

Sharing insights on key industry issues

IASB/FASB Board Meeting – Insurance Contracts

PwC Summary of Meetings –October 20, 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 meeting:

- *User outreach update*
- *Scope: fixed fee contracts*
- *Statement of comprehensive income*
- *Statement of financial position*
- *Premium allocation approach*

Highlights

The IASB and FASB held a joint Board meeting on October 20, 2011 where they discussed four topics; the scope exclusion criteria for fixed fee service contracts, the information to be provided either on the face of or in the notes to the statement of comprehensive income and statement of financial position, and the eligibility criteria for applying the premium allocation approach. In addition, the staff provided a summary of user outreach activities since the June 2011 efforts.

The boards approved the latest staff proposal to exclude from the scope of the insurance contracts proposal fixed-fee contracts that provide service as their primary purpose if they exhibit all three specified characteristics, subject to some redrafting.

With regard to the statement of comprehensive income (SCI), there was general consensus by both boards that where insurance contracts are a significant part of an entity's business, volume information needs to be presented on the face of the SCI. Therefore, the boards agreed that if insurance contracts are a significant part of an entity's business, then at a minimum, premiums, claims and underwriting margin should be shown on the face of SCI. Where insurance contracts are a minor part of an entity's business, presentation of underwriting margin on the face of SCI would be sufficient.

The boards voted on various issues regarding presentation of insurance contract liability (or asset) balances. They agreed on the components of the insurance asset or liability that should be presented either on the face of the statement of financial position or in the notes. They also agreed that the two components of the premium allocation approach (PAA) liability, the claim liability and liability for remaining coverage, should be separately presented on the face of the statement. The boards agreed that consistent with current practice, there should be gross presentation of conditional rights to premiums under the premium allocation approach (PAA). They voted for separation of the building block approach (BBA) and PAA liabilities (or assets), and separate presentation of portfolios in net asset positions from those in net liability positions.

The board asked the staff to redraft the criteria for PAA eligibility and apply this to various contract types as the criteria proposed by the staff could lead to different results.

Summary of recent user outreach

The staff provided a summary of user outreach activities since the June 2011 efforts. The outreach included both buy and sell side analysts globally. Outside of the U.S., users expressed an urgent need for a global standard, given the current lack of comparability under IFRS 4, with diversity in practice regarding acquisition cost capitalization given as an example. They continue to describe the current insurance reporting as a black box and welcome a new standard that will provide more comparability and transparency, even if it means issuing a standard that may differ from the ultimate U.S. standard.

From a U.S. perspective, there was concern expressed with the perceived lack of response to user comments, which one FASB board member attributed to a potential lack of familiarity with the FASB's process. In terms of technical issues, U.S. users have concerns with the measurement model, especially with the subjectivity involved in management assumptions, and many are also concerned with unwarranted accounting volatility in the income statement that a current value measurement will yield. Many still believe that the U.S. short duration model should be retained for non-life contracts, including non-discounting of liabilities, as users would prefer to have the nominal cash flows available to them for their own modeling.

The staff summary of various user comments was consistent with the prior outreach activities on topics including concerns with accounting volatility (but acceptance of economic volatility), the need for volume information on the statement of comprehensive income or in the notes, and the need for detailed disclosures of inputs and explanations for changes in estimates considering the large amount of management judgment going into the model.

A FASB board member suggested that in soliciting and analyzing user comments, the staff and boards should understand various users' objectives and strategies, noting that while sell side analysts may value consistency in results from period to period, others, such as some buy side analysts, "thrive on" transparent disclosure of volatility.

Scope: fixed fee service contracts

The exposure draft (ED) and discussion paper (DP) proposed a very broad definition of insurance contracts: "A contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain event adversely affects the policyholder."

As discussed in the proposals, this definition would scope into the insurance contracts standard certain fixed fee service contracts that today utilize a revenue recognition model which the boards believe is an appropriate model that provides relevant information to users. The staff acknowledged that many service contracts that might be scoped into insurance could still meet the premium allocation approach criteria, but nevertheless noted that the revenue recognition model would still be less complex to employ. The ED and DP therefore proposed the exclusion

of fixed fee service contracts for which the level of service depends on an uncertain event if the primary purpose of the contract is provision of services. Many respondents to the proposals agreed with the intention of the exclusion but were concerned that it is difficult to determine whether the primary purpose of some fixed fee contracts is the provision of service.

