

Insurance alert

FASB Education Session and Board Meeting, November 7 and 14, 2012

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

PwC summary of meetings:

- *Ceding commissions*
- *Business combinations and loss portfolio transfers*
- *Participating insurance contracts of mutual insurers*

The FASB had an education session on November 7 and a FASB only board meeting on November 14 where they discussed the accounting for ceding commissions, business combination issues and loss portfolio transfers, and participating insurance contracts issued by mutual insurance companies.

The FASB tentatively decided that ceding commissions should be netted in their entirety against the ceded premium, which is consistent with the IASB's view.

On the topic of business combinations, the board tentatively decided that for insurance contracts acquired, the single margin should be measured as the difference between the fair value of the insurance contracts assumed and the present value of expected net cash flows under the building block approach. The discount rate at the business acquisition date would be the locked-in rate used to accrete interest on the insurance liability through the income statement. Further, the board decided that insurance contracts acquired through a loss portfolio transfer that do not meet the definition of a business combination

should be accounted for as reinsurance assumed, and that insurance contracts acquired through a combination of entities or businesses under common control would apply the guidance in Topic 805, Business Combinations. The board also tentatively decided that for business combinations that occurred prior to the effective date of the insurance contracts standard, applying the transition guidance will require insurers to reallocate the purchase price attributed to the insurance contracts to the components in accordance with the decisions reached above, using the fair value guidance in effect at that date.

With regard to participating insurance contracts, the board tentatively decided to clarify that in measuring the insurance contract liability, discretionary payments to policyholders should be based on the insurer's expectations, (considering the entity is a going concern), thus resulting in equity (deficits) for mutual insurers.

Ceding commission accounting

The accounting for ceding commissions was addressed in the IASB's July 2010 exposure draft but not in the FASB's September 2010 discussion paper. The issue is whether such commissions should be:

- 1) treated as a reduction in premium ceded to the reinsurer, as the IASB has concluded;
- 2) netted against direct acquisition costs incurred in the direct insurance transaction (which is against the margin), or
- 3) a combination of both (i.e., netted against direct acquisition costs to the extent they represent recovery of those acquisition costs and then any excess netted against any ceded premium).

An argument supporting alternative 1 is that since the premium ceded amount paid to the reinsurer and the ceding commission received from the reinsurer are both part of the same contract (i.e., in substance, one net amount is due to the reinsurer), the amounts should be netted to one net premium ceded amount. Under this view, any amounts stated separately in the contract for ceded premium and ceding commission would be arbitrary.

The FASB staff noted that alternative 1 would apply whether the reinsurance was proportional (such as quota share or coinsurance) or whether it was non-proportional (such as excess of loss). Those opposing alternative 1 believe that that in the case of proportional coverage, alternative 1 would distort the ceded premium amount reported in the statement of comprehensive income and current insurance performance indicators. For example, if 50% of premiums and claims are ceded, but the ceding commission is netted with ceded premium, the premium ceded would be an amount less than the 50%.

Alternative 3 is viewed as a compromise, but has a disadvantage in that it requires an insurer to separately impute a ceding commission amount. This can be difficult, especially for non-proportional contracts without explicit ceding commissions. The staff noted that while alternative 3 is closest to what current GAAP technically requires today, she has observed that in practice today companies may not be making significant adjustments to the ceding commissions stated in the contract.

The board discussed the inconsistency of alternatives 2 and 3 with how the boards are envisioning that reinsurance will be presented in the statement of comprehensive income. Ceded premiums, ceded losses, and amortization of the ceded margin will be presented separately from the direct insurance contract.

In addition, with regard to alternatives 2 and 3, several board members struggled conceptually with the profit on the reinsurance contract impacting the profit on the direct contract and raised concerns regarding the unit of account. A board member said that he presumed that net profit recorded in the income statement would be the same under all three alternatives and that this was only an income statement presentation issue. The staff responded that the bottom line results in each period could be different between the alternatives, but no further explanation of this observation illustrating this point was offered by the staff.

