

Insurance alert

FASB Board Meeting, October 3, 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 meetings:

- *Measurement of the investment component*

The FASB board met on October 3, where they discussed further the three alternatives for the measurement of the investment component amount to be excluded from the income statement.

The three proposed measurement alternatives were previously discussed at prior education sessions and board meetings however, the board decided to defer the discussion at that time until they further reviewed the staff paper and the various examples. At the October 3, meeting they continued to discuss the pros and cons of each alternative but

only took a "tentative vote" with a plan to revisit once the "earned premium" or "premium due" income statement approach has been decided given that the alternatives were thought to have different advantages or disadvantages depending on the approach selected. The staff were also directed to perform further analysis of the alternatives under the different income statement approaches and the amount of effort required to apply them under each.

Measurement of investment component of premiums and claims/benefits

Both the FASB and IASB had decided in March to exclude “investment components” of insurance contract premiums from gross presentation as revenue in the statement of comprehensive income (SCI). Under the proposal, the subsequent repayment of these “investment components” in the form of claim or benefit payments would also be excluded from SCI. However, the FASB did not vote at that time on a measurement method for the investment component from the two alternatives presented at the joint meeting with the IASB.

In the staff’s opening remarks at the FASB only meeting on October 3, they shared with the board feedback that they received from preparers. They noted that some had asked whether the investment component exclusion from premium was meant to apply only under the building block approach (BBA), or also under the premium allocation approach (PAA). The staff responded that it would apply to contracts under the PAA approach for which the investment component definition is met, including property/casualty contracts that had provisions such as experience refunds and retrospectively rated premiums. The preparers expressed their concern that the purpose of these contract terms is not for investment return but instead for collateral and risk sharing. In addition, the preparers believe it would be unduly burdensome, especially for reinsurance contracts which tend to be unique, thereby requiring a separate calculation for each contract. In addition to the examples for the building block approach that were provided in the public handout, the staff noted that they included several examples in the paper provided to the board on how the investment component might work under the PAA approach.

The meeting then focused on the alternatives for measuring the investment component. The staff pointed out that regardless of the alternative chosen, the “bottom line” income statement impact in each period would be the same. The approaches would merely present different amounts in the various line items in the income statement, including the premium, claims, and experience adjustment lines.

The first two alternatives involve measuring the investment component as the present value of amounts the insurer is obligated to pay the policyholders or their beneficiaries either (a) “regardless of whether an

insurance event occurs” (Alternative A) or (b) “absent an insured event” (Alternative B). Alternative A was the view agreed on by the IASB at a previous meeting. The difference between the two is that Alternative A would consider the insurance amount as the amount the insured would receive in excess of the investment amount, whereas Alternative B would treat 100% of the obligatory payments relating to the insured event as attributable to the insurance component and 100% of the payments in the absence of the insured event as attributable to the investment component to determine the split. That is, no bifurcation is made of the insurance component.

The third alternative, Alternative C, would require recognition of premiums equal to the explicit or implicit cost of insurance and other fees charged to policyholder account balances. The amount of the investment component would be determined each period as the increase or decrease in the cash surrender value (or other account balance the policyholder is entitled to in the event of lapse, etc.) for the period plus the amount of actual surrenders, plus the cash surrender value implicitly included in any death benefits paid.

The staff recommended that Alternative A should be applied to determine the amount of consideration allocated to the investment component as they believe there is no insurance risk to these cash flows, that it works well when insurance contracts have multiple insured events, and that it is broadly consistent with US GAAP today for universal life contracts and other contracts with explicit account balances. However, unlike current GAAP, this alternative requires assumptions of future expected cash flows.

Board members then discussed the pros and cons of the three alternatives but only took a "tentative" vote pending the decision on the "earned premium" or "premium due" income statement approach as that may impact significantly the advantages and disadvantages of the alternatives. For example, Alternative C, relying on contractual terms rather than present value of cash flows, is thought to work best with a premium due approach (which is also based on the terms of the contract). The tentative vote was a close vote, with 3 board members supporting Alternative A and 4 board members supporting Alternative C. The board members did not support Alternative B because it did not distinguish the amount that would have otherwise been payable to the

policyholder from the total amount payable upon an insured event.

For those who supported Alternative A, they noted that the approach is consistent with the overall insurance contracts model which is also based on expected cash flows. It is also consistent with the approach the IASB voted for, and since this was such a close vote for the FASB that it would be better to have one less area of difference.

Supporters of Alternative A were also concerned about the potential front loading of premiums in Alternative C if premium is paid up front but the cash surrender value builds up over time. However, one board member noted that potential exists today for certain single premium products under current US GAAP.

In addition, supporters of Alternative A also thought it would be more difficult to apply Alternative C with an "earned premium" income statement approach. They noted that some of the perceived benefits of reduced subjectivity and complexity would not exist if Alternative C was attempted in conjunction with an earned premium approach.

For those who supported Alternative C, it was thought to produce less volatility, as it is not an expected cash

flows calculation but instead is based on contractual terms. Therefore, changes in assumptions would not impact revenue or premiums. From a practical perspective, Alternative C was also viewed as a much simpler approach to implement and they did not want to add complexity by over engineering a number that was meant to be a proxy and where the same objective could be achieved with a simpler approach. One board member also noted that Alternative C would represent the actual amount the insured would receive if they were to surrender as of the reporting date, and he felt some comfort in that, referring to it as a "calm harbor in a storm." Others, noted, however, that the entire model was built on expected cash flows, and the amount a policyholder would get upon surrender was not really a relevant measure if it did not reflect actual expectations.

At the end of the meeting, the FASB chair directed the staff to do further analysis of Alternative C under the "earned premium" approach and Alternative A under both approaches for their further consideration.

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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