

Insurance alert

FASB Education Session – Insurance Contracts

January 18, 2012

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

PwC summary of meeting

- *Premium allocation approach: eligibility criteria*
- *Premium allocation approach: mechanics*

The topics discussed at the FASB only education session included the eligibility criteria for the premium allocation approach, the IASB exposure draft (ED) proposed requirement to discount the liability for remaining coverage and accrete interest on it, and the treatment of acquisition costs. As this was an education session, no decisions were reached; the meeting was in preparation for an upcoming joint meeting with the IASB where these issues are expected to be deliberated. That meeting was originally scheduled for January 25, but the most recent board agendas now show the January 25 meeting as being an IASB only meeting.

Premium allocation approach: Eligibility criteria

The staff noted that the boards had discussed eligibility criteria for the premium allocation approach (PAA) in April, July and October. Respondents to the ED in generally believed that the criterion in the ED that the contract coverage period be approximately one year or less was too restrictive. The

FASB discussion paper (DP) did not address this issue. Some respondents to the ED suggested making the criteria more principles based, and some suggested it be based on the company's business model (e.g., apply the PAA approach where the profitability of the contract is primarily driven by underwriting results rather than investment income).

In prior redeliberations, the IASB and FASB boards could not agree on the objective of the PAA approach, with the IASB generally viewing it as a proxy for the building block approach (BBA), while the FASB saw it more as a separate model and similar to a revenue recognition approach. Although the boards could not agree on the objective of the PAA, the staff was nevertheless tasked with developing criteria for applying the PAA, in the hopes that while the objectives of the two boards might be different, criteria could be developed that would satisfy both objectives.

Several attempts were made by the staff to develop less restrictive criteria than those noted in the ED, with the latest criteria presented in October having two main components, each of which indirectly attempted to deal with the leanings of each board. The criteria were also "flipped" to start with an assumption that the PAA was the appropriate model, unless either of the two specified criteria were met, which would then require application of the BBA.

The first main component, which seemed to reflect the IASB leaning that PAA be used as a proxy, included two sub-criteria: the BBA rather than the PAA should be applied to contracts where (1) the expected cash flows before the claim is incurred are expected to vary significantly over the coverage period and such variance is not expected to result in the recognition of an onerous contract adjustment and (2) the risk in the contract associated with the liability for remaining coverage had the potential to vary significantly.

The second main component, implicitly addressing the FASB view that the PAA approach is more of a revenue recognition approach and that the BBA approach should be reserved for life and annuity contracts, was a requirement to use the BBA if it would be difficult to allocate the premium for the contract in a reliable and rational manner. This might be the case, for example, if significant deposit elements existed that are not unbundled or if there is significant uncertainty about the length of the coverage period, for example due to options for renewal.

While the boards indicated a general agreement with the direction the staff was headed in October, individual board members came up with differing conclusions on how various contracts would be categorized under the criteria. For example, some thought certain life contracts did not typically have significant changes in cash flows and that premium could be allocated, resulting in PAA classification, while others thought BBA was appropriate. Some thought that certain property/casualty contracts such as catastrophe covers could end up under the BBA due to the chance that expected cash flows could change drastically without necessarily triggering an onerous contract result at a portfolio level, while others thought PAA classification was appropriate. The boards thus asked the staff to revise the language to address this disparity and to test the application of the criteria against different types of contracts to determine if the criteria were clear and operational and the results reasonable.

The revised criteria drafted by the staff after the October meeting (but similar to that noted above) and thirteen different contract types were provided both to board members and constituents (including preparers, auditors, and actuaries) for testing.

The results of the survey yielded questions and some inconsistencies in how various contracts would be classified depending on one's interpretation of the unit of account to be used in making the assessment and other subjective judgments such as the meaning of "expected to vary significantly." The staff revised the criteria further in an attempt to make them more operational, with the latest staff paper (IASB/FASB staff paper 2A/78A) providing the following criteria:

"Insurers should apply the building block approach rather than the premium allocation approach if, at the contract inception date, either of the following conditions is met:

(a) It is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfill the contract that would not be captured by the onerous contract test ('expected cash flows criterion').

(b) Significant judgment is required to determine the amount of premium to be recognized in each reporting period, for example if there is significant uncertainty about the length of the coverage period ('allocation of premium criterion')."