There was support from several members for alternative 1 for simplicity due to the operational concerns of the other alternatives, and for the sake of convergence with the IASB. One member also questioned whether users would actually use this information and if the impact to ceded premiums would be significant. The staff noted that alternative 1 may distort the premium analytics; however, additional disclosures could be provided. The FASB voted for alternative 1 with only 1 board member objecting.

Business combinations and loss portfolio transfers

The first issue discussed by the FASB board was the accounting for insurance contracts acquired in a business combination. The issue was whether any special guidance was required beyond that already described in current GAAP for business combinations involving insurance contracts. The staff proposal was rather complicated, and included a suggestion that acquisition costs be imputed and included in the measurement of the insurance contracts acquired. The purpose of this suggestion was to allow for consistency between the accounting for purchased and originated business.

However, the board decided on a simpler approach, whereby consistent with current business combination guidance, an insurer would measure the fair value of the insurance liabilities assumed and insurance assets

acquired. The components of that fair value would then be measured as:

- a) the expected net cash flows, measured in accordance with the insurer's accounting policies for insurance contracts that it issues, using current assumptions, and using the discount rate determined at the acquisition date.
- b) the single margin, measured as the difference between the fair value of the insurance contracts assumed and the expected net cash flows determined in (a) above

A simple numerical example was provided, whereby \$545 million was the assumed fair value attributed to the insurance contracts from the total acquisition price, the present value of expected cash flows for those contracts measured under the building block approach was \$425 million, and thus the difference of \$120 million would be the estimated single margin to be recorded at the acquisition date. The chair acknowledged that the fair value attributed to the insurance contracts could be thought of as the hypothetical premium received by the acquirer for assuming the insurance contracts (i.e., effectively drawing a parallel between a business combination and an assumed reinsurance transaction). It was also noted that the discount rate at the acquisition date (estimated consistent with the insurance contracts model) would be the "locked-in" rate at which interest expense would then be accreted on the acquired insurance obligations in the income statement, consistent with the insurance contracts model. There was no discussion as to what the accounting would be in the event that the fair value attributed to the insurance contracts was less than the present value of expected cash flows discounted at the rate required by the proposal (i.e., a negative single margin).

With regard to the staff proposal to impute acquisition costs, the chair remarked that she saw this issue as similar to the issue just discussed for ceding commissions, where it was decided that such an allocation would be arbitrary and difficult to do in a transaction that was negotiated as a net consideration between two parties.

The board also decided to clarify that insurance contracts acquired through a combination of entities or businesses under common control should apply the guidance in ASC 805-10.

The board then discussed a transition issue relating to prior business combinations. The board agreed that applying the insurance guidance retrospectively will require insurers to reallocate *the components* of the fair value purchase price relating to purchased insurance contracts, consistent with the new insurance contract measurement as decided earlier in the meeting. The staff clarified that this would not impact the amount of fair value originally attributed to the purchased insurance contracts at the acquisition date. That is, fair value would be based on the authoritative literature for estimating fair value applicable at the time of the acquisition. Thus the transition adjustment would not impact other amounts in the business combination such as goodwill or other identifiable intangibles such as customer lists.

The transition issue to be dealt with would be in the allocation of the components of that fair value. For example, in the prior example, under current GAAP the fair value of \$545 million would have been allocated for a long duration life insurance contract using a net level premium method for the liability, with the balancing figure being the present value of future profits intangible asset. The retrospective application of the proposed insurance standard would result in the same \$545 million fair value attributed to insurance contracts, allocated to the insurance liability as the present value of net cash flows under the building block approach, with the balancing figure being the single margin.

Some board members noted that they had some concerns with the potential complexity of retrospective application for business combinations as well as with transition generally. They noted that their tentative decision is subject to the board's review of the cost versus benefit considerations of the overall transition guidance for the project.

