

# *Sharing insights on key industry issues*

## **IASB/FASB Board Meeting – Insurance Contracts**

March 1-2, 2011

### *PwC summary of meeting:*

- *Locking in the discount rate*
- *Discounting non-life contract liabilities*
- *Scope*
- *Financial guarantee contracts*
- *Field testing*
- *Uncertainty in measurement*
- *Acquisition costs*

*Since a variety of viewpoints are discussed at FASB and IASB meetings, and it is often difficult to characterize 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 March 1-2 2011 where they discussed locking in the discount rate, discounting non-life contract liabilities, scope, financial guarantee contracts, a preliminary report on field testing results, an information paper on uncertainty in the measurement of insurance liabilities and acquisition costs. The Boards did not discuss the alternative presentation models due to time constraints.

The Boards agreed with the staff recommendation that the discount rate should not be locked in for any insurance contract. Instead, as provided in the IASB exposure draft ("ED") and FASB discussion paper ("DP"), the rate would be a current rate updated each reporting period.

For non-life contract liabilities, both Boards agreed with the staff recommendation that all long-tail non-life claims be discounted. However, there were mixed views on the staff recommendation that an exception to discounting be made for short-tail non-life claims (i.e., those with a claims settlement period of one year or less). The IASB rejected the staff approach and instead favored an approach whereby all claims would be required to be discounted, consistent with the time value of money axiom already

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confirmed, except that discounting would not be required if the impact is immaterial. In contrast, the FASB Board supported the staff's "exception" approach, but agreed to explore a concept based on immateriality if more guidance could be provided on the circumstances in which the discounting impact would be considered to be immaterial. The Boards agreed to continue discussion of this issue in connection with their redeliberations on the modified approach for short-duration contracts.

The staff discussed a proposal relating to scope that would, consistent with the ED and DP, provide a scope exclusion for fixed-fee contracts that have as their primary purpose the provision of services, but with an added restriction that such contracts also qualify for the modified approach for short-duration contracts. The Boards rejected this added restriction, and instead supported the ED and DP proposals. To address constituent comments that the scope guidance on fixed fee service contracts was not clear, the FASB suggested that the definitions of "insurance" and "fixed fee service contract" needed to be clarified at the future meeting dealing with the definition of an insurance contract.

The IASB unanimously agreed with the staff proposal for the accounting treatment of financial guarantee contracts to carry forward in the short term the existing option in IFRS that permits an issuer of a financial guarantee contract (as defined in IFRS) to account for the contract as an insurance contract if it had previously specifically asserted that it regards the contract as an insurance contract. In all other cases, an issuer should account for such contracts in accordance with the financial instruments standards. The IASB agreed not to provide an exception for intra-group guarantees. The FASB noted their discomfort with the current diversity that exists in US GAAP for financial guarantee contracts and agreed that they should rationalize the different accounting models that exist in US GAAP today. The FASB will work towards convergence with the IASB on this matter as part of their project to issue an insurance contract exposure draft.

The staff introduced the preliminary field testing report and noted that the results from the field tests of the proposals contained in the ED was in line with the views expressed in the comment letters. A more detailed report would be submitted at the end of March.

The IASB is in favor of recognizing acquisition costs for both successful and unsuccessful efforts to acquire a portfolio of insurance contracts. The FASB noted the recently issued changes to US GAAP and that it only supports the inclusion of acquisition costs for successful acquisition efforts. The two Boards were still unclear on which acquisition costs should be included in the contract measurement, especially as it relates to directly allocable costs such as rent and software associated with the selling function, and the staff noted that they will draft acquisition cost cash flow guidance based on the fulfillment cash flow guidance and bring that to the Boards for consideration at a future meeting.

## ***Locking in the discount rate***

The idea of lock-in was suggested by some constituents, particularly large preparers in North America and Europe, as well as standard setters in those countries and international audit firms, but was not widely supported by users. These preparers noted that locking in the discount rate would be consistent with their business model of holding liabilities and related assets for a long period of time, where short term market interest rate movements are irrelevant. They argued that a measurement similar to amortized cost (but with unlocking of all assumptions other than discount rate) would be more consistent with the measurement used for financial liabilities and certain financial assets.

