

## Insurance alert

### FASB Board Meeting, May 23, 2013

*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 summaries 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 meeting:**

- *Cost-benefit analysis*
- *Authorization to ballot*

#### **Highlights**

The FASB held a board meeting on May 23, 2013 where they discussed the costs, benefits and complexities associated with the proposed changes to accounting for insurance contracts. The board directed the staff to proceed with the final drafting of an exposure draft, which the board will then vote on by written ballot. An exposure draft is expected to be issued by the end of June, with a public comment period of 120 days. The FASB intends to hold roundtable discussions with constituents after the public comment period has ended.

The staff summarized for the board those areas likely to result in increased costs and efforts for preparers, including personnel and systems costs. While acknowledging these costs, the staff also pointed out the benefits of the proposal for a new comprehensive current value accounting standard for insurance contracts. These benefits include replacing the multiple accounting models that exist under current U.S. GAAP with two basic models (the building block approach (BBA) and the

premium allocation approach (PAA)), including all costs of fulfilling the obligations to policyholders, moving to a current measurement model, and more faithfully representing the time value of money element of insurance contracts, including short-duration insurance contract liabilities.

Board members had an active discussion on several issues, including the benefits of a new model in light of the potential costs, complexities and lack of convergence with the IASB proposal. Several board members highlighted concerns raised by analysts about the requirement to discount cash flows for short duration contracts under the PAA approach. The board also discussed concerns with the scope exceptions and how non-insurers would interpret and apply them.

Two FASB board members who expressed significant concerns with the proposal are expected to provide their own alternative views to the proposal.

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## Costs, benefits and complexity analysis

### *Staff background*

The staff noted that while there is comprehensive insurance guidance in the U.S., it is only applicable to insurance entities and has evolved into several separate models over many years as products have evolved. The staff believes that the proposed update would eliminate diversity between insurers and non-insurers that write products with similar risks, offer more comparability across the insurance sector, and provide investors with more relevant, transparent, current information. The staff described the benefits of the FASB proposal to the board in more detail as described below.

The proposed update would replace the multiple accounting models currently in place with two models, the BBA and the PAA. The staff acknowledges that while there are significant differences between the BBA and PAA models, many analysts focus on either the life business (which would primarily be accounted for under the BBA), or property and casualty business (which would primarily be accounted for under the PAA). Therefore, the differences in the models should not impact the analysts' analyses.

The proposal would include all costs associated with fulfilling an insurance contract within its measurement. The staff commented that under existing U.S. GAAP, certain options, guarantees and other terms may not be captured in the models, or may be recognized over time rather than currently. The staff acknowledged that there may be potential implementation and ongoing costs associated with this aspect of the model, particularly for those issuing universal life insurance or other products where insurance liability measurement today is not based on expected future cash flows. While cash flow projections are required today for purposes of estimating gross profits in order to amortize deferred acquisition costs, the staff noted that projections may need to be applied with more rigor when used to estimate cash flows in the measurement of the net insurance liability (or asset).

The staff pointed out that the BBA's requirement to separate estimated future cash flows from the margin would provide greater transparency to users, and that requiring insurers to utilize updated assumptions each reporting period would also serve to improve transparency and provide more relevant information.

The staff acknowledged that updating assumptions every quarter would require notable additional effort, particularly for actuaries.

The staff also noted that requiring discounting for short-duration contracts would be an improvement over existing U.S. GAAP. In response to some concerns around the costs associated with this, the staff noted that discounting is already being employed to some degree by insurers (e.g., certain types of insurance liabilities, and for income tax calculations) and that some insurers could leverage information from loss triangles to develop estimates of the expected timing of claims. The staff also noted that the practical expedient would not require discounting for claims paid within 12 months of the incurred date.

Expanding the scope of the project to include non-insurers was also cited as a potential benefit as the staff believes that this would require entities to account for products that have similar economics in a consistent manner. The staff acknowledged that non-insurers may incur significant costs relating to understanding the new model and building systems to comply with it. However, the staff believes these costs are warranted given that it would improve comparability and consistency. In addition, various scope exceptions were added to avoid cost and disruption to non-insurers where the board saw no significant benefit, such as service contracts meeting specified criteria and "one-off" guarantees.