Participating insurance contracts issued by mutual insurance entities

On the issue of participating contracts issued by mutual insurance entities, the question is whether the requirement to measure the present value of expected cash flows (including any participating dividends to policyholders) would result in zero equity/surplus for the mutual insurer.

View 1 is that because all surplus is eventually required to be paid out to policyholders over the life of the company, such amounts should be included in

expected cash outflows in the liability to policyholders. As a result, a mutual insurer would have no equity/surplus.

View 2 is that the liability should only reflect the amount expected to be paid out to policyholders assuming that the company is a going concern. As a going concern, the company needs to retain some permanent capital to meet minimum regulatory capital requirements, for capital growth, for budgeted expenditures not yet incurred, as well as for unforeseen risks. The present value of expected future dividends should equal the amount that the mutual insurer expects to pay to policyholders after considering the amount of surplus it expects to retain. As a result, under View 2 the company would have some equity/surplus. The policyholder relationship would be viewed as having an insurance obligation component, but also a sort of ownership relationship, where dividend payments to policyholders are discretionary and dependent on results and other capital needs and expenditures.

The FASB staff described to the board that many of the insurance contracts written by mutual insurance companies, such as whole life, term life, long term care, disability income contracts, as well as nonlife insurance contracts, are not the types of contracts to which the “mirroring” decisions would apply. Instead, a mutual insurer would calculate the amount it owes to the policyholder using the building block approach or the premium allocation approach. In the staff’s view, the “mirroring” approach is meant to be applied to contracts with a direct contractual linkage between assets and the insurance liability, such as unit-linked and variable annuity contracts.

In addition, the FASB staff believe that View 1 does not provide useful information to users because it would not provide information regarding an insurer’s underwriting results, financial strength, ability to absorb future adverse development, or available working capital to grow its business.

One board member suggested that perhaps the liability relating to policyholder dividends should only be recorded when it is declared, because before that, given the discretion the insurer has in declaring a dividend, it does not meet the definition of a liability. However, this approach would not be consistent with the rest of the insurance contracts model, whereby a liability is recorded based on expected cash flows (even though, as one board member observed, this model could be

seen by some as inconsistent with the definition of a liability under general GAAP).

A FASB board member asked the staff what view the IASB held on this issue, and it was noted that the IASB supports View 1. The IASB staff who had called into the FASB meeting described the rationale for this view, noting that in a stock company with participating policies, not all surplus is owed to policyholders, some of it is for the benefit of shareholders. However, for a mutual insurer, there are no shareholders, and therefore all of the surplus is effectively owed to policyholders.

Throughout the discussion, it was evident that the FASB board preferred View 2. However, there were some concerns raised as to how expected cash flows would be measured under the model if they were truly discretionary. One board member asked how discipline could be built into the calculation, observing that if the liability calculation was dependent on how much a particular insurer intended to retain for capital growth or other purposes, this would seem to grant significant flexibility to an insurer in determining its bottom line.

There was also some confusion as to what the FASB’s previous decision to reflect payments to both “current and future policyholders” in the expected cash flows measurement was meant to accomplish and how it fit in with View 2. The FASB staff explained that the decision to reflect payments to “current and future policyholders” was meant to deal with a different type of contract, such as a contract where a specified percentage of asset returns or insurance portfolio returns was by contract payable to policyholders. Nevertheless, the staff noted that the reference to “current and future policyholders” would not impact the calculation of the amount of expected cash flows for mutual insurers, as the expectation would be based on a dividend formula, and it is irrelevant to whom the dividends are ultimately paid.

The FASB board tentatively voted for View 2. That is, when measuring the insurance contract liability for participating insurance contracts, discretionary payments as a result of a contractual participation feature would be based on the insurer’s expectation of payments to policyholders (considering the entity is a going concern). In other words, insurers would only include what they expect to pay out in dividends to eligible participating policyholders.

The board noted that some refinement is required to the wording relating to how to limit the liability recognition to expectations about which eligible policyholders would be entitled to the dividend.

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 and Jennifer Englert (973-236-4099) a Senior Manager in the National Professional Services Group.

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