

Insurance alert

ISAB/FASB Board Meeting Insurance Contracts

PwC Summary of Meetings

13-15 June 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 13-15 June, 2011 where they discussed whether, in a risk and residual margin model, the residual margin **should be 'locked in' at inception of the contract** or should be adjusted for changes in estimates (unlocked). The Boards also discussed the basis for allocating the residual margin. The Boards also revisited the treatment of acquisition costs and presentation models.

The Boards arrived at different conclusions on unlocking the residual margin. The FASB tentatively agreed to lock in the residual margin at inception, but the IASB tentatively agreed (by a very small majority of 8 to 7) to unlock the residual margin for changes in estimates. Since the FASB had tentatively agreed to lock in the residual margin the FASB did not vote on the follow-on staff proposals regarding the mechanics for unlocking.

The IASB tentatively agreed with the staff proposal that the residual margin should be adjusted for both favourable and unfavourable changes in the estimate of the insurance contract liability. The Board also tentatively agreed that there should be no limit to increases in the residual margin, other than the inherent limit that the residual margin cannot be higher than the expected present value of the future cash inflows less cash outflows. Further, the Board tentatively agreed that the residual margin should be adjusted for changes in estimates of cash flows and discount rates but that changes in estimates of the risk adjustment should be recognised directly in income. The IASB tentatively agreed that any adjustment to the residual margin should be made prospectively. The IASB discussed the staff proposal to allow changes in the discount rate to be recognised in the income statement if recognising such changes in the residual margin would create an accounting mismatch, but did not make a decision.

Both Boards agreed that the residual margin cannot be negative. They then tentatively agreed that the residual margin should be allocated over the coverage period on a systematic basis that is consistent with the pattern of transfer of services under the contract.

The discussions about the mechanics of unlocking the residual margin and the method of allocation highlighted several operational issues that the Boards agreed need to be addressed with more clarity at later meetings. These issues include: the challenges of distinguishing between current experience and changes in estimates, difficulties in dealing with open portfolios of contracts, operational challenges in tracking the adjustment and allocations of the residual margin and determining the relevant driver for allocating the residual margin.

Previously the Boards had arrived at different tentative conclusions on the nature of acquisition costs that should be included as part of the costs to fulfil the insurance contract. At this meeting both Boards tentatively agreed that only the direct costs of acquiring insurance contracts at the portfolio level should be included in the measurement of the insurance liability. However, the Boards continued to have different tentative conclusions whether these costs should only include those related to successful acquisition efforts (FASB), or related to both successful and unsuccessful efforts (IASB).

The Boards directed the staff to further develop the presentation model for insurance contracts based on the expanded margin approach as set out in Example 2 of the staff paper. Key matters to be resolved going forward relate to how one defines premiums for inclusion in the performance statement and the treatment of deposit components which might be included in premiums. The Board members asked the staff to develop minimum required line items that should be presented which would be in line with the **requirements in IAS 1: 'Presentation of Financial Statements'**.

The Chair of the IASB mentioned during the discussion that in his view the standard may need to be re-exposed, however this was not debated further.

Unlocking the residual margin

The staff noted that some respondents commented that locking in the residual margin resulted in counterintuitive results where a loss may be recognised in one period even though there will be gains allocated from the release of the residual margin in future periods. In addition, respondents noted the conceptual inconsistency between not recognising a day 1 gain, whilst locking in the residual margin which can result in recognising day 2 gains/losses where change in

estimates are recorded directly in income. Therefore, the staff proposed that the residual margin should be adjusted for changes in estimates to avoid the counterintuitive effect and to provide more meaning to the residual margin which would represent a current assessment of the profitability of the contract.

A couple of the IASB members questioned whether the residual margin could really be viewed as a measure of the profitability of the contract as mechanically it is the result of not recognising a day 1 gain. The staff acknowledged this but noted that some commentators viewed it as mainly being profit and that re-estimating it would give a more conceptual basis for the residual margin.

Some IASB and FASB members questioned the additional complexity that unlocking the residual margin would add to the model. The staff also accepted this but responded that explaining the counterintuitive impact of locking in the residual margin as also complex.

