Insurance alert

FASB Board Meetings and Education Sessions
July 23-25, and August 1, 2o12

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

PwC summary of meetings:

- *Direct response advertising*
- *Scope: Title insurance*
- *Scope: Charitable gift annuities*
- *Disclosures: Education session*

Highlights

The FASB only education session on July 23 and board meeting on July 25 covered the topics of direct response advertising and title insurance.

The FASB decided unanimously that in the proposed new insurance model, direct response advertising for insurance contracts should be immediately expensed rather than included as part of contract cash flows. This would be a change from existing US GAAP, which currently allows certain direct response advertising costs to be capitalized if the restrictive criteria in ASC 340 are met, and a change from the FASB board's tentative decision in June 2011. Until the insurance contract proposal is finalized, direct response advertising costs incurred in acquiring insurance contracts would continue to be deferred based on the ASC 340 guidance.

The FASB also decided that title insurance should be in the scope of the insurance model and that under this model a title insurer would unbundle the service component (the title search) and account for it under the proposed revenue recognition guidance and account for the remaining insurance component (the indemnification component) under the insurance building block approach.

The FASB also held an education session on July 25 and a board meeting on August 1 to discuss whether charitable gift annuities should be included in the insurance model in whole or in part or instead whether a scope exception should be provided. The board decided that charitable gift annuities that possess a donation element and are issued by not-for-profit entities within the scope of ASC 958, *Not-for-Profit Entities,* should be provided a scope exception from the proposed insurance standard.

The FASB also held an education session on August 1 where they discussed disclosures and decided that further outreach with preparers and users is necessary before any decision making sessions on disclosures can be held.

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Direct response advertising

In earlier discussions on the new insurance model the FASB had tentatively decided to include direct response advertising costs meeting the criteria in ASC 340 in the scope of insurance contract cash flows (thereby effectively allowing them to be capitalized as they are under current US GAAP). However, the FASB decided to revisit this decision in light of its recent decision in the revenue recognition project that all advertising costs, including direct response advertising, should be expensed as incurred.

The FASB board rejected a FASB staff proposal that direct response advertising meeting the criteria in ASC 340, but limited to successful efforts, should be included as qualifying acquisition costs in the model. The staff proposal also recommended adding a requirement to the existing ASC 340 criteria that “no more than a trivial marketing effort has taken place after customer response to the advertising to consummate the sale.” The staff explained that this is consistent with existing SEC guidance. The staff said that under SEC interpretive guidance, the direct response advertising must provide enough information so that the customer can make a decision to enter into a contract or purchase a product in order for the advertising costs to be capitalizable. The staff proposal also recommended that to be included, an insurer would need to show that the direct response advertising results in probable future benefits.

The staff proposal to limit direct response advertising to successful efforts is consistent with the FASB’s latest thinking on an insurer’s accounting for acquisition costs other than direct response advertising. That is, under ASU 2010-26, the board concluded that acquisition costs other than direct response advertising costs be limited to those that relate to successful efforts. However, under the ASU, direct response advertising costs fall under the guidance in ASC 340, which does not distinguish between successful versus unsuccessful efforts. The staff proposal would have changed this, acknowledging that the ASC 340 guidance which includes both successful and unsuccessful efforts is outdated guidance that does not reflect the board’s current thinking.

In its discussion, the staff acknowledged that in some situations (such as television commercials), it may be difficult for companies to determine the successful efforts proportion because it is difficult to determine the total population of potential customers that the advertisement may reach. The staff also acknowledged that the economics of direct response advertising are different from other acquisition efforts and that the percentage of successful efforts to total efforts could be as low as 1%-2%. From a cost/benefits perspective, this could argue for immediate expensing.

When asked what types of business currently meet the very stringent capitalization criteria for direct response advertising in ASC 340, including the SEC’s additional guidance on the matter, the staff responded that the most common examples are one year term life insurance and hospital supplements that provide limited benefits and minimal underwriting.

In terms of the types of costs currently capitalized, the staff mentioned mailing lists, distribution of materials including newspaper advertising space and air time on television, in addition to the costs of call centers that receive the response associated with those advertisements. Later in the discussion, it was noted that if the board decided to exclude direct response advertising from the scope, the successful efforts component of costs incurred by the call centers could still qualify as capitalizable underwriting or selling costs.

The staff acknowledged the board’s decision to immediately expense direct response advertising in the revenue recognition model, but pointed out that the revenue recognition model differs from the proposed insurance model in terms of the types of allowable capitalizable acquisition costs. The revenue model requires such costs to be incremental at the contract level, while the insurance model proposes inclusion of direct costs that an insurer will incur in acquiring a portfolio of contracts, a broader category of costs.

