IASB/FASB Meeting October 2009

IASB agenda reference	**13A**
FASB memo reference	**30A**

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Project	**Insurance Contracts**
Topic	**Resolution of significant tentative decisions**

Purpose of this paper

1. This paper discusses the significant areas where the Boards have reached different decisions. The purpose of this discussion is to see whether the Boards can resolve these differences. Their resolution is integral to the timely completion of deliberations and subsequent issuance of an exposure draft. In addition, this paper discusses whether guidance on policyholder accounting should be included in the exposure draft.

2. This paper briefly describes these decisions, which relate to:

   (a) Policyholder accounting (paragraphs 4 through 7)

   (b) Measurement objective (paragraphs 8 through 18)

   (c) Acquisition costs (paragraphs 19 through 21).

3. This paper does not provide detail on these topics since either (a) both Boards have already deliberated the issues or (b) in the case of policyholder accounting, the issue is relatively straightforward. If Board members need previous agenda papers or more information about policyholder accounting, the staff can provide this information upon request.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Policyholder accounting

4. The scope of the insurance contracts project initially has included both the accounting by the issuer of the insurance contract (the insurer) and the accounting by the purchaser of the insurance contract (the policyholder). The following are the main reasons for dealing, at some stage, with policyholder accounting:

   (a) Relevant guidance in IFRSs is limited and fragmented. (Agenda paper 6 for the IASB's meeting in November 2007 summarises this, and highlights some of the issues to be considered in planning work on policyholder accounting.) Although the staff is not aware of major practice issues within IFRSs, the FASB and EITF have felt it necessary to issue several documents dealing with various aspects of policyholder accounting in U.S. GAAP. Establishing clear principle-based guidance could prevent similar practice issues arising under IFRSs.

   (b) The project deals with the accounting for a particular type of transaction, rather than by particular types of entities. It would be logical and efficient to consider the accounting by both parties in the same project.

   (c) The project clearly needs to deal with policyholder accounting for one specific type of contract: accounting by an insurer for reinsurance that it holds. There is no obvious reason not to deal with all aspects of policyholder accounting.

5. For the following reasons, the IASB has decided tentatively not to address policyholder accounting before finalising an exposure draft on accounting by the insurer for insurance (and reinsurance) contracts issued and reinsurance contracts held:

   (a) It is much more urgent to address accounting by insurers than accounting by policyholders. Most policyholders are individuals (households) and entities (businesses). Most households do not need accounting guidance and, for most entities, the purchase of an insurance contract is not a significant expense. Consequently, the accounting for an insurance contract is not a significant issue for most buyers of insurance.

(b) Although it would be useful to deal with policyholder accounting in due course, it would be an unnecessary distraction in the short term. Indeed, some respondents to the IASB's discussion paper suggested that policyholder accounting is not a priority and argued that the Board should not deal with it now if doing so would delay the urgently needed standard for insurers.

6. The IASB intends to use the comment letter period to further research the feasibility of providing guidance for non-insurance entity policyholders.

7. The FASB has not yet discussed whether policyholder accounting should be addressed in the exposure draft.

Question for the boards
Should policyholder accounting be included or excluded from the exposure draft? [Although the exposure draft should address how both parties - the cedant and the reinsurer - should account for reinsurance contracts].

Measurement objective

8. Both Boards have had significant discussions about the measurement approaches for insurance contracts. The brief analysis below provides (a) the relevant definitions being used for each approach, (b) the similarities, and (c) the differences.

Definitions of Measurement Approaches

9. The IASB has tentatively decided that the measurement should be based on the measurement being developed in the project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, modified to exclude day one gains (the updated IAS 37 approach). The current updated IAS 37 language is as follows (this language is an excerpt of an October 2009 agenda paper, Appendix to Paper 7, prepared by the IAS 37 project team):

(a) The requirement is to measure the amount that the entity would rationally pay on the reporting date to be relieved of the present obligation.

(b) The amount that the entity would rationally pay to be relieved of the present obligation is the lowest of:

(i) The value the entity would gain if it did not have to fulfil the obligation;

(ii) The amount the entity would have to pay the counterparty to cancel the obligation; and

(iii) The amount the entity would have to pay a third party to transfer the obligation to that party.