Several FASB members challenged whether unlocking the residual margin to reflect a current measure of profitability was trying to marry two different concepts (liability measurement and profit recognition) into the insurance model which they viewed as being a liability measurement model. They also questioned whether unlocking the residual margin would be effective in addressing volatility in the income statement. The staff indicated that although adjusting the residual margin for changes in estimates may mitigate volatility in income, the primary rationale for proposing unlocking was to address the counterintuitive issue and that methods to address volatility in income would be dealt with separately. Some IASB members indicated that they found this rationale persuasive.

The Boards arrived at different conclusions on unlocking the residual margin. The FASB tentatively agreed to lock in the residual margin at inception, but the IASB tentatively agreed (by a very small majority) to unlock the residual margin for changes in estimates.

Methodology for unlocking the residual margin

The staff presented their proposal that the residual margin should be adjusted for favourable and unfavourable changes in estimates and that increases in the residual margin should not be limited. This could result in an amount being recognised that is higher than the residual margin on inception of the contract. The staff explained their rationale that if the residual margin is viewed as a measure of profitability, then if a contract is expected to be more profitable than previously envisaged this should be reflected in full.

Several IASB members questioned how adjustments to the residual margin would be tracked and how this could be done at a portfolio level, particularly with open portfolios. The staff indicated that their proposals were similar to the margin on services in the Australian model which was operational. They also acknowledged that it was challenging to address the unit of account in the current discussion until the Boards had finalised their decision on the definition of a portfolio.

One IASB member advocated only dealing with the counterintuitive issue and therefore only adjusting for unfavourable changes in non financial estimates. However other IASB members expressed their view that it would be more complex and be even more challenging to track where there were different treatments for favourable and unfavourable changes in estimates. The IASB tentatively agreed with the staff proposal that the residual margin should be adjusted for both favourable and unfavourable changes in the estimate of the insurance contract liability. The Board also tentatively agreed that there should be no limit to increases in the residual margin.

Type of changes in estimate that adjust the residual margin

The staff proposed that insurers should recognise the effects of all changes in estimates of cash flows as an adjustment to the residual margin. However, the staff also recommended that insurers should be permitted to recognise changes in the discount rate in income where adjusting the residual margin would create an accounting mismatch.

An IASB member queried how the staff would define the difference between current experience and changes in estimate. This may be especially challenging as in practice sometimes insurers may determine a change in assumption in Q3 but then apply that retrospectively to the prior periods. Another IASB member highlighted the interrelationship between some assumptions (for example, lapses) and changes to the discount rate and therefore the risk of an accounting mismatch can be affected by discount rate and other non financial assumptions. A FASB member pointed out that whether a mismatch existed depended heavily on the circumstances affecting the assets and that identifying whether a mismatch was mitigated or aggravated would be complex and judgemental. Another IASB member stated that a key factor was how a mismatch is defined and how the permitted option would work—for example would this apply to some mismatches, all mismatches, for a portion of time, or for a portion of amount. Other IASB members were concerned that the option to recognise changes in discount rate in income where there is an accounting mismatch would adversely impact comparability and also be a significant operational

challenge. The IASB tentatively agreed with the staff proposal to recognise the effect of all changes in estimates of cash flows as an adjustment to the residual margin. However, although they discussed the staff proposal to allow changes in the discount rate to be recognised in the income statement if recognising such changes in the residual margin would create an accounting mismatch, no decision was made.

Risk adjustment

The staff reminded the Boards that changes in the risk adjustment arise from the release from risk in the period, changes in the amount of risk and changes in the price of risk. The staff stated that separating the three elements out to identify the changes in estimate from the release from risk was not practicable. The staff viewed bearing risk as the key service provided by insurers and that a current measure of risk was crucial to understand their business. Therefore changes in estimate of the risk adjustment should be recognised directly in income and not via the residual margin.

An IASB member pointed out that conceptually it was difficult to justify recognising changes in cash flow estimates in the residual margin but to recognise changes in the risk adjustment directly in income. The risk adjustment is derived from the cash flows and therefore there appeared to be no rationale for a different treatment. He also stated it was possible to separate the risk adjustment into the three components and although it may be operationally challenging, many of the issues arising from unlocking the residual margin were similarly demanding.

Another IASB member agreed that logically if it was correct to recognise change in estimates of cash flows through the residual margin then it was also appropriate to recognise changes in estimates of the risk adjustment in the same way. However, he pointed out he was strongly of the view that changes in the risk adjustment should be recognised in income as that was the best **reflection of the insurer's business. The IASB tentatively** decided that changes in the risk adjustment should be recognised in income.

