria. The Boards generally agreed with the staff proposals to develop unbundling criteria for goods and services and explicit account balances in insurance contracts based on those criteria being developed for identifying separate performance obligations in the revenue recognition project.

However, after some issues were raised over whether all the same criteria were appropriate for insurance contracts, the Boards asked the staff to attempt to combine and align the criteria for goods and services and account balances with the proposals in the revenue recognition project. These proposals will be taken to the Insurance Working Group meeting on 16 May 2011 to obtain input from preparers and users on the proposals. The Boards did not discuss participation features due to time constraints and will bring those papers to the Boards at a future meeting.

Detailed discussions

The staff briefly took the Boards through supporting background material on unbundling, noting that the project plan for unbundling included analysing each of the three major components of unbundling and then reviewing the model in total and answering ancillary questions. One such question is whether, in addition to being required if specified criteria are met, additional unbundling should be permitted. An IASB member observed that throughout the papers reference is made to “non-insurance” services although insurance services are not specifically defined. A FASB member observed that the implicit intention was to not separate any services that are integral to providing insurance cover. For example, claims handling costs would be considered part of the insurance activity needed to fulfil the insurance obligation and not a separate service. This key point was reiterated throughout the ensuing discussion.

Unbundling of goods and services

The staff recommended that goods and services should be unbundled from an insurance contract in accordance with the principles to identify separate performance obligations in the revenue recognition project and once separated, those goods and services should be measured in accordance with relevant requirements of IFRSs and US GAAP. It believes consistency with the revenue recognition model is superior to the “closely related” criteria noted in the IASB exposure draft (“ED”) and FASB discussion paper (“DP”), which constituents said was not clearly defined. They also considered but rejected an alternative of only unbundling components that are added to an insurance contract for reasons that have no commercial substance as it resulted in too little unbundling.

The staff highlighted that the key difference between the insurance model and the revenue recognition model was the presentation of revenue and expenses (gross presentation in the revenue model as opposed to net presentation in the insurance model) and the treatment of changes in assumptions about future fees and expenses (under the insurance ED and DP these are recognised in the current period whereas under the revenue recognition proposal these are recognised as revenue and expenses change).

The discussion focussed on the proposed revenue recognition criterion that requires an entity to account for a promised good or service as a separate performance obligation if (i) the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract and (ii) the good or service has a distinct function.

FASB and IASB members indicated their general agreement with no longer using the “closely related” principle as proposed in the ED and their preference to use criteria consistent with that developed in the revenue recognition project. However, FASB members and some IASB members disagreed with the criterion that a promised good or services should not be treated as a separate performance obligation if the pattern of transfer of the good or service is not different from the pattern of transfer of other promised goods or services in the contract. The concern is that service and insurance components with similar patterns of transfer could remain bundled even though they may have a distinct function. A FASB member suggested that the requirement to separate a service with a distinct function was sufficient and that this additional “pattern of transfer” criterion was not needed. This led to a lengthy debate on whether the claims administration service that is combined in an agreement with a stop loss provision should be treated as a distinct service or considered as a deductible on the insurance component and considered an integrated insurance activity.

The IASB staff from the revenue recognition project noted later in the meeting that the “pattern of transfer” criterion was a practical expedient in the revenue recognition project and later upgraded to a criterion to avoid preparers unnecessarily separating contract elements if it would make no difference in the revenue being recognised. A FASB member noted that for contracts in the scope of the revenue recognition standard, if an element has the same pattern of transfer as another element, it makes no difference whether it is separated or not. However, it would make a difference for insurance contracts as unbundled elements would be measured using a different model. As a result, FASB members argued that while the criterion/practical expedient was appropriate for revenue recognition, it was not appropriate for insurance contracts.

The vote on the insurance staff proposal was taken prior to the IASB revenue recognition staff’s clarification that the “pattern of transfer” was really a practical expedient and not a criterion. A majority of the IASB members agreed with the staff proposals including the criterion on the transfer of goods and services. The FASB agreed with the staff recommendation subject to excluding the criterion on the pattern of transfer of goods or services. Both Boards agreed that the proposal to use the revenue recognition criteria should be tested against actual products to ensure it does not result in any unexpected outcomes.