### *Board discussion*

The board had an active discussion on the cost-benefit and complexity analysis. One board member expressed serious concerns with the significant costs of implementing a new standard as well as with the high degree of complexity of the proposal. He later advised the staff that he would be writing an alternative point of view to the exposure draft, hinting at his potential dissent in the written ballot. The board member noted that it would be much easier to accept a new model if the FASB and IASB were converged. However, if there is not a converged model, he commented that the increased costs of implementation and disclosure may not outweigh the benefits. He specifically cited the PAA model that would be required for property/casualty contracts, and suggested that perhaps less extensive, more targeted changes be made to the existing short duration model.

Two other board members brought up the point of convergence, with one noting that he was not “giving up hope” of a more converged solution and the other expressing a view that the FASB and IASB can get closer on convergence. However, one board member noted that even in areas where the IASB and FASB have reached a converged principle, in practice companies applying IFRS and U.S. GAAP may not be converged. For example, he indicated that he is hearing informally that there may not be a converged application of the discount rate principle.

A common theme expressed by at least three board members was that while discounting for the time value of money was theoretically appropriate, they had heard significant feedback from users that the current short-duration model is not broken. Thus, requiring costly changes may not be worthwhile. A board member noted that users today specializing in the insurance industry take undiscounted cash flow information and apply their own discounting techniques. Thus, one board member questioned whether the requirement to apply discounting would actually result in more work for users who had already developed models starting with nominal cash flows. The staff responded that they did not think this would be the case. For users who wanted to continue to use their current models and discount their own cash flows, there would be even more information readily available to them given that proposed disclosures would include undiscounted cash flow information by time period.

A board member who enthusiastically supported the proposal, including the requirement to discount all insurance liabilities, noted that providing discounting is a step forward in that it would put those users who did not typically have the models available to discount on more equal footing with those that do. He noted that while there was inertia by some users causing them to want to keep existing approaches to analyzing data, the analyst community in general would see significant benefits from the new, more transparent discounted information being provided.

One of the FASB members who later noted that he would be providing a written alternative point of view in the ED said that he thought the proposal should have further highlighted the differences between the BBA and PAA approaches. He expressed a view that the PAA is clearly in line with the revenue proposal, where revenue is recognized as performance obligations are satisfied and costs are recognized as incurred. He described the BBA model as a “super

matching” model that smoothes margins rather than recognizing them as they naturally occur. He also seemed opposed to the fact that costs that he would describe as period costs, such as asset management and certain administrative costs, would be included in the margin calculation rather than expensed as incurred.

The board also discussed the scoping of the project. A few board members expressed concern around the number and complexity of scope exceptions and whether the right cut and description had been made in terms of what would be in versus out of scope. A board member indicated that non-insurers have expressed concerns about being scoped in, and thus requested the staff to perform additional outreach on this topic. One board member suggested that perhaps an easier way to address scope was to require insurance accounting for transactions that met the description of insurance at the reportable segment level.

In terms of complexity, one board member also expressed concerns related to transition in general as well as when it is applied to previous business combinations. He questioned whether companies could comply with the standard the way the board intended. He also cited the complexity of the earned premium approach. He noted that while constituents wanted volume information, in the BBA model, liability measurement is the driver. Thus, the revenue amount arrived at for the BBA would not be comparable to revenue shown in other industries.

One board member said that with regard to discounting in the BBA model, he would have preferred that the discount rate reflect the rate inherent in contract pricing. This would be less volatile than a market interest rate. He noted that this would be similar to how banks discount their loan portfolios for purposes of fair value disclosure, using a sort of entry price.

### **Authorization to ballot**

The FASB board voted unanimously to give the staff authorization to proceed with the final drafting of an exposure draft, which the board will then vote on by written ballot. An exposure draft is expected to be issued by the end of June, with a public comment period of 120 days.

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Two board members seemed very supportive of the entire proposal. A few indicated that there were some specific aspects of the project which they liked (such as current value and having two models – BBA and PAA) and some aspects that they would agree with in the hope of a more converged solution with the IASB.

However, two board members indicated that they each would be presenting an alternative view, implying their potential dissention, as described in the preceding section of this summary. In addition, another board member indicated that he has struggled more with this project than any other. He noted that a significant majority of U.S. investors have expressed significant opposition to many of the fundamental concepts in the BBA and PAA approaches. While this gives him pause, he recognizes that one of the key objectives of this project was to reach a converged solution, and he is not giving up hope of convergence or at least getting closer.

The board agreed that after the exposure draft has been issued, and the response letters have been received, the FASB would host public roundtables in order to obtain further input from interested constituents.

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## **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 or Chris Filiaggi (973-236-5358) a Senior Manager in the National Professional Services Group, who is part of the U.S. Consulting Services group.

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