In an attempt to clarify the exclusion, the latest staff proposal is that the proposed insurance contracts standard should exclude from its scope fixed-fee contracts that provide service as their primary purpose if they exhibit all of the following characteristics:

- (a) contracts are not priced based on an assessment of the risk associated with an individual customer;
- (b) contracts typically compensate customers by providing a service, rather than by paying cash; and
- (c) the type of risk transferred relates mostly to the over-utilization of services.

The staff emphasized that the three criteria are not indicators but are requirements; they believe this is necessary given that certain insurance contracts might meet two of the three criteria. A FASB member noted that the term "over-utilization" was a bit colloquial and suggested that the third criterion instead refer to risk of a higher than expected frequency of events. However, an IASB member noted that the term "frequency" risk was a recognized insurance term and thus careful consideration was needed as to whether this term should be used in describing a scope out from insurance.

The staff noted that another way to look at the third criterion was to determine whether the labor component was driving the cost (which implied a service), versus materials/parts of the repair driving the cost, which could imply insurance. The staff did not directly address how this labor/service notion would be applied to healthcare contracts, which typically would involve mostly labor and minimal "parts" in many cases. However, an IASB member asked how a healthcare contract that provided hospital care to a group of individuals for a fixed fee (including major surgical procedures such as bypass surgery) would be classified; the staff responded that it would be considered insurance given that hospital procedures were expected to have more severity risk than frequency risk. Another IASB member requested that the "over-utilization" criteria be clarified, because he was unclear why insurance applied in this example as compared to the capitation example in the staff paper, which noted that a fixed fee contract to provide services between a doctor and an insurer would not typically be considered insurance.

To assess her understanding of the criteria, an IASB member asked whether windshield replacement coverage in which the insurer actually did the windshield replacement in their own shop would be considered insurance or a service. She believed it was insurance and the staff agreed, based on the fact that there was severity risk. In contrast, if the only coverage the insurer provided was towing service to a garage, then that would be considered a service.

Another question arose on towing services: if the writer of the roadside assistance contract charged a different price for a two year contract versus a 10 year contract, would that mean that the contract was priced at the individual contract level and therefore failed to meet one of the exclusion criterion? The staff response was that it would still meet the exclusion criteria.

The staff was asked if they had considered a broad range of contracts for unintended consequences, and the staff noted that their analysis of 15 different contract types revealed no such unintended consequences. The staff described the sequence of steps involved in an analysis of warranty contracts, noting that manufacturer and dealer warranties would be covered by the revenue recognition standard. With regard to third party warranty contracts, while these were scoped out of the revenue recognition proposal, and thus would need to be analyzed under the insurance proposal, if they met the three fixed fee service exclusion criteria, they would end up getting kicked back into the revenue standard. Whether the three criteria would be met would depend on the terms of the warranty contract; for example some might meet the first two criteria, but in some contracts there might be substantial severity risk, resulting in insurance classification.

An IASB member asked whether the purpose of the exclusion was a practical expedient, or a requirement. For example, an insurer might have a warranty subsidiary that issues warranty contracts that, when put through the staff's criteria, might be considered a service, but at the consolidated level, the insurer would view them as another form of insurance and might prefer to use the insurance model. The staff acknowledged that they had not yet considered the consolidated versus separate subsidiary accounting ramifications of the scope exclusion, and gave another example of a situation where a manufacturer of a product might write extended warranty contracts out of a wholly owned subsidiary, which, due to severity risk, might be classified at the subsidiary level as insurance, but in consolidation would meet the manufacturer scope exclusion.

The boards approved the staff proposal, subject to some redrafting to provide clarification, including taking concepts from paragraphs 35 and 56 of the staff paper, that further describe distinguishing characteristics between insurance and service contracts.

Statement of Comprehensive Income (SCI)

The staff acknowledged the overwhelming comments from preparers and users that volume information needed to be incorporated into the SCI, as compared to the ED which proposed a summarized margin approach. The latest staff paper listed the components of income that the staff believe should be disclosed on either the face of the SCI or in the notes, and there was general agreement by board members with this list. The discussion was therefore focused on which particular components should be the required minimum captions on the SCI.