(c) If there is no evidence that the entity could cancel the obligation or transfer it to a third party for a lower amount, the entity measures the liability at the value it would gain if it did not have to fulfil the obligation.

(d) An entity estimates the value it would gain if it did not have to fulfil the obligation using expected present value techniques. The calculations take into account:

(i) The outflows of resources expected to be required to fulfil the obligation (the probability-weighted average of the possible outcomes);

(ii) The time value of money; and

(iii) If the amount or timing of the outflows is uncertain, any additional amount the entity would rationally pay to be relieved of risk.

(e) An entity should measure the resource outflows at their value, not cost. If the obligation is to provide a service at a future date, the entity measures the service outflows at the amount it would rationally pay a contractor at the future date to carry out the service on its behalf.

(i) If a market exists for such services, the amount is the price that a contractor would charge.

(ii) If no market exists, the entity would estimate the amount.

(f) The Board directed the staff to develop guidance explaining how, in the absence of a market, an entity would use a 'building block' approach to estimate the amount it would rationally pay a contractor to carry out the service.

10. The FASB has tentatively decided that the measurement should be based on a current fulfilment value approach. Current fulfilment value is based on the expected present value of the cost of fulfilling the obligation to the policyholder over time, but also includes a margin or margins.

Similarities

11. Under both an updated IAS 37 approach and current fulfilment value, there are several similarities in the approaches. Both measurement approaches require:

    (a) Current estimates of (expected, that is, probability-weighted) future cash flows

    (b) Incorporation of the time value of money

    (c) Consideration of all available information (for example, both approaches would require the use of observable market prices to determine inputs such as interest rates or, when the payouts on an insurance contract are linked to equity prices, those prices)

    (d) No recognition of positive day one differences in profit or loss (day one gains)

    (e) Margin(s) that decline over time as the insurer performs under the contract. (However, the models differ in how they deal with situations in which the risk or servicing effort increases over the life of the contract.)

Differences

12. The differences between an updated IAS 37 approach and current fulfilment value are:

    (a) Measurement objective: The updated IAS 37 approach builds on the amount an insurer would rationally pay to be relieved of an obligation. Although the measurement guidance for the updated IAS 37 approach acknowledges that insurers typically fulfil their insurance liabilities, it also specifically takes into account those cases (few, if any) where there is objective evidence of a lower transfer or settlement amount. Current fulfilment value focuses on the insurer's cost of fulfilling the insurance obligation over time; a transfer or settlement amount plays no role in this context.

    (b) Service activities: The updated IAS 37 approach includes estimates of cash flows for service activities based on what a contractor would charge to undertake the services. In the absence of a market for those services, the entity could

estimate the amount it would rationally pay a contractor by estimating the amount it would itself charge another party to carry out the service. The latter amount includes the profit an entity would require for those services (a service margin). Current fulfilment value does not include an explicit service margin (though, if applicable, that margin is implicitly included in the composite margin).

(c) Risk margin: The updated IAS 37 approach includes a risk margin that is remeasured each reporting period. The current fulfilment value approach does not include an explicit risk margin (though that margin is implicitly included in the composite margin).

13. At this meeting, the staff plans to discuss the issues related to the different tentative decisions related to the measurement objective and risk margins. The staff believes that these are the most significant differences between the measurement approaches. The issues the staff will present at this meeting are:

(a) What role do market inputs play in the updated IAS 37 approach for measuring insurance contracts?

(b) Can a risk margin exist in a measurement not based on a transfer price—for example, fulfilment value?

What role do market inputs play in the updated IAS 37 approach?

14. The FASB has questioned whether the objective for an updated IAS 37 approach (in the context of measuring an insurance contract) is based on a market-participant view or an entity-specific view when determining inputs for measurement. The FASB's concern is that the objective is integral to how the measurement approach will be applied in practice. That is, the objective of the measurement approach will dictate future interpretations as practice issues emerge and will be instructive in resolving those issues. Accordingly, the issue can be summarized as follows:

(a) The FASB questioned that describing the updated IAS 37 approach as the value of the entity not having to fulfil the obligation indicates that someone else is fulfilling the obligation; this may steer the measurement towards a transfer-based

market participant notion. Additionally, the guidance on the updated IAS 37 approach, for example, the guidance around contractors' cash flows, might bring some hypothetical market elements into the measurement.

