Insurance alert

IASB/FASB Board Meetings – Insurance Contracts May 16-24, 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.

PwC summary of meetings

- *Unbundling and disaggregation*
- *Use of OCI for discount rate liability changes*
- *Acquisition cost presentation*
- *IASB risk adjustment and residual margin*

Highlights

The FASB and IASB held education sessions as well as joint board meetings in May to discuss a number of topics.

On the topic of unbundling, the boards decided that if an investment component is distinct, an insurer would unbundle it and apply the applicable IFRS or U.S. GAAP to the investment component. An investment component would be considered distinct if the investment component and insurance component are not highly interrelated. Indicators that an investment component is highly interrelated with an insurance component would include (1) a lack of possibility for one of the components to lapse or mature without the other component also lapsing or terminating (2) situations where the product is not separately sold in the same market or jurisdiction or (3) situations where the value of the insurance component depends on the value of the investment component or vice versa. These circumstances are expected to be uncommon.

The boards also reconfirmed their previous positions on unbundling embedded derivatives and distinct goods/services components, and on disaggregating investment components for income statement presentation purposes in situations where there is an amount that the insurer is obligated to pay to the policyholder regardless of the insured event.

The board and staff also voted to require the use of other comprehensive income (OCI) for reporting changes in the insurance liability arising from changes in the discount rate. However, changes in interest sensitive features resulting from changes in interest rates, such as options, guarantees, and surrenders, would be recorded through income. The rate used to record interest expense in the income statement would be the rate locked in at contract inception for all future estimates of cash flows for that contract. The boards agreed that a loss recognition test would not be required.

On the issue of acquisition cost presentation, one issue discussed was whether expected direct acquisition costs should be shown as an intangible asset or as part of the insurance liability.

The IASB voted to show it as part of the insurance liability. The FASB noted that while they conceptually viewed it as an asset they could support an approach that would instead net it against the margin component of the insurance liability in an effort to reach convergence. With regard to income statement presentation, the FASB rejected a new staff proposal to record direct acquisition costs as immediate expense when " incurred" with an offsetting amount of revenue. The IASB decided to wait until the overall income statement presentation proposal was ready for discussion to address this issue.

In an IASB only session, the board voted in favor of retaining the IASB's tentative decisions to include an updated explicit risk adjustment, with changes in risk adjustment taken through profit and loss. The majority also voted in favor of offsetting in the residual margin changes in estimates of future cash flows, in line with IASB's tentative proposals.

Unbundling and disaggregation

In March the boards voted to separate (or "disaggregate") as an investment component the amount that the insurer is obligated to pay to the policyholder regardless of the insured event. This amount would be excluded from premium presented in the statement of comprehensive income (SOCI). The investment component would, however, be measured under the insurance model.

Despite this conclusion the staff was asked to bring back for future discussion a proposal to unbundle investment components in what were expected to be those rare situations where two entirely separate contracts would be offered as a single contract but which had no interrelated provisions (e.g., a 5 year deposit contract combined with a one year term life insurance contract where one could be terminated or mature but the other would continue to exist). As opposed to "disaggregation," where the investment component continues to be measured under the insurance model, "unbundling" would require the investment component to be recognized and measured separately from the insurance component, applying the financial instrument standard, rather than the insurance contract standard. The objective of the proposal was to prevent situations where a product could be structured to achieve accounting arbitrage.

The May staff paper presented two alternatives:

A) Unbundle contractual components that were combined for reasons lacking commercial substance;

B) Unbundle investment components that would be deemed distinct from the insurance component (in accordance with criteria similar to those used for unbundling goods and services).

The staff paper recommending Alternative B noted that the objective was to keep the unbundling requirement as similar as possible to those of goods and services tentatively decided by the boards previously.

Under the staff proposal, an investment component is considered to be distinct if the insurer or a third party regularly separately sells in the same market and jurisdiction contracts that are essentially equivalent to that component. However, an investment component or an insurance component in an insurance contract would not be distinct and the insurer would therefore not unbundle the components if the investment component is highly interrelated with the insurance component. An indicator of that would be the lack of a possibility for one of the components to lapse or mature without the other component lapsing or terminating.

FASB education session:

The detailed wording of the staff proposal required that both the investment component and the insurance component be distinct. FASB board members were concerned that this would result in less unbundling than the requirements of the revenue recognition proposal, which the board members view as only requiring one of the components to be distinct (although a staff member noted his interpretation that the revenue proposal also requires both to be distinct). Several board members suggested that the staff proposal should be reworded to say that only the investment component needs to be distinct.

Discussion continued regarding the staff wording that provided that a component is distinct if the insurer regularly separately sells the insurance component or a third party regularly separately sells the insurance component "in the same market and jurisdiction." Several board members suggested that the reference to contracts being regularly sold "in the same market or jurisdiction" could result in inappropriately not unbundling an investment component that might be sold in, say, a banking market as opposed to the insurance market.

The staff defended their requirement that both components be distinct and their reference to regular sales in the same market as a means to ensure that unbundling be done only if it results in both components being measured on a meaningful and relevant basis rather than an arbitrary allocation for a product that does not exist in the marketplace. However, they agreed to consider the board members' revised wording suggestions.

