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IASB/FASB Board meeting 20 October 2011

Insurance Accounting Alert

Boards discuss fixed-fee service contracts

What you need to know

The IASB and FASB Boards decided to exclude fixed-fee contracts that provide service as their primary benefit from the scope of the insurance standard if they exhibit certain characteristics.

They determined that, in addition to the gross underwriting margin, an insurer should show premiums, claims and benefits on the face of the statement of comprehensive income.

The IASB intends to schedule the next Insurance Working Group meeting for the end of March 2012.

Overview

On 20 October, the International Accounting Standards Board and the Financial Accounting Standards Board (the IASB and FASB, respectively and collectively, the Boards) continued their re-deliberations of the tentative decisions in the IASB's Exposure Draft *Insurance Contracts* (ED), and the FASB's Discussion Paper *Preliminary Views on Insurance Contracts* (DP). At this meeting, the Boards discussed excluding certain fixed-fee contracts from the scope of the insurance contract standard, the eligibility criteria for the premium allocation approach (PAA); and certain topics on presentation and disclosure related to the statements of financial position and comprehensive income.

Fixed-fee service contracts

The definitions of insurance contracts in the ED/DP may result in more fixed-fee service contracts falling within the scope of the insurance standard. However, the Boards together with many respondents to the ED/DP, believe that certain fixed-fee service contracts should follow the revenue recognition model instead. They think that these contracts are intended mainly to provide service and not indemnification. Therefore, they should not be treated as insurance, even if the service was contingent on occurrence of an uncertain, adverse event. For these contracts, integral application of the insurance standard is seen as unduly complex and burdensome.

At this week's meeting, the staff proposed that the guidance for the final standard should exclude fixed-fee service contracts if they exhibit all of the following characteristics:

- Contracts are not priced based on an assessment of the risk associated with an individual customer
- Contracts typically compensate customers by providing a service, rather than by paying cash

And

- The type of risk transferred relates mostly to the over-utilisation of services

After discussing possible implications, including unintended consequences, the Boards approved the staff proposal, subject to revisions of the final language.

How we see it

Companies should consider whether their contracts for services meet the requirements of the final standard. It is possible that health organisations that provide health care services primarily in their own facilities (e.g., US Health Maintenance Organizations) may not be excluded from the insurance standard if they underwrite risk. Moreover, it is also possible that extended warranties may be excluded on the basis of this decision, even though it is apparent, from prior discussions, that the Boards thought they would be in the scope of the insurance standard.

Eligibility for the PAA

During their previous meetings, the Boards discussed application of the PAA. The PAA provides a simplified measurement based on allocation of premiums over the coverage period for certain types of contracts, including many short-duration contracts. It is intended as an alternative to the building block approach (BBA), based on the presumption that an allocation model would be appropriate for certain contracts and less costly. In previous meetings, the Boards struggled to find criteria to determine to which types of contracts the PAA would apply. Instead of focusing on defining criteria for the PAA, the staff recommended in the papers for this meeting that insurers should take the BBA when either of the following applies:

- The BBA provides more relevant information for these portfolios than the PAA, relative to the cost of presenting that information.
- It is difficult to allocate the premium for the contract in a reliable and rational manner.

The staff papers described circumstances in which these criteria might occur.

The PAA would be applied in all other cases, although some staff members suggested that for portfolios of contracts with durations of one year or less, there should be a presumption that the PAA will be applied.

Board members noted that, compared with prior discussions and the proposals in the ED/DP, the staff recommendation reversed the order of consideration, i.e., it appears that contracts must be analysed to determine if the BBA, rather than the PAA, should be applied. Despite this change in focus, the Boards were supportive of the direction that the recommendation expressed. However, after discussing the use of the criteria, they were not satisfied that the guidance was sufficiently clear to avoid different interpretations and classification results. The Boards asked the staff to further refine eligibility based on certain conditions, such as variability in cash flows and uncertainty about the length of the coverage period. They also asked for examples that demonstrate how conditions would apply to particular types of contracts.

How we see it

The Boards are at a point where they know the direction they would like to take, but need to provide the justification to support their intentions. Expressing their objectives clearly is proving to be difficult. However, this is a practical issue and does not indicate a fundamental concern about the PAA among Board members.