The IASB chair later noted sympathy with the FASB concerns regarding the pattern of transfer criterion and indicated that the proposals would be taken to the Insurance Working Group meeting scheduled for 16 May to obtain input on the proposals. He also emphasised the objective of the Boards to achieve consistency with the revenue recognition standard and asked the staff to work closely with the revenue recognition staff to attempt to combine and align the criteria for goods and services and account balances with the proposals in the revenue recognition project.

Other comments made by members during the goods and services discussion included the following:

An IASB member questioned whether the revenue recognition criteria were easier to apply than the “closely related” principle proposed in the ED. However, he acknowledged the benefits of aligning to the requirements in the revenue recognition project.

An IASB member questioned whether the criteria would set the minimum requirement of elements that should be unbundled and whether insurers would be allowed to unbundle more elements. The staff indicated that this would set the minimum requirement but that they would be asking the Boards at a future meeting whether insurance should be allowed to unbundle more components.

Another IASB member noted his support for the staff proposal indicating that it would not result in many elements being unbundled from insurance contracts. He noted that if one element influenced another element in the contract then he would not want to unbundle the different elements.

Another IASB member asked the staff to consider whether the criterion in the revenue recognition proposal that was meant to address construction contracts should be deleted from the insurance proposal as it could be misinterpreted. This criterion says that an entity should account for a bundle of promised goods or services as one performance obligation if the entity provides a service of integrating those goods or services into a single item.

A FASB member questioned, once it is determined that components should be separated, how inflows and outflows would be allocated between the different components. An IASB member also noted that external presenters on unbundling at the February meeting had commented that this allocation would be difficult, costly, and arbitrary. Another FASB member noted that difficulties could result not only from transaction price allocation, but also from differences in how acquisition costs and variable consideration are accounted for between the insurance and revenue recognition models.

The staff noted that they are planning to bring a separate paper to the Boards at a future meeting on how to allocate consideration, costs, etc. to the different contract components.

Unbundling of investment components

The staff proposed that explicit account balances in insurance contracts that meet specified criteria should be unbundled. The specified criteria were also adapted from those that are being developed for identifying separate performance obligations in the revenue recognition project. The staff described explicit account balances as account balances that are regularly communicated to the policyholder and to which the insurer credits an explicit return based on the value of the account balance. The insurer may have the ability to vary the fees and assessments that are charged. The policyholder may have the right to withdraw cash and pay for insurance coverage, depending on the contract terms.

The Boards first discussed how explicit account balances should be defined. A FASB member questioned how one would distinguish the intended explicit account balances from cash surrender values included in contracts. The staff responded that the cash surrender value was not dependent on actual investment performance. An IASB member questioned why the staff placed emphasis on the communication of the account balance to policyholders in order to define explicit account balances and noted that if it was determinable, it should also be considered an explicit account balance. A FASB member questioned whether you would make the cut for those amounts that could be withdrawn without affecting the insurance cover under the contract.

The IASB and FASB generally supported the description for an explicit account balance as an amount which is explicitly known, with returns credited based on the account balance and which could be withdrawn without terminating or amending the terms of the insurance component or requiring an insured event. The Boards asked the staff to develop this principle and to obtain input from the Insurance Working Group.

The IASB agreed that explicit account balances in insurance contracts should be separated from an insurance contract based on those criteria being developed for identifying separate performance obligations in the revenue recognition project. The FASB, on the other hand, while seeming to agree with the general direction of the staff proposal, asked a number of questions on how the revenue recognition criteria would be applied to explicit account balances to determine if they were distinct versus “integrated” with the insurance component. A FASB member emphasised that the criteria for goods and services as well as account

balances should be combined to ensure a contract is only evaluated once to identify components that requires separation. He noted the importance of testing the proposals against actual contracts that contain explicit account balances to ensure the proposals will produce the expected results.

On the issue of measurement, the IASB supported the staff proposal to measure any unbundled explicit account balances in accordance with relevant financial instrument guidance, whereas the FASB noted that they could not completely respond to this proposal given that they had the same questions on allocation as they did in the goods and services discussion.

An IASB staff member asked the FASB whether they had at least ruled out the alternative rejected by the staff to measure all explicit unbundled account balances at face value (which the staff paper described as consistent with the current requirements under US GAAP for universal life insurance contracts). A FASB member responded that he didn't understand the difference between this alternative proposal and the staff proposal. The staff member explained that the main difference was that under the face value proposal, all fees would be ascribed to the insurance component rather than allocated between the insurance and account balance components. In addition, the face amount would not be a fair value allocation, and would exclude items such as acquisition costs.

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