

Insurance accounting alert

IASB opens the residual margin; Boards define acquisition costs

What you need to know

- ▶ The IASB tentatively decided that the residual margin should be adjusted for specified changes in estimates.
- ▶ The Boards agreed that acquisition cost should include direct costs only, and provided examples of indirect costs that are excluded. However, the FASB reaffirmed that acquisition costs should be limited to those that can be allocated to successful efforts, while the IASB retained both successful and unsuccessful efforts.
- ▶ The Boards did not come to a final conclusion on a presentation model for the statement of comprehensive income, but decided to pursue a presentation that provides both margin and volume information on the face of that statement.

Overview

At a joint meeting on 13-15 June, the International Accounting Standards Board and the Financial Accounting Standards Board (the IASB and FASB, respectively and collectively, the Boards) discussed the residual margin, acquisition cost and presentation of the statement of comprehensive income. The *Insurance Contracts* exposure draft (ED) required that the residual margin be locked at inception and that the statement of comprehensive income be based on a summarised margin approach, with volume information disclosed. Respondents to the ED requested the residual margin be adjusted for changes in estimates (that is, unlocked) and the statement of comprehensive income present volume information (similar comments on presentation were received by the FASB on their Discussion Paper (DP)). Based on those comments, the Boards discussed the following topics at this meeting:

- ▶ Should the residual margin be unlocked? If so, should it be unlocked for favourable and unfavourable changes in cash flow and discount rates?
- ▶ Should the statement of comprehensive income include volume information?

Also, the Boards continued their discussion on identifying those costs that should be included as acquisition costs in the measurement model, in an attempt to converge on this issue.

(Un)locking the residual margin

The staff proposed that the residual margin be unlocked for specified changes in estimates. Several members of the Boards expressed concern that unlocking the residual margin could create additional operational issues for an already complex measurement model. Moreover, some members noted that the decision to unlock the residual margin should also be discussed in connection with the accounting for changes in financial instruments. In a narrow vote, the IASB tentatively decided that the residual margin should be unlocked for changes in estimates. The FASB tentatively decided that if their proposed insurance contract standard has a residual margin, then the margin should be locked at inception.

How we see it

The IASB's decision to deviate from the ED for this aspect of the proposal was not unanimous, indicating that several Board members are uncomfortable with a model that does not reflect all current period changes in profit and loss.

Characteristics of unlocking the residual margin

The IASB decided that the adjustments to the residual margin should represent both favourable and unfavourable changes in the estimates. Furthermore, the proposed unlocking model would not impose limits on the changes to the residual margin, unless the amount causes the residual to become negative. In those situations, the residual margin would be floored at zero. For example, if an insurer experiences unfavourable changes in one period that would reduce the residual margin below zero, the unfavourable change (after zeroing out the residual margin) should be recognised in profit or loss. When favourable experience occurs in a subsequent period, the insurer should recognise the favourable change in the profit or loss to the extent of the prior period's losses. Any favourable change in excess of those prior year losses would reconstitute the residual margin.

The staff proposed that the residual margin should be adjusted for the effects of all changes in estimates of cash flows. In addition, the staff proposed that changes in discount rates would be permitted, but not required to be recognised in profit or loss when adjusting the residual margin, if including that change would create an accounting mismatch. The IASB agreed with the staff that the residual margin should be adjusted for changes in estimates of cash flows. The IASB did not make a decision regarding the proposal for changes in discount rates and acknowledged that those changes should be considered in connection with the accounting for an insurer's financial assets. Accordingly, the IASB will further discuss how changes in the discount rate will be reflected when they continue their debate on how to deal with earnings volatility.

The IASB affirmed that any changes in the risk adjustment should be recognised in the profit or loss and not as an adjustment to the residual margin.

How we see it

It appears that the IASB's approach to require gains to the extent of previous losses could increase the complexity of the model, especially if the reversal of previous losses spans multiple years. Insurers would be required to track over time how losses and gains each year affect the companies' measurement of insurance liabilities. We believe that companies will have to expend the effort and incur the cost to track this information to reduce some of the volatility.