The staff believe the above proposed criteria would result in the following measurement models for example contract types (details of which are provided in the staff paper):

1. Traditional whole life	BBA
2. Term life (1 year)	PAA
3. Term life (5 years, with additional renewal rights)	BBA
4. Universal life	BBA
5. Annuity	BBA
6. Personal auto	PAA
7. Construction surety bond	PAA*
8. Catastrophe insurance	PAA
9. Workers' compensation	PAA
10. Long term disability	BBA
11. Directors and officers insurance	PAA*
12. Health insurance	PAA
13. Japanese fire (30 year)	BBA

*The staff paper notes that these contracts are particularly impacted by the macro-economic environment but that the impact of any significant changes in that environment on a contract would be covered by the onerous contract test and thus would qualify for PAA.

The staff noted that the criteria would be assessed and classification determined only at contract inception (which could proceed the contract coverage period), as this would allow companies to make their determination based on pricing and underwriting information readily available.

Questions arose in the testing as to what the appropriate unit of account should be. Some suggested that application at the individual contract level would result in all contracts that meet the definition of insurance being classified under the BBA approach, as the definition of insurance necessitates the potential for a significant loss. Others noted that if the portfolio were used as the unit of account, certain life insurance contracts would not be expected to have significant changes in cash flows. The staff paper explains that they did not intend for either unit of account to be used, but instead that the criteria be applied to "the characteristics of a representative contract or average contract." The staff described this as a level higher than the individual contract level, given that it considered the grouping of similar contracts. This explanation seemed unclear to some board members, and a few commented that it would be difficult to conclude on this issue without a better understanding of the unit of account. The staff acknowledged that the boards had not yet concluded on a number of unit of account issues, which would be addressed at a future meeting.

With regard to criterion (a), the staff noted that the reference to onerous contracts was added after the survey was completed to deal with contracts such as catastrophe covers, surety, and director and officer coverages that were in the "gray" area when tested. The staff felt that by adding the onerous contract test wording, such covers would more likely meet the PAA approach. That is, some of those surveyed thought that these three types of contracts might be expected to have significant changes in cash flows, and yet thought that consistent with current practice, they should apply the unearned revenue approach (PAA) to such contracts. The staff reasoned that for these contracts, significant changes in cash flows would most likely be the result of expected adverse experience, and in those

situations, if the additional phrase on onerous contracts were added, the contracts would be onerous, leading to PAA classification. This and similar responses throughout the discussion implied that, as suggested by some participants in the study, the staff appeared to be trying to backward engineer a set of criteria in order for contracts to end up with a classification of either BBA or PAA consistent with current accounting as either a long duration or short duration contract. For that reason, some participants suggested that existing criteria for contract classification, such as the US GAAP definitions of long and short duration, be used instead.

With regard to criterion (b), the staff noted that significant uncertainty about the length of the coverage period could arise in life and annuity insurance contracts due to the uncertainty in terms of how long a policyholder would live, what renewal options might be elected, and whether or not he/she would surrender. For such contracts, allocation of premium would in the staff's view be subjective and complex.

The board discussion on eligibility criteria centered mostly on two items: the operationality of the criteria given the lack of an explicitly stated unit of account, and the application of the "onerous contract test" within the expected cash flows criterion (a).

With regard to the onerous test, one board member questioned how an insurer would know, at the inception of a contract whether or not an expected significant change in net cash flows would be so large (and negative as opposed to positive) so as to cause an onerous contract situation. The staff responded that typically, changes in certain property/casualty lines of business were adverse, and once they occurred, would bring a contract into a loss position. Several board members questioned this logic, noting that changes could potentially be positive (depending on how the contract was originally priced), and more importantly, even if negative at the individual contract level, might very well not be negative at the level that an onerous contract test would be performed.

Holding the three "gray area" contracts aside, a board member questioned why, in the other examples, it seemed that the conclusion was that whenever an insurer writes a life insurance contract, it is expected that cash flows could change significantly, but when a property/casualty contract is written, such as an auto policy, the insurer would assume cash flows would not change significantly. The staff responded that what is

really driving this criterion is the difference between a life and P/C contract in terms of the length of the contract period. The longer the contract term, the more likely net cash flow estimates will change over time. For this reason, the one year term life contract would be accounted for as PAA, while the longer term life contract would be BBA. In a one year auto policy, the insurer's expectations as to whether the insured will have an adverse event are typically the same throughout the contract based on the insured's risk profile, whereas in a longer term life insurance contract, the insurer's expectations about mortality would be expected to change over this longer time period.

Another board member questioned what the staff meant by "during the period." Is this an annual period? Or is it a quarterly period for a US public company? For example, if a 4 year term life contract were accounted for as PAA when viewed from an annual perspective, could it potentially be BBA if viewed as having 16 individual periods for which the criteria needed to be satisfied (e.g., the allocation of premium to each of these 16 periods). The staff noted that they hadn't considered this issue, but thought that the analysis would not change for that example, whether viewed from an annual period or quarterly reporting period perspective.

