

Insurance alert

IASB/FASB Board meeting - Insurance Contracts 27-28 February 2012

PwC Summary of Meetings

27-28 February 2012

- Premium allocation approach
 - Eligibility criteria and practical expedient
 - Permit or require
 - Discounting and interest accretion
 - Treatment of acquisition costs
- Onerous contracts
- Infrequent high severity claims
- Unbundling
- Financial instruments with discretionary participation features (IASB only session)

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 first day was an IASB and FASB joint Board meeting. The Boards discussed eligibility criteria and mechanics of the premium allocation approach (PAA), onerous contracts, measurement of infrequent, high severity events and the unbundling of goods and services components. On the second day, which was an IASB only session, the IASB discussed financial instruments with discretionary participation features.

On the PAA, the Boards confirmed that the FASB views the PAA as a separate stand alone model whereas the IASB views the PAA as a proxy to the building block approach (BBA). However, the Boards did agree on the drafted criteria to identify contracts eligible for the PAA, subject to some rewording. In addition the IASB will include a principle to use PAA as long as it approximates to BBA whereas the FASB will not. The FASB will require the use of the PAA if the criteria are met whereas the IASB will permit use of the PAA. A number of practical expedients were agreed on by both Boards in relation to the mechanics of the PAA.

When deliberating the onerous contract test for contracts under the PAA for which the undiscounted incurred claims practical expedient has been elected, the Boards decided that the expected cash flows should not be discounted for both identification and measurement of onerous contracts.

On the measurement of high severity events the boards decided that an insurer should not update period end cash flow estimates in light of the occurrence or non-occurrence of insured events after the balance sheet date.

On unbundling goods and services from insurance contracts, the Boards agreed that in principle the criteria for identifying the 'distinct' nature of such goods and services from the Revenue Recognition project should be used.

On the second day, the IASB voted for the inclusion of financial instruments with discretionary participation features within in the scope of the insurance contract standard. However this will be limited to contracts issued by insurers.

PAA: Eligibility criteria and practical expedient

The staff explained that they had, as a result of the education sessions in January 2012, revised the PAA eligibility criteria. In this session, the staff wanted to discuss the boards' views on the revised eligibility criteria, whether there should be a practical expedient to apply the PAA as well as 'permitting versus requiring' the PAA if the criteria are met.

With regard to the criteria themselves, whilst the staff at the IASB and FASB agreed on the wording of the criteria, the IASB staff proposed to include an overall principle alongside the practical expedient and include eligibility criteria as application guidance only. The principle envisaged by the IASB staff would be that the PAA can be used as long as the results approximate that of the building block approach (BBA).

On the practical expedient both the IASB and FASB staff agreed that a practical expedient should apply, i.e. allow the PAA without further evaluation, if the coverage period is one year or less. The rationale is that it is unlikely in that case that there will be significant changes in the net cash flows, there will be no uncertainty over the coverage period and there will be no significant judgement in allocating the premium.

The revised eligibility criteria as indicated in the staff papers are:

Insurers should apply the BBA rather than the PAA 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; or
- (b) Significant judgement is required to allocate the premium to the insurer's obligation to each reporting period. This may be the case if, for example, significant uncertainty exists about:
 - (i) the premium that would reflect the exposure and risk the insurer has for each reporting period; or
 - (ii) the length of the coverage period.

A FASB member asked how the criterion (a) would be interpreted for a 3 year hurricane policy. The FASB staff noted that a catastrophe policy would be the most difficult one to apply the criteria to as there would be no way of knowing one or two days before the hurricane hits whether a claim was incurred or not. However, insurers do have expectations of losses in hurricane seasons. Even though the amount of change when the event does occur could alter the cash flows significantly compared to initial expectation, there is still an expectation at inception which may or may not change. The FASB member thought that this contract example (and catastrophe

contracts in general) would fail the PAA criteria as the initial expectation is only an estimate and it is very likely that there will be significant changes in the cash flows.

The FASB staff explained that generally the intention would be that catastrophe policies should be in the PAA since the criterion is applied at the inception of the policy, and at the inception of the policy and up until the point immediately before the catastrophe happened, there is really no better estimate or reason to change the estimate made by the insurer. Hence, looking at this criterion in isolation, the contract should meet the criteria of the PAA.