The staff provided an example of a deferred annuity that provides a guaranteed annuitization option at rates specified in the contract. The staff expressed concern that using the board's revised requirement that only the investment component needs to be distinct to be unbundled, the investment component might be required to be unbundled given that it was in substance similar to a mutual fund investment (i.e., it was distinct even though the forward starting option to purchase an annuity was not). In contrast, under the staff paper proposal which requires that both the investment and the insurance component be distinct, and since a forward starting annuization option was not a product regularly offered separately in the marketplace, the insurance component would not be considered distinct and unbundling would not be required. However, board members noted that they were not proposing to eliminate the "interrelated" provision and the related indicator. Under that provision, given that the ability to utilize the annuization guarantee would disappear if the account balance went to zero, the contract would not require unbundling.

The last recommendation made by the staff was that voluntary unbundling should not be permitted in situations where the criteria for unbundling were not met. No concerns were raised by the board with the staff's recommendation.

IASB education session:

The IASB discussion was mostly about the actual wording of the criteria and the hierarchy of the conditions included in the principle suggested for unbundling. A component is considered to be distinct if the insurer or a third party regularly separately sells in the same market and jurisdiction contracts that are "essentially equivalent" to that component. One of the major concerns raised by the board members was what the term 'essentially equivalent' means. Would this requirement result in no unbundling if there is a relationship between the two components (meaning that not exactly the same components are sold separately by the insurer or by its competitors)? Would not all the contracts already fail this test? Is there a need at all for the additional condition on the interrelationship of the components to avoid unbundling? Would not one condition be sufficient?

The staff replied that the first criterion (essentially equivalent components are to be sold) might be considered for removal, although in response to a later question they added that this criterion helps to avoid the unbundling of components that although not interrelated they are not sold separately and thus their unbundling would be artificial due to the lack of a standalone product to compare to. The IASB member who raised the question said that he would not support the removal of the criterion but suggested that the first criterion should be phrased as an 'easy' test and if met the second criteria might include a more complex question on assessment.

There were also questions raised around the term 'highly interrelated'. Will there be a definition for that and does that mean the same as 'closely related'? What does 'highly' refer to? The staff replied that constituents struggled with the term 'closely related' and adding a definition or examples to make the term clear might be needed. Additionally, the staff noted that the same term is used in the revenue recognition exposure draft. FASB staff added that during the FASB education session the day before, FASB members found the last sentence of the requirement, referring to joint lapses or maturities, very useful.

One board member suggested looking at extreme examples to test the criteria. He was concerned that due to the narrow subset of contracts to be unbundled under the staff's suggested Alternative B, investment components that are payable on demand might be measured under the insurance standard at a discounted lower value rather than at the required amount payable on demand. He would like to avoid such a situation.

Other board members raised their concern about the potential overlap of disaggregation and unbundling and asked the staff to consider the consistency of all the tentative decisions taken so far including how all cash flow items of the contracts (including acquisition costs, fees and claims) should be split in calculating the unbundled components and the disaggregated balances. If the contract would not be unbundled due to the high interrelationship between the components, they questioned what the basis would be for disaggregation (how the components could be separated and measured independently from each other even for presentation purposes if they are highly interrelated).

Overall, the staff emphasized that Alternative B would result in a very narrow scope and that an insurer would be expected to apply disaggregation to a much wider range of contracts than unbundling.

The staff also recommended that no special requirements are to be set for investment services but the application of the general unbundling criteria of goods and services should be applied. The board did not express concerns regarding this question.

The last recommendation made by the staff was that voluntary unbundling should not be permitted in situations where the criteria for unbundling were not met. No concerns were raised by the board with the staff's recommendation.

Joint FASB/IASB board meeting:

The meeting concentrated on Alternative B of the staff proposal. After some debate, both the IASB (12 votes) and FASB (7 votes) tentatively decided to adopt Alternative B of the staff paper, with modified wording to address concerns raised at the meeting. The revised approach would require that if the investment component is distinct, an insurer would unbundle the investment component and apply the applicable IFRS or U.S. GAAP to the investment component. An investment component would be considered distinct if the investment component and insurance component are not highly interrelated. Indicators that an investment component is highly interrelated with an insurance component would include (1) a lack of possibility for one of the components to lapse or mature without the other component also lapsing or terminating (2) situations where the product is not separately sold in the same market or jurisdiction or (3) situations where the value of the insurance component depends on the value of the investment component or vice versa. If the investment component is not distinct it would be accounted for together with the insurance component under the insurance contracts standard.

The staff proposal was modified as noted above due to concerns raised by FASB and IASB members at each of their respective education sessions with the lack of clarity as to the definition of interrelated. An IASB board member asked for clarification as to whether "interrelated" referred to what in previous board discussions had been referred to as interdependence. For example, in situations where the insurance component cannot be measured without reference to the investment component (e.g. the death benefit is based in part on the account balance) then the insurance and investment components should be considered interrelated.

A good portion of the meeting was focused on an example introduced by an IASB board member relating to a demand deposit combined with a life insurance policy for which the repayment of the deposit would cancel the life insurance. The existing applicable accounting guidance requires that a demand deposit be measured at the amount payable on demand. However, if the contract were evaluated under the staff proposal it would not be unbundled and thus the demand deposit would be measured consistent with the measurement of the insurance contract, i.e., at a discounted amount and thus less than face value, even though payment could be immediately demanded for the face amount. The board member seemed to support unbundling of the investment component and measurement at no less than the amount payable on demand. However, the staff expressed concerns that unbundling in the example provided would result in a day 1 loss. There were also concerns raised about the inconsistency of the duration assumptions used between the two models in an unbundling approach. That is, the investment component would be assumed to be payable immediately (which would technically cancel the life insurance), while under the insurance model the expected life of the contract would be required to be used.