(b) The IASB's IAS 37 project team has responded that because a market does not exist for insurance contracts, the updated IAS 37 approach is based principally on the insurer's inputs and does not require the search for market inputs (except for market variables such as interest rates, which would also be used in current fulfilment value). However, the guidance of IAS 37, for example, the guidance around contractors' cash flows, provides discipline around the estimation process.

15. A key question for consideration is how some inputs are determined for an insurance contract and, in relation to that, what potentially the impact is of the difference between the two views in paragraph 14. For example, since a market does not generally exist for insurance contracts, the majority of inputs would be based on the insurer's own inputs anyway.

Can a risk margin exist in a measurement not based on a transfer notion?

16. Is the risk margin only part of a measurement that aims to estimate a transfer (or settlement) price or could a risk margin also exist if it the objective of the measurement is to estimate the cost of fulfilment over time?

17. Some believe that a risk margin can only be used in a measurement where the objective is to arrive at a transfer price (fair value or perhaps another form of a transfer or settlement price). In other words, a risk margin is integral to (an estimate of) a transfer notion but not to a value that estimates the fulfilment cost over time. Others believe that a risk margin is not limited to a transfer notion, but can also be used in other types of measurement when uncertainty is an inherent characteristic of the contract being measured. In their view, the purpose of the risk margin is to translate the significant uncertainty present in (for example) insurance contracts into a measurement.

18. One solution may be to rename the *risk margin* when it is not used in the context of a measurement based on fair value. For example, the risk margin could be described as an *uncertainty adjustment* when not used in the context of a transfer notion. However, the issue still remains as to whether it is appropriate to include this type of adjustment on top of the expected cash flows when that adjustment is based on the shape of the probability distribution of those expected cash flows.

Question for the boards
Do the boards confirm the similarities discussed in paragraph 11 and that no other major differences exist other than those explained in paragraph 12? Do the boards need more information about the discussion in paragraph 14 related to the objective of the updated IAS 37 approach? Should the measurement of an insurance contract include a risk margin regardless of the measurement approach (an updated IAS 37 approach or current fulfilment value)?

Acquisition costs

19. Both Boards have reached a tentative decision that acquisition costs should be expensed. However, the Boards have reached different tentative decisions about whether a part of the premium equal to the acquisition costs should be recognized at inception:

    (a) The IASB has tentatively decided that an insurer should, at inception, recognize as revenue a part of the premium equal to acquisition costs. For this purpose, acquisition costs should be limited to the incremental costs of issuing (that is, selling, underwriting, and initiating) an insurance contract and should not include other direct costs. Incremental costs are those costs that the insurer would not have incurred if it had not issued those contracts.

    (b) The FASB has tentatively decided that an insurer should not recognize revenue (or income) at inception to offset those costs incurred.

20. The IASB supported recognizing revenue at the same time as acquisition costs based on the view that part of the premium received is compensation for acquisition costs, not compensation for assuming the insurance risk. That is, the IASB was looking for the observable factor that brings the liability closest to the remaining obligation under the insurance contract. The FASB supported not recognizing revenue at the same time acquisition costs are expensed because it believes the insurer should recognize revenue only when it satisfies its performance obligations to its customer (the policyholder) under the insurance contract. At inception, the insurer arguably has not satisfied any of its performance obligations under the contract, so no revenue (or income) is recognized.

21. At the July 2009 joint Board meeting, the staff presented the issue regarding the recognition of premium to offset acquisition costs but the Boards were unable to reach a converged decision. The staff is presenting this issue again with the hope that through further discussion, a converged solution can be reached.

Question for the boards
What do you believe is a better representation of the remaining liability at inception: (a) Calibrate the margin to the premium or (b) Calibrate the margin to premium less acquisition costs (as defined above)?