Although the IASB did not decide on the staff's proposal on the discount rate, their discussion indicates that they are aware that the accounting for financial instruments could create an accounting mismatch with insurance liabilities. The IASB's preference seems to be to deal with this accounting mismatch in a manner other than through the residual margin. However, a clear way forward has not yet been presented to the Board.

The staff concluded that adjusting the residual margin retrospectively may be impracticable to apply, so they proposed that adjustments should be accounted for prospectively. The IASB believes that retrospective application would be preferable, but understood that this application would require a significant amount of effort. Therefore, the IASB tentatively decided the unlocked residual margin would be adjusted prospectively.

In the ED, the residual margin was amortised based on either the passage of time or consistent with expected claims and benefits. Respondents to the ED agreed that the amortisation period should be over the coverage period, but that there should be a principle that allowed insurers to determine the most appropriate amortisation period for the insurance contracts that it sells. While several Board members agree that the amortisation

method should be principles-based, others indicated that if the insurer provides significant service during the claims handling period, then the amortisation of the residual margin should extend beyond the coverage period.

Ultimately, the IASB decided that the residual margin should be allocated over the coverage period and on a systemic basis that is consistent with the pattern of transfer of the services over that period.

Acquisition costs

The Boards have continually discussed acquisition costs since the ED/DP was released. Those discussions have resulted in the IASB and FASB taking different positions on acquisition costs relating to unsuccessful efforts. The FASB would consider acquisition costs for successful efforts only, similar to the recently released ASU 2010-26 . The IASB would consider both successful and unsuccessful efforts because they defined the unit of account to be a portfolio not an individual contract. The IASB's treatment would, therefore, include significantly more costs as compared with the FASB's approach.

During this meeting, the Boards concluded on the type of acquisition costs that should be considered. They tentatively decided that only direct costs incurred by the insurer in acquiring the contracts in the portfolio are allowed as acquisition costs. They clearly indicated that indirect costs should be recognised as period expenses and gave various examples of such costs, i.e., utilities and administration. However, the Boards remain divided on whether direct acquisition costs for both successful and unsuccessful acquisition efforts should be included in the initial measurement of the insurance liability. In the end, the FASB reaffirmed its decision to allow only direct acquisition costs of successful efforts to be included, while the IASB does not differentiate between successful and unsuccessful efforts.

How we see it

The Boards' approach to acquisition costs, compared with the approach in the ED/DP, result in financial statements of insurers being more comparable, regardless if they elect to produce business internally or outsource it to brokers. However, the decision is inconsistent with conclusions reached in other projects relating to acquisition costs (for example, revenue recognition and leases). In addition, the Boards are continuing to discuss acquisition costs in relation to a portfolio of contracts. They have not finalised the definition for a portfolio of insurance contracts. Furthermore, the discussion on acquisition cost is not yet over - the Boards will have another chance to completely converge on this topic..

Presentation

The IASB and FASB continued their debate on presentation of the statement of comprehensive income related to insurance contracts. The staffs presented three volume approaches and briefly discussed how they developed those models based on feedback they received on the summarised margin approach, and other previous approaches discussed.

The Boards tentatively decided that the presentation of the statement of comprehensive income will not be a purely summarized margin presentation, but will include volume (e.g., premiums) measures as well. Despite agreeing to use a volume-based approach, the Board members had differing views on which volume example that the staffs presented should be selected. The rationale behind the decision to pursue an income statement that combines margin and volume measures is to develop a less complex statement of comprehensive income. This should be understandable to a general user, but, at the same time, provide enough information

to the more sophisticated investors. Accordingly, the Boards stressed the need for line items that clearly define what they represent, to allow all users to understand their nature. However, the Boards acknowledged that they had to avoid creating a prescriptive presentation that would make financial statements of conglomerates that have issued insurance contracts overly complicated. Both Boards agreed that before selecting a particular presentation approach, the staffs needed to refine the wording for the line items and finalise how "deposit components" would be presented. In particular, the Boards appeared concerned about the potential for 'premium due' to be misinterpreted as premium revenue.

How we see it

Volume indicators are likely to be presented in the statement of comprehensive income. However, critical to this outcome will be the definition of premium "revenue" for long-duration contracts, and a final decision on what is required for the primary statement of comprehensive income versus what can be presented in the footnotes. Therefore, without a conclusion on unbundling, the presentation model cannot be considered final.



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