Prospective adjustment

The staff advocated that adjustment to the residual margin should be done prospectively as it was impracticable to adjust the margin retrospectively.

An IASB member asked whether the staff had considered how open portfolios and adjustments to assumptions were being addressed in the financial asset impairment project. The staff indicated that adjustments were prospective in the Australian model they were looking to and reiterated their belief that retrospective adjustments were impractical.

Another IASB member agreed with the staff proposal as he viewed unlocking the residual margin as a change in estimate and under IFRS, changes in estimates are dealt with prospectively. A majority of the IASB tentatively agreed with the staff proposal.

Allocation of the residual margin

The staff reminded the Boards that the IASB exposure draft (“ED”) proposed that the residual margin cannot be negative and indicated that there had been no disagreement with this from respondents. The staff then proposed that the residual margin should be allocated over the coverage period and on a systematic basis that is consistent with the pattern of transfer of the services provided under the contract.

An IASB member noted that limiting the allocation of the residual margin to the coverage period seemed inconsistent with the decision to unlock the residual margin as changes to the cash flow estimates would continue past the coverage period to the claims settlement period. The FASB Chair agreed and suggested that the principle should be to allocate on a systematic basis consistent with the pattern of services provided under the contract. The staff informed the Boards that respondents had been supportive of allocating over the coverage period and that as a type of practical expedient it worked.

Another IASB member preferred to simply recognise it over the coverage period as he believed it is difficult to find a systematic basis for the allocation where there is a tail. Other IASB members reiterated their concern over the operationality and the appropriate level of aggregation to allocate the residual margin. The staff accepted this point and explained they would not address the issue at this meeting but would reconsider it as part of their work on defining a portfolio.

The Boards tentatively decided to support the staff’s recommendation.

The IASB chair summarised the operational and conceptual challenges still to address relating to residual margin which include; distinguishing between current experience and changes in estimates, the major practical issues for dealing with open portfolios, identifying the driver for the systematic basis for allocating the residual margin, dealing with changes prospectively, and taking changes in estimates of cash flows and discount rate to the residual margin but changes to the risk adjustment to income. He pointed out that given the significance of these issues and the fact that the IASB tentative decision to unlock had a very narrow majority the topic would need further consideration.

Acquisition costs

The staff reminded the Boards of their previous tentative decisions regarding acquisition costs. Although both Boards had tentatively agreed that acquisition costs should be determined on a portfolio basis, the FASB had tentatively decided that only direct costs related to successful acquisition efforts should be included in the fulfilment cash flows, whereas the IASB had tentatively decided that directly attributable costs for both successful and unsuccessful acquisition efforts should be included in the fulfilment cash flows. The staff had prepared an analysis comparing the two Boards’ tentative positions, the lease project and the revenue project. They asked whether either of the Boards wished to modify their previous tentative decisions and/or whether they wished treat acquisition costs consistently with the lease project, the revenue recognition project or with the capitalisation of costs for inventory and construction contracts.

An IASB member pointed out that inventory production costs include an element of normal wastage, this analogy would work for including a normal amount of unsuccessful efforts in acquisition costs. Another IASB member stated that differentiating between successful and unsuccessful efforts penalises entities that perform all their acquisition efforts internally compared to those entities that outsource it to third parties.

A FASB member reminded the Boards of the reason for **the FASB’s recent project on acquisition costs as over time practice had developed that included too many period type costs within acquisition costs.** An IASB member indicated his sympathy for the FASB’s concern that too many costs ended up being deferred as acquisition costs rather than being expensed.

Some Board members asked about the presentational differences between the IASB and the FASB approach for acquisition costs, and the staff explained that the tentative decisions today would not address presentation, which would be addressed in later debates.

The FASB reaffirmed its previous tentative decision to only include costs for successful acquisition efforts in the fulfilment cash flows, and a slight majority of the IASB reaffirmed its tentative position to include costs for both successful and unsuccessful acquisition efforts.

Regarding the nature of the costs to be regarded as acquisition costs the Chair of the FASB informed the Board members that recent outreach had indicated a strong desire by preparers that have insurance, revenue recognition and leasing activities to have consistency in the approaches.