After a lengthy discussion of the eligibility criteria, the general leaning of the board seemed to be to potentially remove the reference to the onerous contract test in criterion (a) based on the flaws noted above. In addition, it seemed that the board was suggesting that the unit of account would need to be clarified in describing the eligibility criteria, as board members were unclear what the staff meant that the criteria should be assessed by "type of contract."

Premium allocation approach: Mechanics

The board discussed the three issues within staff paper 2B/78B dealing with the PAA: the ED requirement to discount the liability for remaining coverage and accrete interest, the types of costs to include in acquisition costs for contracts subject to the PAA, and the balance sheet presentation for acquisition costs relating to PAA contracts.

Discounting and interest accretion on the liability for remaining coverage

The staff are split on this issue, with some staff recommending that, consistent with the proposals in the revenue recognition exposure draft, discounting and interest accretion be required in the measurement of the liability for remaining coverage for contracts that have a significant financing component. These staff also recommend that, as a practical expedient (and consistent with the revenue recognition ED), insurers need not apply discounting or interest accretion if the coverage period of the contracts is less than one year. However, other staff recommend that the liability for remaining coverage should not be discounted and interest should not be accreted on the liability, regardless of the coverage period of the insurance contracts.

The staff noted that consistent with the revenue recognition proposal, in considering whether a significant financing component is present, an insurer should consider the expected length of time between receipt of initial premium and the coverage period, whether the amount of consideration would differ substantially if the customer paid in cash upfront or over the coverage period, and whether the interest rate in the contract is at the prevailing market interest rate.

The staff clarified that for a contract for which the entire premium is received upfront, a discounting and accretion model would result in accreting interest expense on the liability for remaining coverage, and then recording as premium revenue over the coverage period this accreted amount, which would be in excess of the premium actually received. Most board members seemed to have an aversion to recording as premium revenue an amount greater than the amount received in cash from the policyholder, which they referred to as an "inflated" revenue amount.

However, one board member argued strongly for the discounting and interest accretion approach, saying that it best reflected the economics of the transaction, where "float" is an important component of the contract. Another board member stated that there hadn't been an outcry from users for this change from the current model, to which the first board member responded that people have a tendency to keep status quo rather than go through the trouble of changing their metrics. He also said that the current ambivalence was due in part to the low interest rate environment.

The staff pointed out some of the operational complexities associated with having to accrete interest on the liability, as detailed in the staff paper. A board member noted that he also had some concerns with the wording of the practical expedient, which was linked to the coverage period. Instead, he believed the practical expedient should be based on the length of time between when the service is performed and the premium payment is made. For example, the practical expedient should apply to an eighteen month contract where the premium is paid monthly, because in that situation, there would be no significant timing difference between when the cash is received and the service is provided.

Premium allocation approach: Treatment of acquisition costs

The staff are also split on the types of acquisition costs that should be included in the measurement of the PAA. Some staff recommend that the measurement be consistent with the BBA, i.e., include directly attributable costs (limited to successful acquisition efforts only in the FASB model). In addition, they believe insurers should be permitted to expense directly attributable costs that are not incremental.

Other staff recommend that the measurement of acquisition costs in the PAA should be consistent with the proposals in the revenue recognition exposure draft. Under this approach, the measurement of acquisition costs would include only incremental costs at the contract level, and insurers would be permitted to expense all acquisition costs if the coverage period is one year or less.

While a couple of board members suggested that the categories of costs included in the BBA and PAA models should be consistent with each other, another board member said he didn't see the need to require additional work for shorter duration contracts, and thus would permit expensing as incurred in the PAA approach.

The final issue discussed with the FASB board was the staff recommendation that, consistent with the model proposed in the revenue recognition project, acquisition costs for PAA contracts should be recognized as an asset, with the liability for remaining coverage thus presented gross of acquisition costs, a change from the ED requirement to net such costs against the liability. Under this approach, acquisition

costs would be amortized in a manner consistent with the recognition of premium (i.e., over the coverage period on the basis of time, but on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time).

Board members seemed to think the staff approach was reasonable, and that direct acquisition costs should be recorded separately as an asset rather than netted against the liability. Some suggested that they would like the boards to reconsider classification of qualifying acquisition costs as an asset under the BBA as well, but the staff reminded them that the decision had already been made to include qualifying acquisition costs as part of net cash flow in the building block approach.

Additional information

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

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