

# **Insurance alert**

## IASB/FASB Board Meeting – Insurance Contracts November 30, 2011

*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.*

### **PwC summary of meetings**

November 30, 2011

- Non-discretionary performance-linked participation features

### **Highlights**

The FASB held a board meeting on November 30, 2011 where they discussed the measurement of contractual features in insurance contracts that provide non-discretionary payments to policyholders based wholly or partly on the performance of other assets or liabilities of the insurer (or the performance of the insurer itself), referred to as "the underlying items." This was a follow up discussion to the May meeting, where the FASB had tentatively concluded that such features should be measured at the present value of expected cash flows related to the contract feature, consistent with the building block approach.

At the November 30 meeting, the FASB redeliberated this issue, in part in an effort to reach convergence with the IASB view that such participating

features should be measured on the same basis as the underlying items in which the policyholder participates to avoid accounting mismatches. The FASB decided that the obligation due to the performance-linked participating features should be measured based on an insurer's current liability (i.e., the contractual obligation incurred to date) adjusted to eliminate accounting mismatches that reflect timing differences between the current liability and the measurement of the underlying items in the U.S. GAAP/IFRS statement of financial position that are expected to reverse within the boundary of the insurance contract. The FASB described this as analogous to the recording of deferred taxes for the difference between regulatory tax basis and accounting book basis of assets and liabilities.



Although the detailed wording of the FASB's revised November view differs from wording used by the IASB in describing its position, the staff later described the views as now being substantially equivalent (i.e., the liability is based on the measurement basis of the underlying items in the US GAAP or IFRS statement of financial position).

The FASB also decided that any changes in the liability for the performance-linked participating feature should be presented in the same way within the statement of comprehensive income (i.e., consistently in net income and / or other comprehensive income) as the changes in the underlying item.

### **Non-discretionary performance-linked participation features**

The FASB staff noted that contracts with non-discretionary participation features included those issued by mutual insurance companies and those issued by former mutual companies that were now included in the demutualized company's "closed block" of business. Universal life insurance contracts and other contracts that provide for discretionary crediting were not included in the current discussion. The staff also clarified that the discussion was limited to the non-discretionary participation feature offered in such contracts and not other options and guarantees which would require separate consideration.

In many cases in the U.S., the participation feature is based on the statutory value of the underlying item (e.g., amortized cost of a bond or real estate). The staff proposed that the measurement of the participation feature in the GAAP financial statements should start with the obligation incurred to date relating to the contractual feature, referred to as a "bottom up" approach. In contrast, the May discussion was a "top down" approach that focused on the present value of expected cash flows related to the contractual feature.

Under the "bottom up" approach, after determining the obligation incurred to date based on the contract (e.g. using the statutory basis for the underlying item), the entity would then determine how the underlying item is accounted for under GAAP. If there is a difference between the contractual measurement basis for the participation feature (e.g. statutory amortized

cost) and the GAAP measurement basis for the underlying item, an adjustment would be made to the obligation to reflect this difference if it is deemed to be a timing difference that will reverse during the life of the insurance contract.

For example, assume the performance-linked participation feature shares 90% of the statutory measurement of a fixed maturity security. Suppose also that for GAAP purposes, the security is measured at fair value. Further assume that the estimated duration of the contract with the participation feature is greater than the estimated duration of the debt security. The calculation of the obligation due to the performance-linked participating feature would (1) be measured based on an insurer's current liability (i.e., the contractual obligation incurred to date using statutory book value of the investment) (2) adjusted to eliminate accounting mismatches resulting from the difference in measurement between the amortized cost (statutory) and fair value (GAAP) measurement of the security. Any changes in the liability for the performance-linked participating feature would be presented in the same way within the statement of comprehensive income (i.e., consistently in net income and / or other comprehensive income) as the changes in the underlying item.

In contrast, if the underlying was measured at book value for purposes of the participation calculation (e.g. assume the underlying is real estate measured at amortized cost for statutory purposes) and for GAAP, the liability relating to the participation feature would be based on the book value of the real estate.

The FASB staff described this proposed accounting as consistent with current U.S. GAAP accounting for participating features.

The staff noted that they had considered, but rejected, the idea of adjusting the assets to a measurement that would be consistent with the liabilities (current value).

They reasoned that the obligation for the participating feature is the dependent variable in the equation (e.g., dependent on the asset return), and it would not make sense to measure assets supporting participating contracts on a different basis from those same assets supporting other products.

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Several board members asked whether the staff thought this measurement approach for participating features was consistent with the building block approach (which estimates the present value of expected cash flows and is essentially a "current value" measurement). The staff replied that although there was no actual projection of various cash flow scenarios and discounting back, they believed it was consistent with the "spirit" of the building block approach (even though it was acknowledged that the underlying, and hence the liability, could potentially be at amortized cost). The staff also pointed out that if an adjustment is not made to the liability to reflect any difference between the participating feature measured using the contractual participation crediting (e.g., amortized cost of the underlying) and the U.S. GAAP basis for the underlying (e.g., fair value), this could result in over or understatement of equity.

The board supported the staff's recommendation that the obligation due to the performance-linked participating features be measured based on an insurer's current liability (i.e., the contractual obligation incurred to date) adjusted to eliminate accounting mismatches that reflect timing differences between the current liability and the measurement of the underlying items in the U.S. GAAP/IFRS statement of financial position that are expected to reverse within the boundary of the insurance contract.

At a future meeting the boards are expected to discuss how and whether the obligation to current versus future policyholders might be disaggregated for presentation purposes (e.g., for mutual insurers).

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## ***Additional information***

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

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