Another FASB member supported the criteria subject to some application guidance wording. He stressed that the insurer does not have reason to update the estimates until the catastrophe has arisen. Therefore one could not say that there is likely to be a significant change.

An IASB member asked the staff what the meaning of 'likely' was in criterion (a). The staff explained that there is no quantification on this, but rather qualitative factors should be considered. The question to ask at inception is whether it is likely that there will be significant changes to the net cash flows.

Application guidance will be given around this, for example longer duration contracts are more likely to be subjected to estimation changes. Also, if the insurer expects that during the coverage period there will be changes in the pricing for similar contracts, then this would indicate that there may be significant changes to the net cash flows. The staff explained that it was not the intent that individual contracts would move in and out of the PAA or BBA depending on updates in estimates on cash flows. In addition, assuming the practical expedient is accepted, many contracts would be in the PAA without further evaluation.

An IASB member noted that he thought it was important before deciding on the details of the eligibility criteria to firstly decide on where the boards stand on whether the PAA is a proxy to the BBA or if there are two models. This would then lead to being able to include a principle in the standard and examples in the application guidance. Should the examples and related guidance not be conclusive the insurer would fall back to the principle. It would therefore make a difference whether the determination of PAA versus BBA is covered by a principle with clarifying criteria in the application guidance or by inserting - without principle - the eligibility criteria into the standard.

The FASB staff explained that they thought it may be possible to achieve common ground as the criteria may work under both viewpoints, even if the FASB and IASB disagreed on the one versus two model outcome.

Another IASB member thought that it is not the criteria themselves but rather the measurement of the claims liability that is the fundamental difference between the boards. The reason why the IASB prefers the one model approach essentially is the risk adjustment. The IASB views the approaches as one model as the claims liability is measured under the BBA and therefore the measurement between PAA and BBA is the same at that point. Prior to that, with the application of the criteria, there is no material difference; hence the one model approach is sensible.

The FASB however, has two models as there is no risk adjustment and a completely different measurement for the claims liability. If there is a different measurement, i.e. a different basis for recognising profit over the life of the contract, there is no reason to say that there is one model or that one model approximates to the other. To resolve everything, the risk adjustment would need to be resolved as well as the pattern of profit recognition. The IASB board member noted that he still supported the criteria; they represent the right approach in his view. Whether the criteria end up in the application guidance or in the standard would be a secondary consideration.

The FASB chair agreed with this reflection. She thought if the criteria could be agreed on it would be possible for the IASB to include a principle in the standard. The FASB would not do that but would probably include it in the Basis of Conclusions and explain the difference there and why the FASB followed the alternative view. The question around 'permit versus require' should still be discussed and may not necessarily lead to a difference.

A FASB member agreed on focussing on the details of the eligibility criteria. However, he pointed out that the risk adjustment discussion may not be the only difference to consider in the discussion of PAA versus BBA criteria. For example, the statement of financial position would show two separate liabilities for the PAA: the liability for incurred claims and the liability for remaining coverage, yet for the BBA there is no distinction. Also, the premium number may be different in the models subject to resolution of the unbundling and disaggregation discussions. He further thought that in relation to the criteria, the follow-on application guidance in the staff papers was focussed around criterion (a). He questioned whether criterion (b) would therefore be necessary at all. Would criterion (a) be the real driver? The FASB and IASB staff noted that both criteria are important and that some of the application guidance on indicators refers to both criteria.

An IASB member generally agreed with the two existing criteria but thought that perhaps additional criteria could be added, including a reference to the length of the contract period and the time value of money, which he believes is not properly reflected. He also noted that to

the extent the IASB continues to believe that the residual margin should be unlocked for changes in expected cash flows in the BBA approach (whereas the residual margin is effectively locked in using the PAA the liability for remaining coverage), this could create a significant difference between BBA and PAA. The unlocking of the residual margin would therefore undermine the principle that the PAA is a proxy for the BBA.

The IASB chair expressed his wish to come to a resolution on the criteria. The FASB staff noted that given the concern expressed by some that the current wording of the first criterion might lead some to conclude that windstorm coverage would require application of the BBA while the intent was that such coverage be under the PAA, they could amend the language. For example, it could say that 'it is likely that during the period before an 'adverse event' has occurred, there will be a significant change in the expectations of net cash flows required to fulfil the contract.' Some IASB staff thought it may be difficult to define what an adverse event is as compared to an insurable event. Introducing a shift towards a new reference point may confuse matters.