After analyzing the issue, the staff ultimately rejected the lock in approach, and recommended that the Boards retain the ED and DP proposal that the rate be the current rate, updated each period. The staff's rationale included the following arguments:

- The level of predictability for insurance contracts is lower than for other financial instruments
- Locking in the discount rate does not represent a current value measurement.
- Developing a different measurement model for some types of long-term insurance contracts and not others would reduce comparability and reduce understandability.

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- Such an approach would require the unbundling and fair valuing of options and guarantees (e.g., interest rate guarantees currently not unbundled) in order to be consistent with IFRS 9 requirements for liabilities, which would be complex and difficult
  - It would require an onerous contract test be developed, raising questions on when the test would be triggered and the level of aggregation
  - It would require guidance on when a contract is considered to be a new contract (i.e., to determine when the discount rate should be unlocked)
  - An option to lock in could result in having to develop mechanisms to avoid abuse
  - Locking in the discount rate would create an issue as to whether cash flows should not be adjusted for inflation for consistency
  - Some believe a more appropriate analogy is to the current IFRS accounting for provisions under IAS 37, in which cash flows are discounted at a current rate updated each period.

Both Boards agreed with the staff's recommendations. A FASB Board member noted that he was not supportive of valuing a liability based on an asset valuation, and that he wasn't even sure how using an inception rate discount rate would work in an open portfolio measurement approach, where new business is mixed with existing business. Another FASB Board member asked whether the staff had considered the extent to which other comprehensive income might be used to report all or a part of interest rate changes, and the FASB staff indicated that would be discussed at a future meeting. Another FASB member noted that he would object to locking in the discount rate, in part because at the last meeting they had discussed how the discount rate might in some instances be used to capture changes in uncertainty that could not be captured in the risk adjustment.

Another FASB Board member clarified that any decision on this issue was separate from the Boards' future discussion of the modified approach for short duration contracts. In addition, she noted that one of the criticisms of US GAAP was its failure to unlock key assumptions such as the discount rate, and so the ED/DP proposal would be an improvement. While she noted that she wanted to make her decision based on what would be the most appropriate rate for the liability measurement (and she agreed with unlocking in this respect), in the end she would like to take a step back to ensure this decision would not create an inappropriate mismatch with the final financial instrument accounting model.

Several IASB Board members noted their approval with the staff recommendation for the reasons cited by the FASB and the staff. One Board member asked the staff how they responded to industry's rationale that a lock in reflected the business model. The staff noted that the constituents' arguments were really about the nature of the contracts, and how the assets were managed rather than how the liabilities were managed, and so they did not find this argument compelling.

## ***Discounting non-life contract liabilities***

The staff noted that US property/casualty insurers and health insurers commented that discounting was not a faithful representation of their business model for most products, including contracts which are "short-tail" (period between incurrence of claim and claim settlement is short) and long-tail contracts where it is questionable whether, when, and how much they will have to pay.

To address constituent concerns with discounting non-life short-tail contracts, and for consistency with other accounting such as leases and short-term receivables and payables, the staff recommended to the Boards that an exception to discounting be made for short-tail contracts with claims settlement periods that are typically less than one year.

Questions were raised by FASB members whether the "one year" started from contract inception or the occurrence of the claim to which the staff responded that it was the latter. Thus, for a policy with a one year coverage period, where a claim is incurred on the last day of the policy year and paid in a year, it would qualify for the discounting exception even though the time between contract inception and payment is actually two years rather than one. Some Board members found this troublesome.

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An IASB Board member struggled with the need to separate cash flows between short-tail and long-tail claims, which she noted could occur within a single contract. She and other IASB members also struggled with a bright line exception test, noting that a better approach would be to apply a principle that discounting is appropriate unless the impact is immaterial.

The staff responded that they struggled with how to define immateriality, and a FASB Board member noted that in order to invoke an immateriality rationale for not discounting, one would need to do the calculation to prove immateriality. This would seem to defeat the purpose of the exception, which is to reduce the cost and complexity of the model. One FASB Board member noted that in the revenue recognition project, they had proposed that companies discount cash flows if they expected the impact to be material, and comments came back from constituents that such an assessment was too subjective and that they would prefer a bright line. The Australian Board member countered that discounting of non-life claims has been required for some time in Australia, and companies have learned how to make immateriality assessments in their calculations without having to do detailed calculations every period.