The components that would be required to be shown in either the SCI or the notes would include detailed components of the building block approach (BBA) and the premium allocation approach (PAA). For the BBA, this would include the underwriting margin, along with the following components of the BBA underwriting margin: the total difference between actual and expected cash flows, showing separately actual premiums received and expected premiums due, actual benefits paid and expected benefits, actual expenses paid and expected expenses; the change in expected future cash flows; the release of the single margin (for the FASB); the change in residual margin (for the IASB); the change in risk adjustment (for the IASB); and any losses on initial recognition of an insurance contract.

For the PAA this would include the PAA underwriting margin and the following components of the PAA underwriting margin: premiums earned; claims incurred, showing separately costs incurred for new loss occurrences during the period, difference between actual and expected cash flows, changes in expected future cash flows, changes in the additional liability for onerous contracts; claims adjustment expenses incurred, showing separately costs incurred for new loss occurrences during the period, difference between actual and expected cash flows, change in expected future cash flows, changes in the additional liability for onerous contracts; amortization of acquisition costs; the change in risk adjustment for the liability for incurred claims (for the IASB); and any losses on initial recognition of an insurance contract

In terms of whether the above amounts should be shown on the face of SCI or in the notes, the staff proposed two alternative views: Recommendation A would disclose the underwriting margin, either in aggregate for all insurance contracts or separately for contracts measured under the BBA and PAA. For insurance contracts measured under the BBA, the insurer would present as a minimum on the face premiums due, expected benefits and expected expenses, either in aggregate or separately, and any losses at initial recognition. In addition, for insurance contracts measured under the PAA, the insurer would present as a minimum on the face premiums earned, claims and claims adjustment expenses incurred, either in aggregate or separately, and any losses at initial recognition.

Recommendation B would be less prescriptive, with no required volume information on SCI other than the BBA underwriting margin. There would be no prescribed captions for the PAA.

An IASB member proposed an alternative approach that would look more like a traditional income statement, with premiums and underwriting margin (aggregated on the face for BBA and PAA) being required minimum captions

on the face, but with additional captions permitted including claims incurred, expenses, variations in cash flows and cash flow forecasts, acquisition costs, investment income, and interest accretion on insurance liabilities. The "premium" amount for BBA contracts would be a derived number arrived at by taking cash premiums received adjusted for certain changes in the insurance liability.

Several FASB members objected to the inclusion in "premiums" of a BBA number that was a derived cash premium plus change in liability, fearing that it would be misleading to readers, implying, by aggregation with PAA premium that it represented "earned premium." The IASB member's rebuttal was that even if it were not a good representation of earned premium, the approach had the practical advantage of making the presentation a more traditional revenue and expense format. Various FASB members responded that by its nature, the BBA approach was a margin approach, not a revenue recognition approach, and thus it was impossible to try to turn BBA results into a revenue and expense presentation. It was also pointed out that premium inflows for life contracts were often more than just revenues and could include deposit, option, and guarantee elements. The staff pointed out that unbundling would be addressed at a future meeting.

By their remarks, it was evident that most of the FASB board members still considered the BBA and PAA approaches to be two different models for two different types of contracts. In contrast, remarks from several IASB members supported the previous IASB view that the approaches were two different methods of coming up with the same number rather than two different business models. An IASB member noted that nowhere else in accounting is there separate presentation in the income statement based on how the underlying amounts are calculated (e.g., Level 2 and Level 3 fair value estimates are not separated on the face of the income statement). Another IASB member suggested that perhaps the term revenue needed to be better defined for insurance contracts.

There was no consensus reached on how to calculate a number for the BBA that might appear as "premiums" on the face of SCI. The staff noted that they had addressed this question in a previous paper and, similar to the current IASB board member's proposal, could only come up with derived amounts for which there was a good degree of scepticism as to whether the number was meaningful. The staff agreed to go back and consider the latest proposal by the IASB board member for the calculation of BBA premium.