The group discussed this further with a numerical example with a payment of $1,000 for a demand deposit which also included a life insurance contract with no explicit premium payment required. It assumed the expected present value of cash flows for the deposit is $950 and the expected present value of cash flows for the insurance contract is $30. This would result in a single margin/residual margin of $20 when bundled. However, if the investment component were unbundled the demand deposit would be required to be measured at $1,000 (the amount payable on demand) and the measurement of the insurance contract would result in a day 1 loss of $30. The staff therefore argued that their proposal to not unbundle this product was superior to an unbundling approach that would mix two different measurement models and thereby result in a day 1 loss.

One board member was unsure how the additional indicator of not being separately sold in the same market or jurisdiction related to the highly interrelated criteria. The staff clarified that if the component is interrelated then it would not sell separately. They also clarified that the test is intended to include parties other than just an insurance company selling to the insured. An IASB member noted that some countries for regulatory or other reasons may not allow companies to sell certain products while other jurisdictions do. He thought the indicator of not being separately sold in the same jurisdiction made sense for such situations. However, another member responded that it would not make sense that an insurer located in a country that had a particular product would be required to unbundle it while an insurer in another country that did not would not be required to unbundle it. The idea that two insurers could get a different accounting treatment for essentially the same contract would go against the objective of convergence. The staff recognized that the term "same market" needed to be clarified and seemed to indicate that implementation guidance would be issued on this topic.

One board member observed that disaggregation was complex and now unbundling would introduce another layer of complexity however, the staff reiterated their belief that there were not expected to be a significant amount of contracts that would be unbundled and therefore, unbundling should not add a significant amount of complexity.

Toward the end of the session, a board member asked what the unbundling conclusion would be for the demand deposit with life insurance example, using the modified Alternative B wording developed during the meeting. The group agreed that it would not be unbundled, but only after such hesitation that it seemed there was either a a lack of clarity with the revised wording or perhaps a lack of strong support for the principle.

The boards then confirmed their previous decisions to require unbundling of embedded derivatives using existing derivative guidance , the unbundling of goods/services when the peformance obligation is distinct, and the disaggregation for presentation purposes of certain investment components.

The boards also voted that insurers should be prohibited from applying revenue recognition or financial instrument standards when the unbundling criteria are not met (i.e., no voluntary unbundling is permitted). Although an IASB member argued that unbundling was the better conceptual answer and thus should be permitted, the staff responded that this would reduce comparability and could also result in information that is not representationally faithful because it would require a subjective split of the interrelated components.

Use of OCI for discount rate liability changes

The May education and joint decision making sessions covered the potential use of OCI for reporting certain changes in insurance liabilities. In contrast, the ED and DP had proposed that such changes would be reported in profit or loss.

The latest staff paper summarized the 3 main objectives of using other comprehensive income(OCI) in the insurance model:

- To reduce short term volatility caused by discount rate changes that are expected to reverse over time
- To enhance transparency of core underwriting such that they are not overshadowed by changes in market interest rates
- To reduce accounting mismatches in the income statement between the insurance liability measurement and related assets recorded at either amortized cost or available for sale through OCI

FASB education session:

The staff felt that all three objectives were met by recommending that changes in the insurance liability resulting from changes in discount rates be presented in OCI. The board members discussed how much weight should be applied to each one of the objectives. Even if the results of the financial instrument classification and measurement project is that assets can be in one of three categories, it will still be difficult to completely meet the third objective, given that mismatches such as assets measured at amortized cost and equity securities required to be measured through income will still exist.

Some members see the OCI proposal as a partial solution to the accounting mismatch and note that it would also address the first objective of reducing the volatility in profit or loss. If the accounting mismatch is less of a concern than other objectives, then the focus should be on reducing volatility or promoting transparency of core operations by presenting changes in the liability relating to discount rate changes in OCI.

IASB education session:

The staff presented an update on outreach activities regarding this issue with UK and Asian users, focusing on how the staff recommendations for the use of OCI would meet the objectives described. The staff noted that in the two territories recently surveyed, users seemd to support an OCI solution as it would reflect management's performance separately from market performance.

However, they did want to ensure that duration mismatches would be prominently displayed and they preferred that interest sensitive assumptions, such as lapse rate changes be presented in income.

A board member challenged the remark that investment performance was separate from management's performance, as part of an insurer's job would be to evaluate financial markets. He also noted that permitting OCI would in essence be rejecting the idea of a proposed insurance current measurement model. The staff responded that an advantage of the OCI solution is that the balance sheet measurement would reflect current value, and the income statement would reflect current underwriting results. However, changes in discount rates that are expected to reverse over time would be separately presented from those underwritng results.

The balance of the meeting focused on several staff paper examples that were later discussed at the joint meeting.

FASB/IASB joint board meeting:

As background, the staff reported that at Monday's joint board meeting dealing with financial instrument classification and measurement, the IASB had voted to reflect fair value changes in certain financial assets in OCI, consistent with the FASB's latest view. The staff expected that many insurers would meet the OCI criteria for many of their assets.