Another IASB Board member commented that given the double digit inflation rates in many of the countries subject to IFRS, it would be difficult to set out a one year time frame or any other bright line as automatically being immaterial, with another member noting that discount rates and inflation rates go hand in hand. The FASB staff responded that given the short tail of these liabilities, the cash flows would typically not include significant inflation, so there would not be a significant mismatch.

In voting, all but two of the IASB members rejected the staff approach and instead favored an approach whereby all claims would be required to be discounted, consistent with the time value of money axiom already agreed to, except that discounting would not be required if the impact were immaterial. In contrast, the FASB Board supported the staff's "exception" approach, but agreed to explore a concept based on immateriality if more guidance could be provided on the circumstances in which the discounting impact would be considered to be immaterial. The Boards agreed to continue discussion of this issue in connection with their redeliberations on the modified approach for short-duration contracts.

The staff then described the recommendation in their paper that discounting should be applied to all other claims, that is, both short-duration long tail claims where the expected payout patterns is reasonably determinable, as well as short-duration long tail claims in which it is questionable if the insurer will have to pay, when they will have to pay, and how much they have to pay. The staff noted that if the model requires that an insurer estimate an *amount* for those extremely uncertain claim payments, it was in the staff's view no more difficult to then estimate the potential *timing* of such payment, on a portfolio basis.

All of the FASB Board members and all but one of the IASB Board members agreed with the staff recommendation that all long-tail non-life claims should be discounted. It was noted that any uncertainty in the timing of payment would be captured in the risk adjustment.

## **Scope**

The staff proposed that consistent with the ED and DP, a scope exclusion be provided for fixed-fee contracts that have as their primary purpose the provision of services, but with an added restriction that such contracts also qualify for the modified approach for short-duration contracts. The staff indicated that this restriction was added given that there will be very similar accounting between contracts that fall within the scope of the modified measurement approach for insurance contracts and fixed fee service contracts that would be within the scope of the revenue recognition standard.

A FASB Board member objected to this additional restriction, noting that it did not seem appropriate that if he had two contracts, both whose primary purpose was the provision of services, that one be accounted for as insurance if it had a long payout period, and the other be accounted for under revenue recognition if it had a short payout period. For example, a five year warranty contract would be treated as insurance, even if written by a non-insurer which considered itself to be providing a service.

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Another FASB member thought it was too onerous to require that anyone who writes a fixed-fee service contract analyze the contract through the entire insurance standard to see if it applies. In very simple terms, she would rather see a model where if someone shows up and does something for you, it is a service, but if someone pays something for you, it is insurance. However, the staff and an IASB Board member commented that the distinction between a service and insurance should not be based on whether the insurer pays in cash or in kind. For example, if your home burns down and an insurer either reimburses you in cash for your cost to rebuild or rebuilds the house for you, it would still be insurance. The FASB member reiterated that she did not think it appropriate that certain contracts that would typically be thought of as service contracts subject to the revenue recognition guidance, such as engaging a lawyer on retainer, be accounted for as insurance, and that better definitions of insurance and service contracts were needed.

Several references were made to roadside assistance programs which varied in length from one year to five years, and some of which offered only towing services and others which offered additional services such as car repair, unrelated travel services and discounted movie tickets. Various answers were given by the staff as to whether such roadside assistance programs would be included or excluded from the scope of the insurance contracts standard. References were also made to healthcare providers who receive a fixed per capita fee in return for providing health care services, with some noting that they would be scoped out of insurance if they met the modified approach but scoped in if they did not (under the staff's latest proposal). Boiler contracts were also mentioned, which often provide preventative maintenance in addition to providing repair services if the boiler breaks down. The staff believes the intent of such a contract is a service (to have a working boiler) and thus would not consider this to be insurance.

The Boards ultimately rejected the staff's additional restriction that fixed-fee contracts qualify for the modified approach in order to get the scope exclusion, and instead supported the ED and DP proposal. To address constituent comments that the scope guidance on fixed fee service contracts was not clear, the FASB suggested that the definitions of "insurance" and "fixed fee service contract" needed to be clarified at the future meeting dealing with the definition of an insurance contract.

The Boards also confirmed the other scope exclusions noted in the ED such as manufacturer/dealer product warranties and residual value guarantees, direct insurance contracts that an entity holds, and employer assets and liabilities under employee benefit plans. The FASB briefly questioned whether insurance coverage provided by insurers to their employees should be in the scope of the insurance standard instead of employee benefits, but ultimately the majority agreed that it would be more appropriate to measure them under employee compensation guidance rather than to impute a premium and account for them as issued insurance contracts.

