

Insurance alert

IASB Education Session - Insurance Contracts

25 January 2012

PwC Summary of Meetings

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- Premium allocation approach: eligibility criteria
- Premium allocation approach: mechanics on discounting and treatment of acquisition costs

Since a variety of viewpoints are discussed at FASB and IASB meetings, and it is often difficult to characterise the FASB and IASB's tentative conclusions, these minutes may differ in some respects from the actions published in the FASB's Action Alert and IASB Observer notes. In addition, tentative conclusions may be changed or modified at future FASB and IASB meetings. Decisions of the FASB and IASB become final only after completion of a formal ballot to issue a final standard.

Highlights

The topics discussed at the IASB only education session included the eligibility criteria for the premium allocation approach (PAA), the requirement to discount the liability for remaining coverage and accrete interest on it, and the treatment of acquisition costs. As this was an education session, no decisions were reached. The meeting was in preparation for an upcoming joint meeting with the FASB.

On the eligibility criteria, the discussion was focussed on whether there is a need to have an underpinning principle for using the PAA. Discussion was held around the one or two model theory. Most Board members expressed a leaning towards seeing the PAA as a proxy for the full Building Block Approach (BBA). They supported a practical expedient to allow contracts with less than 12 months coverage period to be accounted for under the PAA approach. Beyond the 12 month practical expedient, the board asked the staff to simplify the eligibility criteria for the PAA approach that would focus on whether or not there was expected to be a

significant variation in cash flows in the pre-claim period.

On the PAA mechanics on discounting and accretion, the Board members generally leaned towards the view that discounting and accretion in the measurement of liabilities for remaining coverage should be required when a significant financing component is present.

On acquisition costs treatment under the PAA there was more support for inclusion of directly attributable costs in the measurement of acquisition costs rather than only incremental costs as this is in line with the BBA. Also, in line with the BBA, there was a leaning towards not showing deferred acquisition costs as a separate asset but rather as part of insurance contract liabilities.

Premium allocation approach: Eligibility criteria

The idea of using the PAA for certain insurance contracts existed in the ED. However, respondents to the ED noted that those eligibility criteria were too restrictive, requiring a contract coverage period of approximately one year or less to qualify for the PAA.

The staff explained that the Boards have discussed the eligibility criteria for the PAA in prior meetings in April, July and October 2011. The first two meetings focussed on whether the PAA is a separate model or a proxy for the BBA. The Boards could not agree on the objective of the PAA approach, with the IASB generally viewing it as a proxy for the BBA, while the FASB saw it more as a separate model and similar to the revenue recognition approach. Although the Boards could not agree on the objective of the PAA, the staff was nevertheless tasked with developing criteria for applying the PAA, in the hopes that while the objectives of the two Boards might be different, criteria could be developed that would satisfy both objectives.

While the boards indicated a general agreement with the direction the staff was headed in October, individual board members came up with differing conclusions on how various contracts would be categorised under the criteria. The boards thus asked the staff to revise the language to address this disparity and to test the application of the criteria against different types of contracts to determine if the criteria were clear and operational and the results reasonable.

The revised criteria drafted by the staff after the October meeting and thirteen different contract types were provided both to board members and constituents (including preparers, auditors, and actuaries) for testing.

The results of the survey yielded questions and some inconsistencies in how various contracts would be classified depending on one's interpretation of the unit of account to be used in making the assessment and other subjective judgments, such as the meaning of "expected to vary significantly." The staff revised the criteria further in an attempt to make them more operational, with the latest staff paper (IASB/FASB staff paper 2A/78A) providing the following criteria:

"Insurers should apply the building block approach rather than the premium allocation approach if, at the contract inception date, either of the following conditions is met:

- (a) It is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfil the contract that would not be captured by the onerous contract test ('expected cash flows criterion').

- (b) Significant judgment is required to determine the amount of premium to be recognised in each reporting period, for example if there is significant uncertainty about the length of the coverage period ('allocation of premium criterion')."

The staff believe the above proposed criteria would result in the following measurement models for example contract types (details of which are provided in the staff paper):

1. Traditional whole life	BBA
2. Term life (1 year)	PAA
3. Term life (5 years, with additional renewal rights)	BBA
4. Universal life	BBA
5. Annuity	BBA
6. Personal auto	PAA
7. Construction surety bond	PAA*
8. Catastrophe insurance	PAA
9. Workers' compensation	PAA
10. Long term disability	BBA
11. Directors and officers insurance	PAA*
12. Health insurance	PAA
13. Japanese fire (30 year)	BBA

*The staff paper notes that these contracts are particularly impacted by the macro-economic environment but that the impact of any significant changes in that environment on a contract would be covered by the onerous contract test and thus would qualify for PAA.