Various board members cited their reasons for rejecting the staff proposal and deciding that all direct response advertising costs should be expensed. These included the view that any type of advertising could only be described as solicitation noting that ASC 340 was originally written for non-insurers and that the board had already decided to abandon ASC 340 as part of their revenue recognition discussions. They also argued that the determination of what is successful versus unsuccessful would either be too complex or not worth the effort (citing the staff’s example 1-2% successful efforts ratio). Some also pointed out that the added requirement that only trivial marketing effort take place after the customer response to the advertising to consummate the sale seemed to be a very high hurdle not often met.

The board overwhelmingly decided to reject the staff proposal and require that direct-response advertising costs be expensed as incurred, consistent with other forms of advertising costs.

Administratively, it was noted that when the revenue recognition guidance is effective, the direct response advertising guidance from ASC 340 would temporarily be moved into the insurance section of codification (ASC 944). The guidance would continue to be applicable for insurance acquisition costs until the insurance project is completed and effective.

Scope: Title insurance

The staff provided background on title insurance, noting that title insurers issue title insurance contracts to real estate owners, purchasers, and mortgage lenders to indemnify them against loss or damage arising out of defects in, liens on, or challenges to their title to real estate. The staff noted that title insurance compensates the policyholder for past events that existed before the contract is issued (i.e. existing defects, liens, or other encumbrances), but are not discovered until after the contract begins. The term of such contracts typically extend for the period that the insured retains an interest in the property or until the insured refinances the property.

Under current US GAAP, title insurers follow a rather unique model. Premiums for title insurance contracts are generally recognized as revenue on the effective date of the insurance contract under the theory that most of the services associated with the contract (i.e., the title search and related activities) have been rendered by that time. Recognition of premium as revenue when due is consistent with the timing of recognition of premiums for traditional long-duration contracts under US GAAP. A liability for estimated claim costs relating to title insurance contracts, including estimates of costs relating to incurred-but-not-reported claims, is accrued when title insurance premiums are recognized as revenue.

The FASB board decided that title insurance contracts meet the definition of an insurance contract and should be in the scope of the insurance contracts standard, i.e., there should be no explicit scope exception granted for them. The board also decided in a 4 to 3 vote that a title insurer would unbundle a title insurance contract into a service component (a title search service component accounted for using the revenue recognition standard) and an insurance component (the indemnification component that covers title defects that would be accounted for using the insurance contracts standard).

A large minority of board members expressed a view that the service and insurance components were so interrelated that the entire contract should be treated as insurance and questioned how the unbundling would be accomplished. In reaction to that view, the staff offered that an example of how to unbundle a title insurance contract could be included in the application guidance.

An alternative view suggested by some title insurers was that in substance, title insurance is more akin to a revenue recognition contract (a service contract) with a customer assurance warranty, both of which should fall into the scope of the proposed guidance on revenue recognition. The FASB staff described this alternative in its paper as a proposal to grant an exception for title insurance contracts.

The board members opposed to the alternative approach of treating the contract entirely under the revenue model with an assurance warranty noted that unlike a typical assurance warranty, where payment of any warranty would be limited to the replacement value of the product or service provided, the amount paid out under the indemnification provision (i.e., in the event title was later determined to be defective), could be a multiple of the premium. For this reason, they believed the indemnification was more appropriately characterized as insurance. In addition, some argued that unlike a product or service warranty which covers a defect caused by the manufacturer or servicer, the title insurance covers pre-existing defects caused by others, not the insurer.

The board's ultimate decision to unbundle the service component and treat the indemnification component as insurance could raise some issues for other industries and products. That is, it could raise concerns that any representation or warranty on a product or service that can exceed the transaction price of the product may require treatment as an embedded insurance contract. An example provided by the staff during the discussion was a surge protector, which provides protection against damage to electronic equipment well in excess of the cost of the surge protector device. However, others would distinguish the indemnification on title insurance as being unique from other product or service warranties in that it provides protection on a risk that was not created by

the insurer but that already existed, while a typical product or service warranty provides protection against defects for an item actually manufactured by a company or a service performed by a company.

Scope: Charitable gift annuities

The board held an education session on July 25 and a voting session on August 1 to discuss the potential application of the proposed insurance guidance to charitable gift annuities issued by not-for-profit entities ("NFP"). In a charitable gift annuity transaction, an individual transfers assets to a charity in exchange for a tax benefit and a lifetime annuity. As with any other lifetime annuity, when the beneficiary dies, the annuity payments cease, and the charity retains the remaining funds. The board acknowledged that these annuities would typically meet the definition of insurance, i.e., the NFP has the potential to suffer a significant loss if the donor survives longer than expected.

