

Sharing insights on key industry issues

FASB Board Meeting – Insurance Contracts

PricewaterhouseCoopers Summary of Meeting

9 June 2010

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

Highlights

The Board held a meeting on 9 June 2010 to discuss two related topics:

1. whether some short-term insurance contracts should be accounted for using an unearned premium approach for the measurement of pre-claims liabilities (i.e., rather than the full building block approach); and
2. whether short-term, short-tail claims liabilities should be measured using only the expected cash flows (i.e., without margins or discounting).

The Board focused most of their discussion on the first of these topics and expressed their interest in an alternative to the full building block approach for measurement of pre-claims liabilities of qualifying insurance contracts. The alternative approach is intended to simplify accounting for certain short-term insurance contracts. The model proposed is similar to the existing FAS 60 revenue recognition model for short-duration contracts wherein the insurer would defer revenue and recognise it over the coverage period and recognise claims as incurred. The Board also discussed the need for a liability adequacy test on the unearned premium liability. No conclusions were reached on what the criteria would need to be met for contracts to be accounted for under this alternative model.

The Board only briefly addressed the second topic but reiterated their belief that discounting is appropriate for long-tail liabilities. One Board member noted support for not discounting short-term claims liabilities.

Detailed Discussion

In recommending the unearned premium approach (also referred to as the premium allocation approach), the staff noted that it is a model that is both understandable and familiar to existing financial statement users and one that is deemed to be at a lower cost and effort to financial statement preparers. The staff had recommended that the premium allocation approach should be limited to contracts with twelve month or less coverage periods, no embedded options or guarantees, and an average payout period of two years or less. A liability adequacy test would be required under this approach. In recommending these criteria, their stated expectation is that the results would not differ significantly from application of the building block approach.

Several Board members expressed their preference for the premium allocation approach over the building blocks approach and suggested that, perhaps, this approach should be the primary measurement approach and the building blocks approach be used as the alternative approach for short duration property/casualty contracts. In support of this position they opined that it better reflected the economics of the contracts and observed that analysts focus heavily on the underwriting results for short-term contract business. It was acknowledged by the Board that the use of the premium allocation approach would often result in accelerated profit recognition because the profit is released over the coverage period rather than the longer claims payout period.

The Board expressed concerns as to whether it would be clear which contracts were eligible for the premium allocation approach. There was a lot of discussion on how broad the scope of this alternative model should be and over each of the criteria recommended by the staff.

The Board discussed the relevance of the proposed criteria of a coverage period of less than one year but did not reach a conclusion. A point was made that the coverage might not be a meaningful factor to base the scope of the approach on and that the tail might be more relevant. Discussion ensued as to whether to apply a FAS 60 type of description of short term, acknowledged as regularly interpreted as three to five years or less. The Board noted they would like to better understand and further consider the impact on measurement of replacing the proposed one year of coverage criterion with a criterion based on FAS 60's three to five years of coverage and also how the existence of retrospective premium adjustments would impact the scope. It was observed by a Board member that health insurance contracts where the insurer is prohibited from cancelling the coverage and restricted on the amount of price increases would likely not meet the criteria for the premium allocation approach.

The Board agreed that the existence of embedded financial derivatives should not preclude the use of the premium allocation approach. In arriving at this conclusion, they observed that the requirement to separately account for an embedded derivative should not influence the availability of which measurement approach is applied to the remainder of the contract.

In discussing the claims handling period, concerns were raised by the Board related to how to treat long-tail business components embedded in a contract that also includes short tail business. Bodily injury coverage contained in most automobile policies was used as an example. Some believed that a policy containing this coverage would likely be disqualified from the premium allocation approach being discussed. The Board also discussed whether the requirement to determine if the average claims handling period is less than two years would negate any cost or effort savings otherwise gained by not applying the full building block approach. One of the Board members noted that the determination of the average payout period would be based on historical results rather than projections of the timing of future cash outflows. One suggestion was to develop criteria for applying the alternative model based on the type of insurance coverage provided rather than a specific period of time. In discussing claim liability accounting, Board members seemed to acknowledge that the claim liability should be discounted unless the effect is not material.

The Board also discussed whether the use of premium allocation approach should be required or optional for contracts meeting its criteria. Several Board members expressed their opinion that it should be required.

The Board asked the staff to provide additional information about the appropriate coverage period and type of insured events for an insurance contract to qualify for the premium allocation approach, and the effect of a retrospective rating feature on an insurance contract otherwise eligible for the premium allocation approach.

Additional Information

Questions on this summary and the FASB/IASB joint project can be directed to: Chris Irwin (646-471-9033), a Senior Manager in the New York Metro Insurance Group, or 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.

PricewaterhouseCoopers (www.pwc.com) provides industry-focused assurance, tax and advisory services to build public trust and enhance value for our clients and their stakeholders. More than 163,000 people in 151 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

This paper is produced by experts in their particular field at PricewaterhouseCoopers, to review important issues affecting the financial services industry. It has been prepared for general guidance on matters of interest only, and is not intended to provide specific advice on any matter, nor is it intended to be comprehensive. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers firms do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it. If specific advice is required, or if you wish to receive further information on any matters referred to in this paper, please speak with your usual contact at PricewaterhouseCoopers.

For further information on insurance, please contact Rebecca Pratley, marketing leader, Global Insurance, PricewaterhouseCoopers (UK) on 44 20 7804 3749 or at rebecca.j.pratley@uk.pwc.com
© 2010 PricewaterhouseCoopers. All rights reserved. PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.