Presentation of the Statement of Financial Position

Various topics related to the presentation and disclosure of insurance assets and liabilities were addressed. However, the discussions did not include unit-linked contracts or reinsurance assets.

The Boards made a number of decisions about presentation in the statement of financial position (balance sheet):

- Amounts measured under the PAA should be separated from amounts measured under the BBA to reflect different measurements.
- Insurers should disaggregate the building blocks (expected future cash flows, discounting and margin components). This could be presented either in the statement of financial position (balance sheet) or in the notes.
- Portfolios of insurance contracts that result in a net asset measurement should not be aggregated together with portfolios that result in a net liability.
- Premiums due, to which the insurer has an unconditional right, should be disclosed separately as an asset rather than netted against the premium liability; all other rights and obligations should be presented on a net basis.

Two decisions were made on the presentation of the PAA:

- Claims liabilities should be presented separately from liabilities for remaining coverage for contracts using the PAA.
- Premiums and claims should be presented on a gross basis, irrespective of whether the insurer has an unconditional right to those premiums. The Boards concluded that this exception would align the PAA with presentation under existing accounting practices.

The Boards also discussed the presentation of acquisition costs, but were unable to reach a common decision. The FASB voted in favor of showing a separate deferred cost asset (DAC), rather than including acquisition costs in the cash flows of the contracts. They believe it is more informative to display an insurance liability and an asset related to acquisition costs separately, rather than a net amount that would sometimes be a (net) asset and other times a (net) liability. However, the IASB commented that the introduction of an asset for deferred acquisition costs would be inconsistent with the overall concept of a cash flow-oriented building block model.

How we see it

One of the most significant differences in the views of the Boards relates to the treatment of acquisition costs. In a previous meeting, the FASB tentatively decided that only costs of successful efforts should be considered in the cash flows (or in the deferred costs, if that approach is taken). In contrast, the IASB favours considering all direct acquisition costs at the portfolio level. The new disagreement between the Boards on presentation of acquisition costs widens their differing views on this topic.

Presentation in the Statement of Comprehensive Income

During this meeting, the staff offered a list of elements of income and expense items for presentation on either the face of the statement of comprehensive income (income statement) or in the notes. They also presented two approaches to determining what items should be included in the income statement as a minimum.

The Boards decided that, regardless of whether the BBA or PAA is used, when insurance contracts are a significant portion of an entity's business, volume information rather than just an underwriting margin should be required on the statement of comprehensive income. They will address whether the income statement should present this information separately for the BBA and the PAA at a future meeting.

The issue of identifying premium volume information for contracts recorded under the BBA was raised during the discussions. The Boards asked the staff to investigate the feasibility of insurers generating information under this approach. This is of interest in the light of exploring the possibility for a uniform income statement model based on allocated premiums, less claims and expenses.

How we see it

A design for a statement of comprehensive income that provides volume information and displays the sources of profits may prove to be difficult to achieve. The Boards have long since rejected a traditional presentation model for long-duration contracts (premiums due as revenue) that is accompanied in the notes by an analysis of the sources of profits, as is found in Canada. As a result, they have high expectations for the statement of comprehensive income. Whether these expectations can be met remains to be seen.

Insurance Working Group

The fact that insurance is still prominent on the Boards' agenda is also shown by the meeting of the IASB's Insurance Working Group on October 24. The staff updated Working Group members of its progress on the project and asked feedback on recent decisions and specific issues.

The topic receiving most attention is the use of Other Comprehensive Income (OCI) for insurance liabilities, an item that is high on the agenda of many insurance companies as a way to address the potential for short-term earnings volatility. Industry participants presented proposals for an OCI solution, and it is clear from the discussion that the Boards will further investigate the use of OCI. However, several Board members noted that a number of important challenges will need to be addressed, for example, how to align a potential OCI solution for insurance liabilities with the model for financial instruments.

Next Steps

The IASB changed its timetable recently, and now plans to issue a revised exposure draft or a review draft of the final standard in the first half of 2012. It will set a publication date for the final standard in due course. The FASB currently aims to issue its exposure draft in the first half of 2012.

The IASB staff announced that it intends to schedule another Working Group meeting for the end of March 2012, which makes it unlikely that the next document, a revised exposure draft or a review draft of the standard, will be issued before the second quarter of 2012.

The Boards will have their next discussion on insurance during the November Board meetings; the topics for those meetings have not yet been announced.

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