An IASB member indicated that the biggest difference between the two Boards related to the indirect costs where the IASB would allocate an amount that was directly attributable to acquiring the insurance contracts but where the FASB would expense, for example, allocations of rent and utilities. He suggested that the IASB should amend its previous tentative decision to be consistent with the FASB approach and accept only direct costs.

The FASB and 14 IASB members agreed that only direct costs should be included within acquisition costs. The following types of indirect costs would be excluded from acquisition costs; software dedicated to contract acquisition, equipment maintenance and depreciation, agent and sales staff recruiting and training, administration, rent and occupancy, utilities, other general overhead, and advertising.

Performance statement presentation

The staff noted that their current proposals incorporate the comments received from the Boards during the March meeting. They recommended that the performance statement should present the results from insurance contracts using a margin approach, expanded to present volume information. Insurance contracts measured using the building blocks approach would be presented separately from contracts measured using the modified approach. One of the reasons for making the distinction between the two measurement approaches relates to the amount recognised as premiums. For contracts measured using the building blocks approach, premiums due would be presented and measured as the expected premiums for the period as derived from the building blocks model. The presentation format for contracts measured using the building blocks approach would include the underwriting margin, and information on the experience adjustment which is expanded by presenting volume information on premiums received, benefits and expenses. For contracts measured using the modified approach, premiums earned (and other elements) would be presented in line with the treatment under existing GAAP for non-life business.

A FASB member noted that the staff proposal was an improvement on previous proposals and incorporated many of the comments received during the outreach activity. He expressed a preference for the second presentation example in the staff paper (an expanded margin approach) as it more clearly depicted the driver for the experience adjustment between the premium, claims and expenses components.

An IASB member observed that the Boards should decide whether they prefer a margin approach or a more traditional approach of volume information in the performance statement supplemented by margin disclosures in the notes. She expressed her preference

for more traditional presentation approaches in line **with the staff's third example. She noted that she would prefer premiums to be presented on an earned basis for all contracts.** Supplementary note disclosure by measurement model and different type of product could be provided. The staff explained that it is extremely difficult to determine what premiums earned would be for life contracts due to the diverse products, noting immediate annuities as an example where it would be difficult to determine the premium allocation over the annuity payment period.

A FASB member indicated his support for the staff's second presentation approach but noted that the terminology should be simplified so that general users would be able to understand items such as experience adjustments versus changes in assumptions and premiums earned versus premiums due.

An IASB member said that he did not support presenting contracts measured using the two different measurement approaches separately. He also noted that it was an odd presentation format to first present the underwriting margin followed by premium information (expanded as part of the experience adjustment) which would be interpreted by users to be revenue information.

A FASB member responded that the aggregation of premium information on an earned (modified approach) and expected (building blocks) basis into a single line item would not reflect the economics of the two different measurement models and believed that non-specialist users would assume the combined premium numbers, as presented, to be revenue. He also raised concern that deposit elements included in long duration contracts would be included in the premium number as presented.

An IASB member referred to the Boards' deliberations in the financial statement presentation project in which users clearly expressed the need to disaggregate information on the face of the performance statement. This information should be cohesive between the different primary statements. She noted that separating contracts measured using different measurement approaches was in line with this need expressed by users.

The IASB chair indicated that the two Boards have moved away from a summarised margin approach as proposed in the ED. The staff reminded the Boards that one of the reasons why the ED proposed the summarised margin approach was due to the same key concerns that were raised by the Board members in this meeting namely, how one defines premiums for inclusion in the performance statement and the treatment of deposit components included in premiums.

In a vote to steer the direction of the staff for further development of the presentation model, the FASB voted in favour of an expanded margin approach as set out in Example 2 of the staff paper. The IASB was split in its vote between Example 2 and Example 3. The IASB chair asked the Board whether they would object moving forward on a basis consistent with the FASB vote to achieve convergence and only three members objected.

Several Board members observed that the presentation format should not be too prescriptive in order to allow the incorporation into the consolidated accounts of a conglomerate group in an appropriate basis. An IASB **member reminded the Boards that IAS 1: ‘Presentation of Financial Statements’ only prescribe minimum line items** and noted that the Board has not mandated a specific presentation format for any other industry. His view was that the Boards should only define which line items should be presented as a minimum and that this would allow for the appropriate presentation in different scenarios. For example, the staff proposal could be appropriate for insurance dominated groups, whereas minimum line items may be appropriate for conglomerate groups where the insurance component is not that significant. Many Board members agreed with this proposal.

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