## ***Financial guarantee contracts***

The staff recommended as a temporary measure (pending the outcome of Board discussions on the financial instrument impairment project) that the IASB carries forward in the IFRS for insurance contracts the existing option in IFRS that permits an issuer of a financial guarantee contract (as defined in IFRS) to account for the contract as an insurance contract if it had previously specifically asserted that it regards the contract as an insurance contract and requires an issuer to account such contracts in accordance with the financial instruments standards in all other cases (initially measured at fair value with subsequent amortization of that amount coupled with a test for credit losses). The FASB staff recommended that also as a temporary measure the FASB exclude from the scope of the insurance contract project the accounting for certain financial guarantees (those currently accounted for under FAS 163 financial guarantee guidance, or for a non-insurer, under FIN 45 guarantee guidance) noting the various different accounting treatments that currently exist for these contracts under US GAAP. The FASB staff also proposed to carry forward the exception from recognition requirements for intra-group guarantees.

An IASB Board member noted this would be a grandfathering provision whereby a new insurer would be required to apply financial instruments accounting to financial guarantee contracts. Another IASB member noted that the insurance standard should provide a transition provision that would allow issuers of financial guarantee contracts to change their current accounting treatment once the IFRS 9 proposals that will be applicable to financial guarantee contracts are finalized. An IASB member observed that the comment letters received as well as the input from outreach activity has convinced him to change his view from the ED proposal and to allow the treatment as proposed by the staff. However, he noted that the IASB will have to address the accounting for these contracts as a

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priority once the impairment and insurance projects are completed. An IASB member noted that under the current proposal you could end up with different accounting treatment in a set of consolidated accounts and questioned why the IASB would allow an option.

In a vote the IASB unanimously agreed with the staff proposal for the accounting treatment of financial guarantee contracts as well as not to provide an exception for intra-group financial guarantees.

The FASB chair noted that the FASB was in a different position than the IASB in that the FASB is working towards an exposure draft. She noted her discomfort with the current diversity that exists in US GAAP for financial guarantee contracts and noted that the FASB should rationalize the different accounting models that exist in US GAAP today. A FASB member noted that the FASB should work towards convergence with the IASB on this matter but after the financial instruments and, in particular, the impairment project has been finalized. He noted that this would only happen subsequent to the finalization of the IASB insurance standard. It was noted the FASB will propose a treatment for the US ED and noted that this will be a significant sweep issue with many consequential amendments to other US standards. The FASB noted that they also need to converge with the IASB on the issue of the intra-group exception but that they will decide on this when they deliberate the treatment of financial guarantees in the future.

### ***Field testing – preliminary report***

The staff introduced the report noting that it contains the preliminary results from the field tests of the proposals contained in the ED. It notes the population of type of insurers covered, the basis of data used by participants, type of feedback received and the assumptions and limitations of the tests performed. The staff noted that the results were generally consistent with the feedback received from the comment letters and that they are currently busy with outreach to the participants to better understand and clarify some of the issues that were raised. A more detail report will be available towards the end of March. The staff noted that the preliminary conclusions from the field testing had been included in the papers considered by the Boards to date. The FASB noted that it would be useful if the issues highlighted by the field testing are monitored to ensure the Boards address these through the current project plan or by having a specific session for those aspects not addressed elsewhere in the project. It was noted that it would be useful to have input from those insurers that do not currently perform risk adjustment calculations for regulatory purposes to determine the expected time needed for implementation of the proposals.

### ***Information session on the uncertainty in the measurement of insurance liabilities***

The staff noted that the purpose of the paper was to address the Boards' concerns about possible double counting of risk and uncertainty that arose during the February joint board meetings. The paper provides a comprehensive view of the measurement model considering all building blocks and analyses where the model intends to capture the elements of risk and uncertainty. The Boards commended the staff on the paper and had limited comments.