The staff recently asked users to rate, in order of importance, the above noted three objectives for using OCI in insurance contract measurement. While reaction was mixed, it appeared that they valued transparency of underwriting results above the other two objectives. Users noted that they were also interested in having visibility to the impact of changes in discount rates on the measurements, but not necessarily in income.

The staff paper requested the boards' response to a number of questions:

- Should changes in the insurance liability arising from changes in the discount rate be presented in OCI?
- Should changes in the insurance liability arising from changes in interest sensitive cash flow assumptions (as opposed to just changes in the discount rate) be presented in OCI or profit or loss?
- If the boards agree with presenting changes in the insurance liability arising from changes in discount rates in OCI, should all such changes be presented in OCI unless presenting those changes in profit or loss would eliminate or significantly reduce an accounting mismatch?
- In determining whether changes in the insurance liability arising from changes in discount rates should be presented in OCI or profit or loss, what unit of account should be used: the portfolio, or the individual contract level based on an allocation of asset mix?
- What discount rate should be used to present interest expense through the income statement on the insurance obligation? The discount rate locked in at inception or the current rate at the beginning of the period?
- If the boards agree with presenting changes in the insurance liability arising from changes in discount rates in OCI, should there be a loss recognition test?

One board member remarked that while his preference would be for all changes to go through income, presenting current value of the liabilities in the balance sheet and presenting the discount rate change in OCI would improve transparency and would be an improvement to current practice, and so he supported the use of OCI as a good compromise position.

Much of the discussion centered on a view presented by one of the IASB board members that the "OCI solution" presented by the staff actually had the effect of potentially creating "massive mismatches" in the income statement and other comprehensive income, thus decreasing transparency and presenting misleading information. He believed that other revisions made to the model have addressed the objective of reducing volatility, such as the "top down" method for estimating the discount rate, perhaps eliminating the need for an OCI solution to the volatility issue.

The board member who objected to the OCI solution argued that when there is a mismatch between the duration of assets and insurance liabilities, there will be meaningless results portrayed in the income statement.

He noted that even if there is asset/liability duration matching, the sale of an asset prior to a liability reduction will also produce meaningless results in income.

One example used to illustrate his point was a 10 year insurance contract for which debt securities with matching duration were purchased. If the debt securities were sold at a gain in year 5 (due to a decline in interest rates from, say 7% to 5%), and new debt securities were purchased to again match the duration of the remaining 5 year insurance contract, a gain would be shown in the income statement at the date of sale. However, the unrealized loss on the insurance liability due to the decrease in rates would continue to be shown in OCI. This would be followed by reduced investment income due to the lower coupon on the new securities against higher interest expense on the accreting insurance obligation. Only if there were zero asset sales during the entire term of the insurance obligation would there be a matched position in income and OCI. He argued that this example was evidence that the OCI solution did not work as compared to both the asset and liability side being presented at fair value/current value through income.

A second example presented in the staff papers showed an equally troubling result in his view. The example assumed that at inception of a 5 year insurance contract, an insurer purchases 3 year bonds (because there are no assets available of a similar duration). Interest rates fall over the 3 year term, and the insurer then reinvests at the lower rate for the remaining 2 year duration of the insurance obligation. The income statement in his view would be meaningless, because it would show a positive spread being earned in the first 3 years (even though from inception there is a duration mismatch), and in the final two years, when the duration is matched, a negative spread would be shown in the income statement. Total comprehensive income, on the other hand, would show the economic reality of the duration mismatch, showing increased losses as the rates drop and then positive comprehensive income in the final two years when the duration mismatch is resolved.

Board members and staff rebutted the board member's argument with various points. One noted that the mismatch highlighted was a consequence of accepting an amortized cost or available for sale designation for assets, and noted that the income statement accurately reflected the contractual returns on the purchased assets. If there was a problem with the model, it was a problem with having an asset valuation model at something other than fair value through income, but the boards had already decided and recently redeliberated this issue and obviously were not willing to reverse their position. It was also noted that on a comprehensive income basis, the entire impact, including the duration mismatch in the second example, could be seen. However, another cautioned that despite the boards' embracing of the comprehensive income concept, many users still focused heavily on the income statement. Another noted that in the first duration matched example, where assets were sold, the more likely scenario in a duration matched portfolio would that liabilities would be paid at the same time, thus offsetting the gain.

Another board member pointed out that an alternate solution to OCI presentation would be to show changes in discount rates in a separate section of the income statement, and noted that allowing one industry to use OCI "blindly" was not appropriate. However, the staff later noted that for every other industry, the boards had not concluded that liabilities should be at fair value through income, and so to force the insurance industry to carry its liabilities at current value through income seemed equally unfair.

The board members asked the IASB board member who brought the two "mismatch" examples to them what his solution might be. He proposed that a better approach would be to adopt a model similar to IFRS pension accounting, where the interest rate used to calculate interest expense on the pension liability is the current rate at the beginning of the period. The remainder of changes would be recorded through OCI. A staff member responded that this method is viewed by some as being complex and difficult to understand for users who focus on a cost type accounting approach. A FASB board member noted that the IASB board member's proposed methodology is more of a fair value presentation for net interest in the income statement, with all the remaining balancing items shown in OCI, whereas insurance companies manage their business based on contractual interest flows from period to period. Another IASB board member objected to the pension methodology as a smoothing mechanism and voiced his view that he, like others, would prefer to see the amortized cost components; i.e., the real contractual rates; running through income.