Nevertheless, because both users and preparers had overwhelmingly requested premium volume information on the face of SCI, there was general consensus by both boards that where insurance contracts are a significant part of an entity's business, volume information needs to be presented on the face of SCI. Therefore, the boards agreed that if insurance contracts are a significant part of an entity's business, then at a minimum, premiums, claims and underwriting margin should be shown on the face of SCI. Where insurance contracts are a minor part of an entity's business, presentation of underwriting margin on the face of SCI would be sufficient. The second issue of whether any gross amounts should be separated between BBA and PAA or aggregated was not resolved. The staff agreed to research once again whether a meaningful number (and one that was comparable to earned premium under the PAA) could be determined for premiums under the BBA such that aggregation of the two amounts on the face of SCI would result in an "apples to apples" presentation rather than "mixed fruit".

Statement of Financial Position

This issue covered presentation/disclosure of components of the insurance asset or liability, the two components of the PAA liability, gross versus net presentation of conditional rights to premium, separation of the BBA and PAA liabilities (or assets), and separate presentation of portfolios in net asset positions from those in net liability positions.

The boards agreed with the staff proposal that insurers should disaggregate the following components, either in the statement of financial position or in the notes, in a way that reconciles to the amounts included in the statement of financial position: expected future cash flows, the risk adjustment (for the IASB), the residual margin (for the IASB), the single margin, where relevant (for the FASB), and the effect of discounting.

However, during the course of this discussion, a FASB member proposed that, despite the previous board decision to include direct acquisition costs as part of net cash flows in the net liability (or asset) valuation, that direct acquisition costs instead be presented as a separate asset (as deferred acquisition costs). Various FASB members seemed to support this proposal as more consistent with the revenue recognition model, and providing a better indication of the volume of the business written. In addition, it was argued as being a more intuitive result to show an insurance liability (and separate DAC asset) rather than a net insurance asset in situations where the net cash outflows in the early years of a portfolio of contracts due to high initial acquisition costs were greater than premium inflows.

IASB members generally disagreed with this proposal, noting that it represented a fundamental change to the agreed upon model, which is based on net cash flows and not an accrual and deferral model. If acquisition cost information was deemed important, it could be provided in the notes. A suggestion was made by an IASB staff member that perhaps the gross up on the statement of financial position could be achieved without changing the bottom line in SCI by merely amortizing the DAC using the same methodology as the amortization of the residual or single margin. However, this could be complex in the event that the IASB proceeded with their proposal to unlock the residual margin for changes in cash flow estimates.

The proposal was put to a vote, where a small minority of the IASB agreed to it and a majority of the FASB agreed to it. The FASB staff noted that they would pursue the idea to see if it was viable.

Board members also were asked whether, for those contracts measured under the premium allocation approach, the liability for remaining coverage should be disclosed separately from the liability for incurred claims. FASB members reiterated their belief that the claim liability was different in nature from the "stand ready" liability for remaining coverage. Both the FASB and the IASB voted in favor of separate presentation for these two liabilities on the face of the statement.

The staff also asked the boards to consider a change to the ED and DP whereby conditional rights to any premium measured under the premium allocation approach would be netted against the liability. Only unconditional rights to any premium (i.e., where the insurer is entitled to payment because coverage has already been provided or would be entitled to it in the event of contract termination) would be shown separately as an asset. This would be a change from current practice for short duration contracts, where these amounts are presented gross. For example, for an annual contract with \$1,200 in premium which is payable in monthly \$100 instalments, industry practice today is to record the entire \$1,200 as a premium receivable with a corresponding unearned premium. However, because the policyholder can cancel, the amount is really a conditional receivable and, under the revenue recognition model and staff proposal, would not be recorded gross as a receivable and unearned liability.

Despite the departure from the revenue recognition project conclusion, a majority of the FASB and IASB voted to retain the presentation of these conditional rights as assets. The rationale was that gross presentation provided better information by showing a liability for the unconditional obligation to provide coverage.

The boards were also asked whether they would support a requirement to present contracts measured using the building block approach separate from those measured using the premium allocation approach on the face of the statement of financial position. The FASB members easily supported this approach, given their belief that these were two separate models. At first the IASB voted against the requirement for separate presentation of these contracts on the face. However, it was pointed out that this vote seemed inconsistent with the prior two votes whereby the claims liability and unearned liability components of the PAA would be shown separately, as would the conditional receivable for PAA contracts. A re-vote was taken and the IASB agreed with the proposal.