### ***Acquisition costs***

The staff introduced the paper noting that the purpose was to decide on which acquisition costs should be included in the building blocks cash flows at a portfolio level and not to consider the other building block components. At the February meeting, the FASB agreed to limited the acquisition costs to successful contracts whereas the IASB was undecided on whether to include unsuccessful contracts too. It was noted that the staff had different views. Some staff proposed that acquisition costs included in the cash flows of insurance contracts should be limited to those costs related to successful acquisition efforts, limited to direct costs that are related to the acquisition of a portfolio of contracts. They proposed that implementation guidance be provided to clarify the types of acquisition costs that should be included incorporating the sales force contract selling, underwriting, medical and inspection, and policy issuance and processing functions.

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Some staff proposed an alternative view that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the costs that the insurer will incur in acquiring the portfolio (both successful and unsuccessful), including costs that relate directly to the acquisition of the portfolio (e.g. commission) and costs that are directly attributable to acquisition activity in general and can be allocated to the acquisition of the portfolio, using the same principles as other fulfillment costs.

The FASB noted that the difference between the staff proposal and the alternative staff proposal reflects the difference between current US GAAP (both successful and unsuccessful sales efforts) and the recent revision to US GAAP (successful sales efforts only, and limiting allocable costs to salaries and related employee benefits but excluding other overhead). The FASB noted that it would be very difficult for them to revert back to the current US GAAP position having gone through due process to come up with the new proposal for insurance acquisition costs.

Many IASB members questioned how you would implement the staff's main proposal in practice. They believe it would not be practical to allocate costs between successful and unsuccessful acquisition efforts. An IASB member questioned what useful information would be provided by including the acquisition costs as a contract cash flow compared to expensing the costs on day one. An IASB member noted his preference for the alternative proposal and explained that a company that attempts less sales efforts but spends more quality time with the prospective customer to ensure a sale is made compared to a company that attempts far more sales efforts but spends less effort per sales attempt could end up selling the same amount of contracts and incurring the same amount of costs but recognizing a different amount as part of the contract cash flows. This has the same consequence as only recognizing incremental acquisition costs at the contract level where a different business model will result in a different accounting treatment. An IASB member noted support for the alternative proposal because the model being developed has the objective to measure the costs to fulfill insurance contracts at the portfolio level.

In an IASB vote on the staff's main proposal, only two members present were in favor of the proposal. All but two of the IASB members were in favor of recognizing the acquisition costs for both successful and unsuccessful efforts to acquire a portfolio of insurance contracts. At this stage of the discussion the board was not considering which acquisition costs would be included.

A FASB member noted that acquisition costs incurred was not part of the cost to fulfill the obligation towards the policyholder. He noted that you should not attempt to minimize the residual margin by including additional costs in the building block cash flows. He noted that all other businesses would expense acquisition costs as "period costs" and noted that information on costs incurred on unsuccessful acquisition efforts would be useful information in order to compare different companies as well as a company's acquisition performance over time. He noted his very strong disagreement with the alternative staff proposal. The FASB unanimously agreed with the staff's main proposal to only consider successful sales efforts.

The Boards next discussed which acquisition costs should be included in the building block cash flows. The staff included a detail list of typical acquisition costs that are incurred, categorized between incremental direct costs, direct costs and direct and indirect costs.

The majority of the FASB supported the inclusion of direct costs but noted that implementation guidance will have to be provided due to the different interpretations on what would be considered direct and what would be considered indirect. For example agency office rent and software costs would generally be an indirect cost but if the rent and software were only used for contract acquisition a minority of the FASB thought it potentially could be considered a direct cost.

A number of IASB staff members questioned the difference between "directly attributable acquisition costs" as noted in the alternative staff proposal and the direct and indirect costs as in the main proposal. An IASB member noted that the implementation guidance that will be prepared should contain a couple of examples to illustrate the principle but should not be a comprehensive list of acquisition costs as included in the staff paper. Another IASB member noted that the acquisition costs to be included in the building block cash flows should be consistent with the decision reached for the other contract cash flows.

The two Boards were not clear whether they were talking across purposes or actually in agreement on which acquisition costs should be included. The staff noted that they have to draft the fulfillment cash flow guidance and

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that they will use that guidance and adapt it, as necessary, for acquisition costs. They will then bring acquisition cost cash flow guidance to the Board for consideration to determine if there are any specific areas where the Boards disagree. It was noted that the FASB staff would consider the aspect of unsuccessful contracts too as part of that drafting.

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## *Additional information*

Questions on this summary and the FASB/IASB joint project can be directed to:

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