Some Board members thought it was not beneficial to continuously change the criteria. Rather the Boards should be clear on whether they believe that the PAA is a proxy to the BBA or a separate model. In the minds of these Board members, the staff is struggling with the exact wording of the criteria because they are not clear what the objective of the PAA is.

Another Board member who agreed with the above noted that there is no benefit in over-engineering the criteria, they should be simple. Possibly the 12 month criterion (apply the PAA if the coverage period is 12 months or less) from the original ED was enough, although some application guidance may be needed.

It was noted also that some thought that there was benefit from discussing the criteria again to improve them, but the discussion would need a steady backdrop of clarity on the PAA objective.

Another Board member disagreed with a 12 month criterion alone as being too simplistic. A bright line would force certain contracts into BBA that should not be. This Board member gave the example of a surety contract that may be suitable for PAA but may be forced into BBA if there was a simple bright line.

A Board member noted that a practical expedient to use the PAA for short term contracts would make sense as a proxy for the BBA. The PAA should give similar answers as the BBA. However, it felt to him as though

complexity is added to the criteria because there is no clarity on whether we have one or two models. The idea should be that the BBA is seen as the default model but the PAA may be used as an expedient to achieve outcomes similar to the BBA. The basis for the exception would be that the PAA is close to the BBA in certain situations.

It was noted by a Board member that the Boards had agreed that the BBA would give the best information but if a proxy (PAA) would give similar answers, the standard should not insist on the BBA. For each deviation from the BBA there needs to be a test of the assertion that the PAA is really a close enough proxy. There are constituents who simply do not want discounting or risk adjustment to feature in certain contracts. The correct treatment of these contracts should not be based on their wishes but rather on what gives the best measurement for the user. For example, a 3 or 4 year surety contract might not qualify for PAA, and in fact the BBA approach may provide better information to users.

A Board member noted that the PAA does include discounting and risk adjustment on inception. He further stressed that all contracts over 12 months would need to be assessed using the proposed criteria to determine if they qualify for PAA. In contrast, an arbitrary 12 month rule standing alone would not allow a 3 year surety contract to be accounted for under PAA. Therefore, there should be eligibility criteria in addition to the 12 month practical expedient.

Another Board member stressed that there needs to be a clear message that the default model is the BBA and PAA is a proxy. Using a 12 month bright line for PAA may not be very elegant, but bright lines are used in other projects too. But having some sympathy for the prior board member's comments, he might agree to building in some principles as well.

The staff then summarised that they had difficulties with the criteria and drawing a dividing line as there is no principle. From what they heard so far, the Board is comfortable overall that contracts with less than 12 months coverage period would fall under the PAA model but that also a principle would be needed in addition to the 12 month expedient. This would however put the burden on the preparer for contracts with coverage periods over 12 months, to prove that the principle of the PAA/BBA divide is still met.

The Chair of the Board then summarised that it appears the Board supports the view that there is only one model (the BBA) and the PAA is a proxy. A 12 month expedient can serve a useful purpose even though it is a bright line, but the question is whether a principle is needed on top of the expedient to cover contracts that are outside the 12 month line.

Another Board member noted that what the two criteria are setting out is what an entity would need to meet to get into the PAA. The Board could use the criteria as they are and simply add a 12 month expedient. In fact, either they could use the criteria as they are and add 12 month practical expedient or set 12 months as a bright line and add the criteria to allow contracts longer than 12 months into the PAA. This would come to the same answer.

The staff noted that the criteria could be used as application guidance examples to a principle of using the PAA as a proxy, in addition to the bright line of 12 months.

The FASB staff then summarised the discussion they had on the same paper last week. Our summary of this meeting can be found on www.pwc.com/us/insurance.

The FASB chair noted it appeared that a consensus had emerged in that most Board members would say that contracts with a coverage period of 12 months or less should qualify for the practical expedient. Also, a general sense is that for contracts outside the 12 month coverage period board members would like eligibility criteria for the PAA approach that would focus on whether or not there was expected to be a significant variation in cash flows in the pre-claim period. The FASB Board Chair asked if it would be possible for the next meeting that the staff could revisit the wording. She thought it would not be necessary to explicitly state if there are one or two models, or to refer to it as a proxy or practical expedient.

An IASB Board member asked the FASB Chair to confirm if she agreed that the principle is one model and the PAA is a proxy. The FASB Chair said she carefully avoided confirming this as there are differences of view.

There seemed to be general agreement with the suggestion to proceed with an approach whereby contracts with a coverage period of 12 months or less would fall into the PAA. Beyond the 12 month practical expedient, the board asked the staff to simplify the eligibility criteria for the PAA approach that would focus on whether or not there was expected to be a significant variation in cash flows in the pre-claim period.

Premium allocation approach – Mechanics

The board discussed the three issues within staff paper 2B/78B dealing with the PAA: the ED requirement to discount the liability for remaining coverage and accrete interest, the types of costs to include in acquisition costs for contracts subject to the PAA, and the balance sheet presentation for acquisition costs relating to PAA contracts.