Another IASB member supported the criteria as well but thought that the catastrophe example would be a BBA contract. He expressed his wish to vote on the principle first as opposed to the detailed criteria.

The IASB then voted unanimously on including a principle in the standard and a practical expedient for contracts with coverage of one year or less.

An IASB member noted that the principle will help in the decision making process to classify for example the catastrophe policy. Even if the criteria are not fully fitting for a particular example, the principle will guide the entity. The IASB staff pointed out that the decision on BBA or PAA should be made at contract inception. When the contract is written, there is probably no better estimate for the claim incurrence and the contract could be PAA. Conversely, if the entity believes that during the coverage period there will be changes in estimates that affect net cash flows, they would not be in the PAA.

A FASB member thought there is no logic in including a catastrophe cover in the BBA as there is not a lot more reliable data that could be included during the coverage period, i.e. before the hurricane hits land, someone would be guessing to include different data from what was included at inception.

The IASB chair asked therefore if the staff could tweak the criteria such that the hurricane policy would clearly go to PAA. The FASB staff confirmed they could probably do this.

Given that the FASB views the PAA as a different model compared to the BBA, the FASB chair asked the FASB members to vote on the practical expedient first. There were 3 disagreeing votes and 4 agreeing votes. With regards to the revised PAA criteria themselves the FASB members then voted with a clear majority in favour of the criteria subject to clarifying language to be added to include catastrophe policies. The FASB chair then also asked for a vote if there should be the same overriding principle as well that the IASB just agreed to. Only one FASB member agreed to this.

The IASB then unanimously voted on accepting the revised PAA criteria with modification to clarify for the application to hurricane policies.

PAA: permit or require

One IASB member thought that the question on whether to permit versus require the PAA approach instead of the BBA approach is implicit in the vote taken on the one versus two model approach. That is, the IASB would argue that the PAA can only be used when it gives a similar answer to the BBA, and thus it is a practical expedient to be permitted rather than required.

The IASB voted unanimously in favour of the view that an insurer should be permitted but not required to apply the PAA to contracts that meet the eligibility requirements.

In contrast, a large majority of the FASB members, who generally view the PAA as a separate model rather than a practical expedient, voted to require rather than permit the PAA approach if the criteria are met. One FASB member explained this by saying he understood the IASB rationale for 'permitting' but in his view, having voted effectively for a two model world, a 'requirement' to use the PAA would be more consistent.

PAA: Discounting and interest accretion

The next issue discussed was whether to require adjustment of the liability for remaining coverage for the time value of money. The staff proposed two alternatives:

Alternative A: no discounting or interest accretion

Alternative B: discounting and interest accretion is required for contracts that have a significant financing component and, as a practical expedient insurers need not apply discounting or interest accretion if the insurer expects at contract inception that the period of time between payment by the policyholder of all or substantially all of the premium and the satisfaction of the insurer's obligation to provide coverage will be one year or less.

The latter alternative is consistent with the spirit of the revenue recognition proposal, although the wording on the practical expedient varies slightly.

Both Boards unanimously voted for Alternative B, i.e. the time value of money concept should be applied where significant.

On the practical expedient the staff explained that the proposed insurance wording is slightly different from that in the revenue recognition proposal due to an unintended flaw in the revenue recognition proposal wording. It appeared from the boards' discussion that they intended on pursuing a revision to the wording in the revenue recognition practical expedient guidance to correct this.

The staff provided an example of how the insurance practical expedient would be applied for the following scenarios:

- a. An insurance contract with a coverage period of two years where payments are paid monthly in advance.
- b. An insurance contract with a coverage period of three years with premiums paid annually in advance.
- c. An insurance contract with a coverage period of three years with all premiums paid at the beginning of the first year of coverage.

The practical expedient of not requiring discounting and accretion of interest on the liability for remaining coverage would be permitted in scenarios (a) and (b) above but not for scenario (c) where the time between the payment of premium and provision of coverage is greater than one year. Scenario (c) would therefore need to be analysed to determine if the financing component were significant, and if so, discounting and accretion would be required.

PAA: Treatment of acquisition costs

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

- which costs to include, i.e. measurement of acquisition costs;
- which costs may be expensed as an option; and
- 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
- Include only incremental costs (consistent with the revenue recognition proposal).