Because there was some confusion in the ED and DP, the staff presented revised wording on portfolio aggregation that would clarify that portfolios in an asset position should not be aggregated with portfolios in a liability position in the statement of financial position. Both boards supported this proposal.

Allocation Approach: Eligibility criteria

The focus of the discussion was on determining the eligibility criteria for the PAA. However, unlike prior approaches, where the BBA was assumed to be the default, the new approach would start with the PAA. Under the staff proposal, insurers would apply the building block approach rather than the premium allocation approach to portfolios of contracts when either of the following applies:

- a) the building block approach provides more relevant information for these portfolios than the premium allocation approach, relative to the cost of providing that information.
- b) it is difficult to allocate the premium for the contract in a reliable and rational manner.

The staff paper also stated that some staff would also recommend that, for portfolios of contracts in which most of the contracts' coverage periods are approximately one year or less, insurers should always be permitted to measure the liability for remaining coverage (the pre-claim liability) using the premium allocation approach as a proxy for the full building block approach. However, this proposal was not discussed at the meeting.

The staff paper noted that criterion (a) above might be the case if the portfolio of contracts has either of the following features:

- (i) The expected cash flows before the claim is incurred are expected to vary significantly over the coverage period (for example, the contract contains options and guarantees that significantly affect the variability of cash flows based on changes in market factors) and such variance is not expected to result in recognition of an onerous contract adjustment; and
- (ii) (for the IASB) the risk in the contract associated with the liability for remaining coverage has the potential to vary significantly.

The staff paper indicated that criterion (b) might be met where:

- (i) it is difficult to determine the amount of the premium to allocate to reporting periods, for example because the contract contains significant deposit elements that are not unbundled.
- (ii) There is significant uncertainty about the length of the coverage period, for example because the contract includes options for renewal.
- (iii) It is difficult to identify and separate the insurers' obligations to the policyholder arising from the contract, for example contracts where the expected payments to policyholders are affected by complex interdependent options.

A FASB member commented that the way that the criteria are currently written, they could be interpreted as requiring the BBA approach be applied to many non-life contracts (since these tend to have more chance of a change in expected cash flows or risk), and the PAA approach be applied to life contracts (which typically have lower variability).

The staff responded that this concern with life contracts had prompted them to revise the proposal to indicate that the analysis be done at the individual contract level rather than at the portfolio level, since, while mortality tables might prove consistent on a portfolio basis, there was still a chance that mortality could vary significantly for any individual. Examples of contracts where cash flows and risk were not expected to vary significantly also included homeowners and auto policies. There was some question raised by board members as to whether catastrophe covers would make it into the PAA approach. The staff paper seemed to indicate that they would, given that there is little advance notice of events such as earthquakes and hurricanes such that there would be few changes in expectations of cash flows before the insured event occurred.

Following that logic, a FASB member noted that a life insurance contract has low variability because there is little chance the insurer would change the expectation about death prior to its occurrence. An IASB member concurred, noting that one could make a good expectation of life expectancy using mortality tables. Another FASB member pointed out that even a one year homeowner's policy is cancellable (similar to non-renewal of a life policy), such that it could be interpreted as having "significant uncertainty about the length of the coverage period" and therefore subject to the BBA rather than the PAA.

Although the boards seemed to support the objective of the staff proposal (i.e., to establish principles for determining those contracts eligible for the PAA approach that would result in classification similar to existing industry practice for short duration contract classification), the discussion revealed different interpretations of the criteria. One board member indicated his concern that without further clarification, the interpretation of the existing criteria could lead to "drastically different results." Therefore, the boards directed the staff to redraft the criteria, and to include examples of various contract types and the logic behind their classification as BBA or PAA. One board member suggested that to test the criteria, each board member be given descriptions of 6 contracts which they would then attempt to classify using the revised criteria.

In redrafting the criteria, the staff agreed to focus on four main components, all of which were described in some form in the staff paper: significant variation in cash flows that could result in changes in the mean, significant variation in the risk adjustment, the impracticality of determining the amount of premium to allocate, and significant uncertainty in the length of the coverage period.

Additional information

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

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