Assuming that a charitable gift annuity would technically meet the definition of insurance, the staff provided the board with several alternatives as to how to account for them, given that they also include a donation element. These included treating the entire contract as insurance with no unbundling (and deferring any day 1 gains), measuring the insurance liability using building block cash flows with no margin and accounting for the residual as contribution revenue under not-for-profit guidance; or unbundling the insurance, measured using the building block approach (with a single margin) based on a stand-alone selling price and accounting for the residual as contribution revenue under NFP guidance.

Another view discussed but not included in the staff paper was to provide a scope exception for these annuities. As a result, such transactions would continue to be accounted for under existing NFP guidance (ASC 958), under which the excess of the fair value of assets received and the present value of expected annuity payments are recognized immediately as contribution revenue. Subsequently, under current GAAP, assumptions used in the liability measurement are revised to reflect current market conditions, other than the discount rate which is locked in at contract inception unless the fair value option is elected.

After some discussion, the board decided to exclude from the scope of the proposed insurance contracts standard charitable gift annuities that include a donation element and are issued by a NFP that fall within the scope of ASC 958. The rationale for the scope exception given by various board members included cost/benefit considerations of changing to a model that had subtle differences in measurement from the existing model (e.g., definition of discount rate and inclusion of risk adjustment in ASC 958).

In addition, some pointed out that NFPs look at these arrangements primarily as donations with the insurance element as a byproduct. This differs from a typical insurer, which is in the business of issuing insurance contracts to generate a profit. The exception voted on by the board was purposely worded very narrowly to ensure that the exception would not be relevant for mutual insurers, or for NFPs that might choose to write insurance contracts without the donation element.

Disclosures

The FASB held an education session on August 1 on the topic of disclosures under the proposed insurance contracts standard. Disclosures had previously been discussed at a joint board meeting with the IASB in September 2011 as well as throughout the project. Both boards had previously agreed to retain many of the disclosures recommended in the IASB ED and FASB DP. They also agreed at a prior meeting not to retain the minimum disaggregation level for disclosures in the ED and DP which prohibited aggregation of information relating to different reportable segments. In addition, they had agreed that an insurer should disclose separately the effect of each change in inputs and methods to the measurement of insurance contract liabilities, together with an explanation of the reasons for the change. The boards had also agreed to yield curve disclosures for non-participating contracts.

At the August 1 education session, the staff provided the board with a paper summarizing the disclosures recommended by the staff for inclusion in the proposed insurance standard based on previous decisions. This included liability related risk and liquidity disclosures proposed under the FASB's recently issued exposure draft for financial instruments, *Disclosures about Liquidity Risk and Interest Rate Risk*. The insurance staff paper was not provided to observers.

The general reaction from board members was that while each of the recommended disclosures seemed appropriate, there was concern that the overall volume

of the proposed disclosures could lead to information overload. The board asked the staff whether they had solicited input from users and preparers on the latest staff proposal. The staff responded that they had not done so specifically with this latest package of disclosures, but that they had taken into account the many suggestions made during the comment letter process. With regard to volume, the staff noted that the current staff proposal had streamlined many of the existing US GAAP requirements as well as reflecting comments from the board throughout the entire deliberation process on the project.

The board noted that feedback from users and preparers was essential and asked the staff to organize an outreach workshop with them. Another board member suggested that as part of the preparation for that workshop, the staff should prepare actual examples, for example, for a property/casualty company and a life insurance company. Another comment made was that the proposal was unclear with regard to quarterly versus annual disclosures.

Despite the criticism that the proposed disclosures might be too voluminous, a board member suggested that an important disclosure in his view was missing—one describing an insurer's asset/liability management strategy. He noted that the financial instrument proposal requires liquidity information, i.e., the ability to meet obligations as they fall due. However, that disclosure does not deal with duration mismatch and considerations for dynamically managing such mismatches.

Based on the comments received, the board determined that the next step would be for the staff to organize a user/preparer workshop rather than to proceed to a voting session. No exact time table was provided, but the aim seemed to be September at the earliest.

The board asked an IASB staff who was observing the FASB meeting what the IASB plan was with regard to disclosures. The staff responded that the IASB was planning on discussing disclosures at its September meeting. The IASB staff also noted that much of the proposed disclosure is based on existing IFRS 4 disclosure requirements, and that unlike the FASB, they had received positive comments on the disclosure proposal, except perhaps for the requirement to disclose the confidence level to which the risk adjustment corresponds. The IASB staff noted the current plan to deliberate through October and hopefully draft a document in November.

Additional information

Questions on this summary and the FASB/IASB joint project can be directed to: Mary Saslow (860-241-7013) a Managing Director in the National Professional Services Group, who is part of both the U.S. and Global Accounting Consulting Services groups

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