With regards to 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 proposal.

An IASB member explained that in the January education session he supported an alternative that would measure acquisition costs to include directly attributable costs in accordance with the BBA, but permit expensing of all acquisition costs if the contract coverage period is one year or less. Another IASB member agreed as this would ensure that PAA and BBA contracts would be treated similarly, while allowing a practical expedient for immediately expensing PAA acquisition costs.

A FASB member thought it was a difficult choice as consistency with revenue recognition guidance on measurement and presentation was effectively up for debate. If presentation for PAA contracts in effect follows the revenue guidance, then measurement should also follow this same principle. Therefore he would advocate including only incremental acquisition costs, but allowing expensing as a practical expedient for PAA contracts, which is consistent with the revenue recognition guidance.

In contrast, an IASB member thought it would be confusing for the reader to have different models for acquisition costs under BBA and PAA insurance contracts.

In voting, a large majority of each board supported including directly attributable costs consistent with the BBA approach.

A large majority of the IASB and FASB (unanimously) voted for the option to permit expensing of all acquisition costs for PAA contracts if the contract coverage period is one year or less.

On presentation of directly attributable acquisition costs under the PAA approach, the staff asked the board the appropriateness of either:

- 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; or
- Netting acquisition costs against the insurance obligation as originally proposed.

A FASB member suggested what was described as a new alternative and which he seemed to be suggesting for both

the BBA and PAA approaches: include the acquisition costs as part of the residual (single) margin (or the liability for remaining coverage in the case of the PAA approach) which would be presented separately from the liability to the policyholder (or claim liability in the case of the PAA approach) with disclosures in the footnotes.

An IASB member supported this alternative. He also stressed that acquisition costs should not be a separate asset. Another FASB member also supported this on the grounds that there is merit in not having acquisition costs as part of the expected cash flows. The expected cash flows other than acquisition costs are between policyholders and the insurer.

However, revenue treats incremental acquisition costs as an asset. The implication may be that revenue recognition guidance may need to be reconsidered. Offsetting costs against the margin that is deferred in insurance is more sensible than offsetting the costs against the liabilities. It is worth noting that in the revenue guidance there is no deferred margin.

When it came to the voting, a large majority of IASB members and all FASB members voted in support of this new alternative to offset the acquisition costs against the single or residual margin.

Expected value measurement for infrequent high-severity events

The boards discussed whether the expected cash flows for infrequent high-severity events should be adjusted to reflect post-balance sheet events. This issue could apply to both expected cash flows estimated under the BBA as well as those estimated in the onerous contract test.

The example given by the staff of a situation where this might occur is a wind storm coverage for which a hurricane might be sitting off the coast at period end which is resolved several weeks after the balance sheet date. The issue is whether the actual loss results of the wind storm damage that are known in the post-balance sheet period should be used in the prior period end estimation of the liability.

The staff paper suggested several possible alternatives:

(1) the IASB exposure draft proposal that an insurer would not update cash flow estimates in light of the occurrence or non-occurrence of insured events after the balance sheet date

(2A) update cash flow estimates for events that occur after the balance sheet date but before issuance of the financial statements for onerous contract liabilities when the PAA is applied

(2B) update cash flow estimates for events that occur after the balance sheet date but before issuance of the financial statements for all insurance contract liabilities

(3) the IASB exposure draft proposal amended to not recognise an onerous contract at the balance sheet date if the onerous contract liability is known to have reversed in the post balance sheet period as a result of subsequent events.

The staff paper conceded that alternatives 2A, 2B, and 3 would be exceptions to the conceptual model described in the ED. Paragraph B40 of the ED provided an example of a catastrophe spanning a period end and suggested that the probability assigned to each scenario in estimating period end expected cash flows should reflect conditions at the end of the reporting period, and not the storm that, with hindsight, is known to have occurred. Nevertheless, the staff proposed that alternatives 2A, 2B, or 3 would provide more meaningful, comparable information to users.

During the discussions some IASB and FASB members seemed to question the need for such guidance at all since making an exception for high severity and infrequent events might open the discussion for several issues that might be analogised to the one here. One of the members also noted that very few comment letters received by IASB raised this as a problem (4 out of 250, all 4 received from US insurers). However, FASB staff added that the respondents to the exposure draft were not aware of the issue and during the deliberation and outreach process they have received substantial feedback on the potential issue.