When pushed for a vote, both the FASB (unanimous) and a large majority of the IASB voting for changes in the insurance liability arising from changes in the discount rate being presented in OCI.

The second question addressed was whether changes in the insurance liability arising from changes in interest sensitive cash flow assumptions (rather than just the discount rate) should also be presented in OCI. Examples include options and guarantees (such as minimum crediting rates), as well as lapse/surrender assumptions.

An IASB member noted that some staff have said that rerunning the model to include changes in interest sensitive assumptions when discount rates change is operationally easier while others have said excluding them is easier. An IASB staff clarified that both methods require an extra calculation.

A FASB member pointed out that for options and guarantees, changes in the discount rate will actually change the amount the insurer owes, which would seem like a cash flow change that should go through income. Another FASB member agreed, saying that income presentation was necessary in order to understand underwriting results.

An IASB member asked whether the boards should permit different approaches, given that companies may have different models and ability to run and rerun the models. The staff responded that whichever approach is decided upon, it would be their recommendation to require it rather than leave companies the option to do either.

In a vote, both the FASB (5) and IASB (13) supported recording changes in the insurance liability arising from changes in interest sensitive cash flow assumptions through income rather than OCI.

The third question posed to the boards was whether all changes in insurance liabilities resulting from changes in the discount rate should be presented in OCI unless presenting those changes in profit or loss would eliminate or significantly reduce an accounting mismatch. In discussing this question, the issue of unit of account was indirectly dealt with as well.

One IASB member strongly disagreed with the staff proposal, noting that it was inconsistent with financial instrument guidance to use OCI as the default. He believed an insurer should record changes through income unless it could prove that recording through OCI would be an improvement (i.e., to prevent a mismatch). Another agreed that he had concerns with situations where an insurer held trading securities with changes in value reported through income, and another with a non-insurer who issued an insurance contract who might not have any specific assets matched against it. The staff responded that the reason for using OCI as the default was that there were two other objectives trying to be met through the use of OCI beyond accounting mismatch, as noted at the start of the meeting (to reduce volatility in income and segregate underwriting performance). It was also noted that a great majority of an insurer's assets would be expected to be recorded as available for sale through OCI, while a smaller percentage would likely be mortgage loans at amortized cost or trading securities at fair value through income.

A FASB member proposed that the boards should require fair value through OCI, with no secondary test to determine whether or not an accounting mismatch existed between invested assets and the related insurance liabilities, as it would be too difficult to keep track of this mismatch Another FASB member seemed sympathetic to this view, noting that an insurer may rebalance its asset portfolio from time to time, and he would have a problem requiring a methodology that would provide that whenever it sold an asset it would be required to redetermine where the change in discount rates would go. It would be too hard to track, with constant adjustments and with the ability to manipulate or "cherry pick" the asset sales.

An IASB member noted that even at the portfolio level it would be difficult to track. Another FASB member added that it may be difficult to track when there is an accounting mismatch, other than when there is contractual linkage, such as with participating contracts.

The staff explained that with regard to participating contracts, the boards had already concluded that the insurance liability value would be accounted for consistent with the asset value ("mirror accounting"). The staff will be reviewing at a future meeting how other decisions, such as this one on discount rate changes, would interact with the decisions on participating contracts.

The revised proposal put to a vote by the chair was whether, in presenting changes in the insurance liability arising from changes in discount rates in OCI, all such changes should be presented in OCI. This would eliminate the secondary component suggested in the staff paper that provided "unless presenting those changes in profit or loss would eliminate or significantly reduce an accounting mismatch."

Five of the 7 FASB board members supported this proposal, and in the initial vote only 7 of the 14 IASB board members supported it. However, in an effort to come to a conclusion, an IASB member changed his vote in support of the chair's proposal. Given the decision that all changes in the liability due to discount rate changes would be presented in OCI, there was no need to deal with the unit of account question that had originally been posed in the staff paper; the boards moved on to addressing questions on the mechanics of application.

The next question posed by the staff was what discount rate should be used to present interest expense through the income statement on the insurance obligation: the discount rate locked in at inception or the current rate at the beginning of the period?

While one IASB member proposed that the current rate was more relevant (consistent with the earlier discussion), other IASB and FASB members supported using the rate at inception. The staff supported using the rate at inception with the rationale that it represents the rate inherent in the insurer's pricing and noting that it was more consistent with an amortized costs model. Both boards voted in support of the staff position that the rate at inception of the insurance contract be used.

A follow-on question was what rate should be applied to changes in assumptions such as increases in expected cash outflows when calculating the interest expense to be presented in the income statement. The staff recommended locking in the rate determined at inception.

The staff believe that it would be too complicated to use the current rate, and without much added benefit. An entity would need to layer the cash flows and the discount rate within the liability used to initially recognize the liability and each of the changes in cash flows. These layers would then need to be tracked through future periods and compared to the present value of cash flows at the new current rate to determine the OCI adjustment. The layers would then need to be reduced in some order as cash outflows are made.

In a vote, a large majority of both boards agreed with the staff recommendation to use a locked-in rate.

The last question addressed in the OCI discussion was whether a loss recognition test was needed in light of the fact that under the proposed OCI solution, the income statement would not reflect the value of the liability using the current discount rate (but instead the rate at inception). This could potentially delay income statement losses in situations where asset returns are lower than expected and negative interest margins result. Without such a loss recognition test, the negative spread losses would appear in the income statement as interest expense and interest income are recognized over the remaining life of the contracts.