Discounting and interest accretion on the liability for remaining coverage

The staff considered the following alternatives regarding whether to include discount and interest accretion in the measurement of the liability for remaining coverage. Two alternatives were tabled:

Alternative A: The liability for remaining coverage should not be discounted and interest should not be accreted on the liability, regardless of the coverage period of the insurance contracts.

Alternative B: Require discounting and interest accretion in the measurement of the liability for remaining coverage for contracts that have a significant financing component. As a practical expedient, do not require discounting and interest accretion if the coverage period is for one year or less.

The staff are split on this issue. Alternative B would be consistent with the Revenue ED. Also, it would account for the fact that investors are not indifferent to timing of cash flows. There is a simplification in this alternative as it allows no discounting / accretion if the period of coverage is less than a year. An argument for Alternative A is that the effect of discounting / accretion is likely to be immaterial and therefore would only add complexity to the model. Further, this information may not provide useful information to users.

Several Board members noted that they fully support Alternative B. This would be because in various constituencies there may be high inflation and high interest rates in which case the timing of cash flows will have a significant effect.

Another Board member asked if they would then also agree with the practical expedient in Alternative B even though there are high inflation and high interest rates. This Board member noted that for A (even if time value was insignificant) he completely disagrees with the argument that the accreted amounts should not be added to revenue. Insurance revenue should be the same as other entities' revenue accounting. Not to add accretion to revenue would completely misrepresent revenue.

A Board member questioned if a 24 month contract with monthly premiums would meet the expedient or not. The way the guidance is currently written assumes it does not as the coverage period is more than 24 months. However, under Revenue Recognition ED guidance he would argue that it does as the monthly premium paid is for the coverage period of the next month. The staff noted that the intention was that the Revenue ED should be the same as for Insurance and this issue is being considered by the revenue team.

The Board members indicated a leaning towards Alternative B. However, the FASB staff mentioned that in the FASB meeting, members gave a split view. If Alternative B was chosen, then they were leaning towards showing the premium separately from the

interest accretion as to not interfere with key performance indicators.

An IASB member noted that he disagreed with the calculation in the staff papers as there is an increasing premium income over time. He noted that this should be annuitised. There should then be no misrepresenting of premium income. Furthermore, if premium comes in early the only way to show faithfully the source of earnings would be by including time value of money as part of revenue. Time value of money can be successfully included in the PAA.

Treatment of acquisition costs

The staff noted that there are three topics to discuss on acquisition costs under the PAA:

- a) which costs to include, i.e. measurement of acquisition costs,
- b) which costs may be expensed as an option, and
- c) presentation of acquisition costs

The staff tabled the following alternatives on measurement for PAA acquisition costs:

- Include directly attributable costs (for the FASB limited to successful acquisition efforts only), consistent with the tentative decisions made under the BBA; or
- Incremental costs (this would be consistent with the Revenue ED)

With regards to the optional expensing, the staff gave the alternatives to expense either:

- Acquisition costs that are directly attributable but are not incremental; or
- All acquisition costs if the contract coverage period is one year or less, consistent with the revenue recognition proposals

On presentation, the staff sought leanings from the Board on the appropriateness of:

- Recognising acquisition costs as an asset (and thus the liability for remaining coverage would be gross of acquisition costs) and
- Amortising acquisition costs consistent with the boards' tentative decisions on reducing the liability for remaining coverage (over the coverage period on the basis of time, but on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time)

The staff's recommendation on presentation is consistent with the model proposed in the revenue recognition project: acquisition costs for PAA contracts should be recognised as an asset, with the liability for remaining coverage thus presented gross of acquisition costs; a change from the ED requirement to net such costs against the liability. Under this approach, acquisition costs would be amortised in a manner consistent with the recognition of premium.

On measurement for the PAA acquisition costs, the Board members seemed to mainly support an approach that would include directly attributable acquisition costs rather than including incremental costs only. They opted for consistency with the BBA because they viewed the PAA as a proxy to the BBA.

Most Board members leaned towards allowing expensing of all acquisition costs rather than only non-incremental costs under the PAA if the contract coverage period is one year or less.

Contrary however to the FASB members' leaning as explained by the FASB staff, most IASB members were not in favour of showing a separate DAC asset. Such an asset, it was argued, would require additional guidance on impairment. Further, the consistency between BBA and PAA was seen again and under the BBA it was decided that acquisition costs form part of the Day 1 residual margin/single margin measurement.

The FASB staff noted that the FASB members' concern was not so much on the DAC asset itself but rather on the fact that the asset is somehow netted against the liability and that would conceal understanding of movements in the liability.

An IASB member stressed that he was not against disclosing the DAC asset in the notes but against recognising it as a separate asset. He thought this decision had already been made in the discussions around the BBA.

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