The board members who emphasised that there is no need for specific guidance suggested that instead, users should simply be referred to IAS10/FASB ASC Topic 855 on the events occurring after the balance sheet date that make a distinction between adjusting (type I) and non-adjusting (type II) events. They indicated that the issue was similar to other assets and liabilities subject to uncertainty, such as litigation claims.

The staff acknowledged that IAS10/FASB ASC 855 guidance could be referenced, but pointed out that the guidance was more typically applied in an incurred loss model rather than an expected loss model situation, and offered limited guidance for the latter. The staff later suggested that perhaps the ED example in paragraph B40 should be maintained, along with a reference to IAS10/FASB ASC 855 and explicit acknowledgement that such situations should be treated as type II disclosure events rather than measurement events.

The supporters of alternative 1 emphasised that any volatility caused by measurement at expected value based on information available at year-end is economic and is

not artificial therefore should not be eliminated. One member said that the issue was analogous to a fair value measurement of an equity security for which the stock price is known to have declined immediately after period end. The stock is nevertheless valued at its fair value at the balance sheet date, with no use of post-period hindsight.

Supporters also added that the application of alternative 2A and 2B is too complicated and also suggested that the solution chosen should be as simple as possible. Both IASB and FASB members raised the issue on the lack of comparability option 2 could cause in cases where companies had different issuance dates for their financial statements: potentially different information about hurricane losses and resultant different adjustments to their year-end liabilities.

However, a few IASB members seemed to disagree with alternative 1. They expressed the view that it might result in strange accounting if the post-balance information available at the time the financial statements are issued is ignored. If the insurer is forced to develop an expected value estimate including a risk adjustment for uncertainty, the insurer might include a significant risk adjustment for an expected hurricane at year-end that is known not to have occurred by the time the financial statements are released.

In summary, a clear majority of both boards supported alternative 1, which is consistent with the ED proposal. However, the boards acknowledged that the interpretation of IAS10 and FAS ASC Topic 855 is not straightforward for expected loss models and therefore decided to add guidance on infrequent high-severity claims in terms of their classification as non-adjusting/type II events.

Onerous contract test

As discussed at a prior meeting, the onerous contract test would be applied both to contracts in the pre-coverage period and to contracts applying the PAA. A contract would be onerous if the expected present value of future cash outflows exceeds (1) the expected present value of future cash inflows (for the pre-coverage period) or (2) the carrying amount of the liability for remaining coverage (for the PAA).

The boards briefly discussed whether the measurement of the liability for onerous contracts that have been identified should be updated at the end of each reporting period. Both boards unanimously voted for re-measuring the liabilities for onerous contracts at the end of each reporting period.

The second issue addressed (by IASB only) was whether the risk adjustment should be considered when identifying onerous contracts.

An IASB member expressed his view that the answer should be consistent with the IASB's view on the risk adjustment itself: if the IASB continues with its present view that the risk adjustment is part of the measurement of the liability then the consistent answer would be to include it both for identification and for measurement purposes. However, if the risk adjustment is seen as unearned profit, it possibly should not be included. After limited discussion 9 IASB members supported the staff proposal to include the risk adjustment when identifying and measuring onerous contracts.

The boards then discussed jointly the third issue - the application of the onerous test for contracts under the PAA for which the undiscounted incurred claims practical expedient has been elected. The key issue debated was whether or not expected cash flows should be discounted in performing the triggering test for a loss contract and in measuring the amount of the loss.

The staff proposed two possible alternatives:

- (1) identify whether a contract is onerous on a discounted basis and measure the liability for onerous contracts on an undiscounted basis; or
- (2) identify whether a contract is onerous on a discounted basis and also measure the liability for onerous contracts on a discounted basis.

At the start of the discussion an FASB board member challenged the staff view by raising a fundamental issue: the paper seems to suggest that there are contracts that are so marginally priced that the time value of money drives their profitability. His opinion was that in such cases the boards might revisit their previous tentative decision and declare that the non-discounting of incurred claims under the 12 month practical expedient was inappropriate for such contracts and therefore they should not be eligible for the practical expedient. While some IASB members shared his view they added that an override of a practical expedient would be difficult.