Objections to a loss recognition test were voiced by both IASB and FASB members. One noted that the boards had just decided that OCI should be required for the reasons noted, and this would be inconsistent with that conclusion. Another noted that throughout the insurance project it was emphasized that liability and asset measurement should be separated. A staff member noted that financial institutions do not record such a loss when financial liabilities have contractual yields of say, 5% and assets are yielding only 3%, or in any other industry where returns are less than borrowing rates. The opposing view offered by one FASB board member was that without loss recognition, the retained earnings distributable to shareholders would be understated.

In a vote, a large majority of both boards rejected a loss recognition test in the OCI model.

Acquisition cost presentation

The two main reasons for bringing acquisition cost presentation issues to the boards again for discussion were (1) FASB members had voiced some concern with presenting costs to be paid to third parties to acquire business in the same way as cash flows expected to be incurred to fulfill obligations to policyholders and (2) the boards' revised tentative decision to include volume information in the statement of comprehensive income, which raised the issue of how acquisition costs should be presented.

The staff developed three alternatives for financial statement presentation under the building block approach (BBA):

(A) recognize the right to recover acquisition costs as an asset (consistent with current practice and the latest revenue recognition project proposal).

(B) include acquisition costs in the cash flows used to determine the margin, but present these estimated cash outflows separately from the obligation to policyholders. This liability (potentially presented together with the margin liability) would be reduced as acquisition costs are "incurred," with no immediate effect on the statement of comprehensive income (SOCI). The costs would not be amortized separately, but would instead be amortized as part of the margin; or

(C) include acquisition costs in the cash flows used to determine the margin (consistent with the ED and DP). In SOCI, expense acquisition costs and recognize income equal to those costs as the acquisition costs are "incurred."

Although the phrase "as acquisition costs are incurred" in Alernative B and C was not described in the staff paper, it appears to refer to the point at which a contractual obligation exists to pay a particular acquisition cost (e.g., when a renewal premium is due which would trigger payment of a renewal commission).

FASB education session:

A board member commented that while the staff paper rejected Alternative A, rejecting asset classification seemed inconsistent with the latest views the boards had reached in the revenue recognition project to recognize an intangible asset. It also seemed inconsistent with views expressed by some users that separate presentation of the DAC asset was important for key performance metrics.

The FASB staff explained that while they preferred Alternative A, they recommended Alternative B as a compromise in order to converge with the IASB ED view that acquisition costs should be thought of as one of the cash flows relating to the contract rather than as a separate intangible asset. However, it would also satisfy the FASB's objective that the obligation to policyholders be separated from the obligation to pay acquisition costs. That is, the obligation for expected future acquisition costs would be shown separately from the policyholder obligation (and instead combined with the margin), and this obligation would be reduced as acquisition costs were incurred. Acquisition costs incurred would be separately displayed in the margin rollforward (thereby providing users with requested information about acquisition costs incurred to generate new business). This treatment would avoid showing a decrease in the policyholder liability when acquisition costs are paid or changes in the policyholder liability when there are changes in estimates of acquisition costs.

From the standpoint of the SOCI, under the BBA approach, the staff explained that under their yet to be finalized proposal on presenting gross premium and expense information in the SOCI, Alternative B would have the disadvantage of displaying in SOCI over time an amount less than the cumulative premiums received from policyholders. Although not described by the staff, this presumably results from presenting as premiums a derived amount that starts with the net margin. A board member asked why acquisition costs could not instead be shown gross as a cost rather than netted against premium. The staff responded that this could be done, but that it might prove to be operationally difficult.

Alternative C would treat acquisition costs as any other cash flows, and under the revised "gross" presentation of premiums, claims, and expenses in SOCI, they would be presented as costs when incurred with an equal and offsetting amount of revenue. FASB members seemed strongly opposed to this approach, noting that there was no rationale for recording premium revenue for an event (e.g., paying commissions to agents) that had nothing to do with fulfilling the contractual obligation to policyholders (a revenue recognition concept).

One board member noted that he would rather immediately expense acquisition costs (i.e., not include them as part of the insurance contract measurement model at all) with no revenue offset, but recognized that this approach had already been discussed and rejected at a previous meeting. However, another FASB board member remarked that he thought supporters of expensing all acquisition costs might prefer Alternative C, as it effectively expenses acquisition costs, but then recognizes that deferring all profit at inception does not make sense and allows offset to the extent that profit covers such costs. The other member responded that in his view, acquisition costs are a period expense, and thus offsetting against deferred profit was not appropriate.

For the premium allocation approach (PAA), the FASB staff recommended a similar approach as in the BBA approach in that acquisition costs would not be presented as an intangible asset but instead would be offset against a liability. However, in the PAA the margin is implicit in the liability for remaining coverage, and thus acquisition costs would be netted against the liability for remaining coverage in the balance sheet. In SOCI, premium would be recognized on a gross basis with the amortization of acquisition costs also recorded gross.

The FASB board members overall seemed supportive of this approach, although some questioned why gross presentation of acquisition costs would be doable in the PAA but not in the BBA. The staff explained that the gross up was less complex in the PAA and that more users requested it in order to calculate expense ratios.

IASB education session:

The staff noted that the boards' previous tentative decision to include volume information in SOCI required reconsideration of how to present acquisition costs within that statement.

