

# Sharing insights on key industry issues

FASB board meeting – Insurance contracts

PricewaterhouseCoopers summary of meeting

November 24, 2009



Since a variety of viewpoints are discussed at FASB meetings, and it is often difficult to characterize 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 Statement, Interpretation or FASB Staff Position.

## Highlights:

Issues discussed at the meeting included the recognition of an insurance contract, the derecognition of insurance liabilities, and, briefly, embedded options for future coverage.

While the meeting discussion was varied the Board seemed to come to agreement on the basic principles for recognition and derecognition of insurance contracts. They were not asked for and not reach any decisions on the accounting for options for future coverage embedded in existing contracts.

On the recognition issue, the Board tentatively decided that an entity should recognize an insurance contract at the earlier of (1) the date the entity is "on risk" to provide coverage to the policyholder for insured events and (2) the contract signing date. However, the Board did not conclude on financial statement presentation for any such obligation. Presentation of insurance contracts before and after coverage starts is expected to be discussed in December.

On the derecognition issue, the Board tentatively decided that derecognition of an insurance liability should occur when the obligation no longer qualifies as a liability, i.e., when an entity is no longer on risk and no longer required to transfer any economic resources for that obligation.

## Detailed discussion:

### *Recognition*

The question posed by the staff was at what point should an insurance contract initially be recognized in the financial statements? For example, an insurance contract may be executed in October with an effective date (i.e., coverage beginning) on the following January 1. The background provided in the IASB staff paper and a shorter FASB paper described the two main choices for the timing of initial recognition of an insurance contract as:

1. Recognize an insurance contract when coverage starts and treat it as fully executory until the start of the coverage period
2. Recognize an insurance contract when coverage starts and treat it as a forward contract or option until the start of the coverage period (this essentially recognizes an insurance contract at the date the insurer becomes a party to the contract, the conclusion reached in the May 2007 discussion paper on insurance contracts)

The discussion was somewhat unclear in the beginning, in that the staff, rather than using the "date the insurer becomes a party to the contract" language, instead said that better wording to describe their position would be the "date the insurer is on risk," as further described below. The Board and staff seemed to support a recognition principle closer to #2 above, rather than #1. That is, the Board and staff seemed to agree that waiting until the coverage period started could result in a failure to accrue a liability for a risk existing prior to the start of the coverage period.

The staff used the phrases "party to a contract" and "signing of the contract," and it appeared that these two phrases were meant to capture the same idea. The staff noted that rather than use the date the insurer becomes a party to the contract, they believed it would be clearer to describe the initial recognition point as the date the insurer is "on risk." The Board ultimately came to the tentative view that an entity should recognize an insurance obligation at the earlier of (1) the entity being *on risk* to provide coverage to the policyholder for insured events and (2) the signing of the insurance contract. It was noted that the Board had been discussing initial recognition in two other projects. In the revenue recognition project, the Board decided on the date the entity becomes a party to the contract as the initial recognition point, and for leases, the contract signing date.

The Board asked the staff whether the IASB had come to a view in its Board meeting the previous week. The staff responded that the IASB had not, and that the IASB was not expected to vote on this issue until December or January.

The Board also discussed, without resolution, whether, if the contract is recorded in advance of the effective date of the policy/coverage period, the accounting should be gross or net. For example, assume a contract is signed in October to begin on January 1 with a present value premium of \$1 million. Suppose the insurer estimate some time prior to January that the present value of expected claims plus risk margin will be \$1.1 million. Should a receivable for \$1 million be recorded, with a separate liability for \$1.1 million, prior to the effective date of the policy? Or would the period prior to the effective date of the policy be treated as if it were an option and recorded on a net basis at \$.1 million?

The staff noted that under the netting approach, which the Board has tentatively decided to use in the revenue recognition model, only an onerous contract would result in the recording of a liability in advance of the coverage period. One Board member suggested that this seemed inappropriate for the insurance project, given the way the model estimates the liability. It was also suggested that accounting for the contract as a derivative prior to the coverage period would not be appropriate, but instead the liability measurement model should be used. However, given that the Board had not yet decided on the presentation approach during the coverage period, it was decided that it was premature to vote on presentation (gross versus net) for the pre-coverage period.