Several members of both boards challenged the staff view that the expected cash flows should be discounted in either the triggering test for an onerous contract or in its measurement where the insurer had adopted the undiscounted practical expedient approach for incurred claims. They suggested that if there is an exception it should be applied consistently which means that the onerous test should be identified and measured consistently with the practical expedient liability measurement choice (undiscounted).

The staff replied that identifying the onerous contracts based on an undiscounted basis might result in recognising a liability for onerous contracts when the contract is written even if the contract itself is not onerous

since the investment income is taken into consideration when pricing the contract.

In spite of the staff argument, members of both boards still saw the undiscounted alternative as consistent with the measurement of the incurred claim liability when the undiscounted practical expedient is chosen. The boards therefore dismissed the two staff proposals and instead voted for a third alternative: if an insurer opted for the practical expedient of not discounting incurred claims, there should be no discounting of expected cash flows in the onerous contract test. 11 members of IASB and 6 members of FASB supported this conclusion. An IASB member pointed out after the voting that the decision also implies that if an insurer applies the practical expedient and therefore is required to identify and measure onerous contracts on an undiscounted basis, it is not allowed to change from the practical expedient to a discounted measurement basis to avoid an onerous contract charge.

Unbundling goods and services

In a prior meeting the boards had tentatively agreed to unbundle goods and services within insurance contracts based on criteria developed for identifying separate performance obligations in the revenue recognition project.

In the latest staff paper discussed during the session, the staff tailored the revenue recognition wording to fit insurance contracts, but the objective is the same. An insurer should identify whether any promises to provide goods or services in an insurance contract meet the definition of a performance obligation, and if any such performance obligations are distinct from the insurance contract, the insurer should apply other applicable accounting principles to those performance obligations.

A good or service is distinct if the insurer regularly sells the good or service separately or if the policyholder can benefit from the good or service either on its own or together with other resources that are readily available to the policyholder. Readily available resources are those that are either sold separately by the insurer or another entity, or those that the policyholder has already obtained.

However, a good or service is not deemed to be distinct if both (1) the good or service is highly interrelated with the insurance component and transferring them to the policyholder requires the insurer to also provide a significant service of integrating the good or service into the combined insurance contract and (2) the good or service is significantly modified or customised in order to fulfil the contract.

The staff noted that the current paper excluded discussion of asset management services that are provided in conjunction with account balance insurance products, which will be dealt with separately at a future meeting

when the unbundling of investment components is discussed.

The staff paper examples dealt principally with health insurance contracts that provide claim processing services in addition to varying amounts of health insurance coverage ranging from none (which would be accounted for purely as a service contract), "stop loss" coverage (which would require bifurcation of the service element), and "high-deductible" coverage (which would require no unbundling)

An IASB member asked whether some of the related paragraphs copied over from the revenue recognition exposure draft were really needed in the insurance guidance as he thought some might not be relevant for insurance contracts. For example, he did not see the relevance of the guidance on determining whether a good or service was distinct that noted " the policyholder can benefit from the good or service either on its own or together with other resources." The staff responded that the application of that guidance to insurance contracts was illustrated in the appendix with an example health care contract with a distinct claims servicing element.

A FASB member referred back to the educational session the FASB previously had on the same topic and observed that it may be difficult to allocate acquisition costs between the two models given the differences in terms of measurement and presentation. Another FASB board member supported the observation and added that the insurance measurement model differs from the revenue recognition model in terms of contingent consideration and discounting. Therefore, the boards need to decide on the allocation approach at a future meeting by considering its consequences. One concern raised was that if the good/service component is valued first and the residual is allocated to the insurance component, since it is continuously re-measured, any difference will appear upon the next measurement in the statement of profit or loss.

In a vote, all IASB and FASB members voted in support of the staff's suggested wording on identifying separate performance obligations. However, a FASB member reiterated that follow up is performed on the impact on allocation of differences between the insurance and revenue recognition models, such as the accounting for contingent consideration, acquisition costs, and discounting.

Financial instruments with discretionary participation features – IASB only session

The IASB discussed whether to include financial instruments with discretionary participation features in the scope of the insurance standard. The staff introduced the session by highlighting some of the key characteristics of these 'non-insurance' contracts and some of the similarities when compared to insurance contracts with similar features. They noted that typically these financial instruments are issued by insurers, have similar conditions to participating insurance contracts and are managed in the same way as participating insurance contracts. However such contracts are common only in certain jurisdictions.