Although the staff paper rejected the Alternative A intangible asset presentation, several board members asked for clarification on this. They emphasized that a clear conclusion should be drawn whether or not acquisition costs could meet the definition of an asset.

The staff replied that in the revenue recognition discussions the boards conclusion was to recognize a separate asset. However, they added that while in the revenue project the focus is on allocation of revenue from the customer (i.e. the earning of the performance obligation) in the insurance project the focus is on the liability measurement. Some board members raised their concerns here that cash flows relating to acquisition costs are not related to the insured event therefore should be excluded from the measurement of the insurance liability. However, other board members explicitly expressed their rejection towards recognition of an asset.

During the discussions the board members identified the following key decisions that the boards should make relating to this issue:

- gross versus net presentation in the balance sheet
- full or partial recognition of customer consideration in the statement of comprehensive income
- potential upfront recognition of revenue
- potential different approach for the BBA and the PAA.

The staff acknowledged that none of the alternatives are without drawbacks and the board members agreed with this statement. Even so, some board members said that they could support a solution that is close to Alternative C but instead of the upfront recognition of premium it should be recognized over time.

However, other board members disagreed with the proposal on eliminating the upfront recognition of premium. They had a strong view that upfront recognition of income to offset acquisition costs might be justified by the fact that the agent performed the service and thus created value for the company.

The only subtopic that did not raise any issues from the board members' side was whether there was a need for a different presentation of acquisition cost for the PAA. The staff paper was not even discussed since IASB members (and IASB staff) agreed that since IASB sees the PAA as a proxy for BBA, the same presentation principles for acquisition cost should be applied.

Joint FASB/IASB board meeting:

The staff reminded the boards that acquisition costs are particularly important to insurers given the high level of costs incurred in relation to revenue. For example, for long duration life insurance the commission can exceed the first year premium.

The staff also noted that while the two boards have different views on the types of costs that should be part of the measurement (with the FASB rejecting costs relating to unsuccessful efforts), that difference was not being debated during the current discussion.

The staff summarized the differences between the 3 alternatives in the staff paper as follows:

- Alternative A would show gross presentation of an intangible asset while B and C would present a net contract asset or liability
- A and C would show acquisition costs as a line item in the income statement whereas B would not
- A would allocate amortization of acquisition costs over time while C would show the costs when incurred
- B would show disclosure of the costs as part of the margin and margin roll forward
- B would show at least two liabilities (the policyholder obligation separate from the sum of margin and the acquisition cost obligation) while C would show one.

Several IASB members commented that the answer to the income statement presentation for acquisition costs would depend on whether and how the income statement would be grossed up for all the other elements of the model. For example, whether premiums would be grossed up on a written or an earned basis would dictate the timing of acquisition cost recognition. The staff has not yet presented a paper to the boards on this issue.

An IASB member suggested that if volume information was to be presented, then Alternative C would be preferrable to Alternative B. The FASB staff responded that Alternative B could be modified to allocate acquisition costs on a gross basis in the income statement.

The discussion went in many directions. At one point, both an IASB member and a FASB member suggested that perhaps acquisition costs should be expensed as period costs, while another member reminded them that this would be inconsistent with the recent position to capitalize certain acquisition costs in the revenue recognition project. Several FASB board members implied that they would prefer to record acquisition costs as an asset, consistent with the revenue recognition project, rather than as part of insurance cash flows. The IASB member who at first suggested immediate expensing agreed that if not expensed, he thought asset presentation seemed simpler than Alternative B or C.

A FASB member expressed the view shared by other FASB members to exclude acquisition costs from the insurance contract calculation. In his view, they should be separate from the insurance liability given that the costs are payable to other than the policyholders. When asked whether that meant that claim adjudication costs should also be excluded from the model, another FASB member described them as costs incurred to fulfill the obligation to the policyholder, and thus includable in the insurance contract measurement.

When asked whether Alternative B would compute a different margin than Alternative C, the FASB staff responded that it would be the same margin, calculated in the same way. That is, the margin would be calculated as expected premiums minus expected cash outflows (including a risk adjustment in the IASB version), and those outflows would include direct acquisition costs. In the staff example, this would be represented by the CU2400. However, under Alternative B, the CU1200 expected obligation payable to agents would be included with the CU2400 margin until paid, rather than being included with the CU 8400 obligation payable to policyholders. The income statement would have the same net result each period under either method, but in terms of presentation, Alternative C would record acquisition costs as incurred with an offsetting amount of revenue while Alternative B would show neither of these. Total revenue under Alternative B over time would be CU10800 versus CU12000 in Alternative C (the actual amount collected from policyholders over time).

The FASB chair and several other board members made it clear that they were opposed to Alternative C, in particular to the requirement to record acquisition costs as incurred and record an equal amount of revenue in the same period. It was counterintuitive to them that the more acquisition costs that were incurred in a period, the higher the revenue. Revenue should only be earned over time. While they would prefer Alternative A (record an asset), with one member suggesting he could also support an immediate period expense, at least 5 said that they could support Alternative B as a compromise.

The IASB chair called for a vote to at least decide whether Alternative A (gross presentation of an intangible asset) could be eliminated from consideration. Ten IASB board members voted to eliminate Alternative A. The FASB chair worded the FASB board vote in a different way, first asking whether any supported Alternative C (none), then how many preferred Alternative A (6 in favor) and then whether they could support Alternative B as a compromise (5 in favor).