When asked whether any liability recorded prior to the coverage period was a claim liability or a performance obligation, the staff agreed that the model gets "muddy." One Board member expressed a view that a claim liability could not exist before a claim was actually incurred, while another noted that the measurement model for the liability is an expected model, not an incurred model, so that the "incurred event" was irrelevant. One Board member noted that they may have a different model for short duration contracts (given the IASB proposal to use an unearned premium approach for the pre-claim obligation as a practical expedient for short duration contracts). In response to one Board member's concern that this might lead to recording a liability later than the date when the insurer is a risk, another member noted that a premium deficiency might still need to be recorded.

#### *Embedded options for future coverage*

The FASB staff noted that at a previous IASB meeting, some IASB Board members questioned whether the measurement of an insurance contract would include the expected present value of cash flows arising from a policyholder option in an existing contract to purchase additional coverage or coverage other than the coverage specified in the current contract. Examples include coverage for a second automobile, health insurance for a spouse or dependent to add on to a policy initially covering one insured, or home

insurance when the policyholder has an existing auto policy. A Board member noted that this issue was similar to the revenue recognition project issue where there are options to buy other products.

The IASB Board member present at the FASB meeting provided his view that it was difficult enough for him to get to the view that future premiums payable at the option of the policyholder (given that insurance contracts are typically cancellable) on existing coverage should be included in the measurement of an insurance contract. He therefore disagreed with going beyond the existing contract coverage. However, he noted that others believe that expected cash flows coming from additional coverages when the options are at constrained prices should also be included in the measurement.

One Board member noted that this was an extension of the "boundaries of the contract" discussion that the FASB had not yet had. The IASB staff present by phone noted that in its previous discussion of contract boundaries, the IASB had agreed in principle that contract terms would be treated as part of the existing contract until the insurer has the unrestricted right to reprice the policy or reunderwrite it.

The FASB Board was not asked to reach a decision on this topic and will discuss this topic at a future Board meeting (January).

#### *Derecognition of insurance liability*

At its November meeting, the IASB decided that an insurer should derecognize an insurance liability when it no longer qualifies as a liability, applying the derecognition principle in IAS 39 *Financial Instruments: Recognition and Measurement*. The IASB staff background paper for the insurance discussion notes that the IASB exposure draft, *Derecognition* (a proposed amendment to IAS 39 and IFRS 7) proposes to amend IFRS 4, *Insurance Contracts*, to state:

"An insurer shall derecognize an insurance liability (or a part of it) when it (or the part) no longer qualifies as a liability of the insurer. An insurance liability ceases to qualify as a liability of the insurer if the present obligation is eliminated and the insurer is no longer required to transfer economic resources in respect of that obligation."

At the November 24 FASB meeting, several Board members noted that this principle seemed straightforward and questioned why explicit guidance was needed at all on this topic. The staff indicated that the guidance would remind people that entering into a reinsurance arrangement would not typically result in derecognition of the insurance liability. The staff pointed out that this guidance was equivalent to the extinguishment guidance that was in FAS 140, par. 16 (now codified as ASC 405-20-40-1).

Several Board members noted that the proposed derecognition guidance is based entirely on similar wording in IAS 39, which covers financial instruments. This makes the proposed guidance somewhat incomplete, given that the FASB views the insurance contract model as having a claim liability element (more akin to a financial instrument) as well as a performance obligation (pre-claim liability). The performance obligation should not be relieved until it is fully satisfied.

While no vote was taken on the specific words proposed in the IASB, the FASB Board tentatively decided on a principle that an insurance liability should be derecognized by an entity when that obligation no longer qualifies as a liability. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.

Additional information

*If you have further questions on either the FASB or IASB project, please contact:*

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