The first paper put forward by the staff proposed that financial instruments with discretionary participation features should be within the scope of the insurance contract standard. The staff highlighted that this proposal was based upon:

- The importance of comparability between contracts with participating features rather than between financial instruments with and without such features.
- Excluding these contracts from scope would cause practical complexities as the majority are issued by insurers and managed alongside participating insurance contracts.
- Difficulties could occur in applying the financial instruments standards to the measurement of discretionary participation features.
- This would lead to more useful information for investors as the measurement would include all cash flows that are expected to be paid to policyholders (and hence will not be available to other investors).

The staff also noted the FASB discussion paper proposed that as financial instruments with discretionary participation features do not meet the definition of insurance, they should be excluded from insurance contracts standard.

One IASB member noted his concerns that these contracts do not meet the definition of insurance. He was also concerned that other industries such as banks may not have considered this scope inclusion.

Another IASB member wanted to further understand the issues associated with using the financial instrument standard for such contracts.

The staff summarised the accounting considerations within the financial instrument standard. The guaranteed element would meet the definition of a liability. However difficulty would arise when considering the discretionary element. If there is discretion over the 'timing' of when the amounts will be declared to the policyholder, then this component would meet the definition of a liability. Due to the uncertainty over timing this would give rise to

measurement uncertainty. If there is discretion associated with the 'amount' to be paid to the policyholder and the entity could in effect avoid delivery of cash to the policyholder, then this is likely to meet the definition of equity. As this amount is presented as equity it would not be re-measured until the amount to be paid to the policyholder had been declared.

An IASB member noted his strong support for inclusion within the scope of the insurance contract standard. He noted that these instruments look like and are managed in the same way as participating insurance contracts and therefore he would want them to be treated in the same way.

However another IASB member highlighted that expanding the insurance model to include such contracts would add too much discretion as to whether the model should be used or not. He also believed that if a bank issued such a contract the question would therefore arise as to whether an obligation existed or not, and he considered that no equity component would exist.

The staff responded that the equity component could be small or negligible. However as equity cannot be re-measured, this would create a disconnect between how the instrument is measured and how it is managed. Should the financial instrument standard need to be applied then this may also reopen the debate on economic compulsion.

An IASB member asked whether the contract is sold with an expectation that the policyholder would share in the contract or if a regulator would force payment, then it could be argued that a constructive obligation existed and therefore this is a liability. The staff noted that this could not be discussed separately from the economic compulsion debate. Theoretically the entity may have total discretion and therefore could avoid payment. However if other competitors do pay out on similar contracts then the entity would have an economic compulsion to pay. As such this would be a liability. Another IASB member responded that this is similar for dividends where companies are compelled to pay a dividend to the share holders. The same argument could therefore not be used to support liability recognition.

An IASB member asked whether the instrument fell within financial instrument standard scope, it would be

measured at amortised cost or at fair value. If at amortised cost, then an accounting mismatch could be created compared to the measurement of the underlying assets. He questioned whether this result would be useful.

Another IASB member expressed his support for the proposals, on the basis that a number of financial instruments are scoped out of the financial instrument standard, for example leases and pensions. All of these instruments are financial instruments; however it is the economic characteristics of such instruments that have determined the accounting. The same principle has therefore been applied here.

An IASB member commented that the proposed definition of financial instruments with discretionary participation features could apply to instruments issued by banks and corporates. The scope inclusion could therefore attract non-insurance products into the standard.

The staff highlighted that if financial instruments with discretionary participation features are excluded from scope of the insurance standard, then time would be needed to develop the financial instruments standard to address the measurement issues.

An IASB member suggested that the scope inclusion could be limited to insurers. Another member supported this view though noted that this was not an ideal solution. Another member suggested that this could raise issues for consolidated groups that include both a bank and an insurance company and whilst he was not against the suggestion, he commented that this situation should be considered. Another member suggested that the limited scope inclusion could be addressed through a change in the definition.

In a vote, 7 members voted in favour of the staff's proposals. However in a second vote, which proposed to limit this inclusion only to insurers, a large majority voted in favour.

The staff was asked to bring a paper back to the board to re-consider the definition of financial instruments with discretionary participation features in light of the second majority vote and to consider any potential consequence of this change for conglomerates.

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