An IASB board member suggested that as a way to reach convergence, perhaps the IASB could support Alternative B, but grossing up the premium to the full amount received from customers and amortizing acquisition costs over time. The IASB chair left this as an open item, deciding to wait until the income statement presentation proposal was ready for discussion.

IASB risk adjustment and residual margin (IASB only session)

The IASB discussed whether any changes should be made to its tentative decisions on the risk adjustment and the residual margin.

The staff paper summarized three key areas of difference between the BBA as proposed by the IASB and that proposed by the FASB:

- *Re-measurement:* The IASB risk adjusted approach reflects both increases and decreases in risk, however the FASB single margin approach reflects only decreases in risk (although amortization can be slowed down in the latter).
- *Release pattern for residual margin*: The IASB proposed release is in line with the pattern of services, however the FASB's is allocated in line with release from risk.
- *Adjustments to residual margin*: For the IASB, changes in estimates of future cash flows are offset in the residual margin. For FASB changes in estimates of future cash flows are not offset against the single margin.

Several board members questioned the rationale for permitting changes in future cash flow estimates to be offset to residual margin, whereas changes in risk adjustment would flow to profit or loss. For example, where cash flows are reestimated and a reduction in future cash flow estimates is made against residual margin, the risk adjustment changes on those cash flows would go to income. They therefore felt that the two elements work against each other, which was counterintuitive. The staff agreed and clarified there were two points that needed to be considered in relation to changes in the risk adjustment. First, there is a natural run-off of the risk adjustment as the insurer gets better information (i.e. as time passes and as the entity gains more experience) and therefore this should go to profit or loss. However in the second case, where there is an increase in either the quantity of risk or a change in the pricing of risk, if the residual margin is unlocked for cash flow estimates, then conceptually this element of the risk adjustment should also be adjusted against residual margin. The staff noted that from a practical point of view this split could be difficult to determine. However several board members came back to this point in later discussions and suggested that the board may wish to explore this option to split the risk adjustment.

Another member was concerned that the insurer would have a great deal of discretion over the calculation of the risk adjustment now that the limitation to 3 permitted techniques had been removed. Others flagged the same concern that the CEO may have complete freedom as to how to change the risk adjustment based upon their view of risk on any given day. However, one board member noted that due to the fact that confidence interval (CI) disclosure would be required, he was more comfortable with this proposal. He also noted that because the risk adjustment is an entity-specific measure, it effectively provides an option to remeasure the risk adjustment simply because the CEO is more worried on a particular day and not because of pricing or quantum of risk. If this optionality were removed, then he would be happy to also remove the requirement to prepare CI disclosures. Other board members discussed using a market participant view as opposed to an entity-specific view of risk to try to address this issue, however they were reminded of the board's previous discussions on the difficultly of practically determining a hypothetical market participant view.

Another board member strongly expressed his views in favor of the risk adjustment. He noted that the key point is that whichever methodology is used by an entity, this will need to be applied consistently period on period. Therefore, the change in the risk adjustment would provide very useful information as it would tell the reader about the type of risk that the insurer is exposed to and how they are managing that risk (although he admitted it would be inconsistent between insurers based on their entity specific view of risk). He added that as this information is already used internally to assess business and price contracts, is used by some regulators and investors, and some countries already report this number, he did not understand why this information would not be used in the insurance model. Another favored the explicit risk adjustment due to transparency. Another supported the risk adjustment as it deals with the scenario of changes in risk after the coverage period, which the single margin does not deal with.

A number of board members did not favor the FASB single margin approach primarily due to the amortization pattern based on risk. One noted that to the extent a life contract may be mostly an investment contract in nature with a small death component, the majority of the profit on the contract would relate to the service provided in an investment management capacity. The service provided may well increase as the level of assets under management increase due to policyholder premiums received and therefore profit should be weighted to the back end of the contract when more services are being performed. However under the FASB single margin approach, since the profit is earned based upon release from risk, this may not lead to back-end weighted profit recognition. However, one board member was attracted to the simplicity of the single margin.

In a vote, a large majority of board members were in favor of retaining the IASB's tentative decisions to include an updated explicit risk adjustment, with changes in risk adjustment taken through profit and loss.

On whether changes in estimates of future cash flows should be offset against the residual margin, one board member questioned whether the residual margin would be wiped out in year one from a change in estimate. She therefore questioned whether in reality the changes would be going through profit or loss in any event (i.e. everything would go through profit or loss as the residual margin had been used up). Staff responded that their analysis had shown that there would be quite a large residual margin and therefore offsetting would create a big difference by not taking these changes to the profit or loss.

Those who favored a locked in approach noted that this was primarily due to the concerns over operationality of an unlocked approach. In response, one board member questioned what the feedback had been to date. The staff responded that although complexity had been noted as a concern, this was seen as being outweighed by helping to resolve the volatility issue.

In a vote, the majority voted in favor of offsetting the residual margin for changes in estimates of future cash flows, in line with IASB's tentative proposals. The IASB decided by a narrow margin that it would not explore whether other changes in estimates (e.g., all or a portion of changes in the risk adjustment) should be offset in the residual margin.

Additional information

Questions on this summary and the FASB/IASB joint project can be directed to: Mary Saslow (860-693-4407) a Managing Director in the National Professional Services Group, who is part of both the US and Global Accounting Consulting Services groups.