

Insurance accounting alert

Boards remain split on the approach to margins

What you need to know

- ▶ The IASB continues to work towards its goal of issuing a final standard for insurance contracts in the second half of 2011, with the FASB expecting to issue an exposure draft around the same time.
- ▶ The IASB decided that the measurement of an insurance contract should contain an explicit risk adjustment. This adjustment would be determined independently from the premium and re-measured in each reporting period.
- ▶ The FASB decided that the measurement of an insurance contract should include a single composite margin that recognises profit as it is released from exposure to risk, as evidenced by a reduction in the perceived variability of cash outflows. The composite margin should not be re-measured or recalibrated to recapture the previously recognised margin.
- ▶ The staff members of the Boards have been instructed to explore reconciliation of the two margin approaches through disclosure information.

At a joint meeting on 17 and 18 May, the Financial Accounting Standards Board and the International Accounting Standards Board (the FASB and the IASB respectively, or the Boards collectively) discussed the topic of margins. They focused on understanding the different approaches proposed by the IASB and the FASB, and attempted to settle on a converged approach, or perhaps a hybrid of the two.

In its Exposure Draft *Insurance Contracts* (the ED) the IASB proposed a model with two distinct margins (two-margin model) that focuses on measurement of the liability. One of those two margins is an explicit risk adjustment measured according to an objective¹ in each reporting period, to provide for the risk that the actual future cash flows exceed the expected cash flows. Further, the ED model includes a residual margin to eliminate profit at inception. The residual margin is an amalgam of unspecified items in the formulation of the premium that are not included in the cash flows when measuring the liability. These include, among other items, recovery of past selling expenses, some acquisition costs and profit margins. The ED proposed to run-off the residual margin over the coverage period.

The FASB discussion paper *Preliminary Views on Insurance Contracts* (the DP) proposes a single (composite) margin for the difference between the present value of the premiums, and the present value of benefits and expenses. There is no explicit adjustment for risk, but a provision for risk is implicitly allowed by the composite margin and does not necessarily correspond to a specified risk measurement technique. The DP noted that the run-off of the composite margin is according to a factor that represents a combination of premiums and claims. As a result, the run-off of the composite margin involves both the coverage and the claims settlement period.

Examples provided in the May meeting highlighted the differences between the two approaches. The profit in the year of coverage includes the release of the full amount of the residual margin, while the release of the composite margin is extended into the claims settlement period. The adjustment for risk is re-measured each reporting period, but the composite margin is not (i.e., it is an allocation over time). Under the composite margin, no test is included to determine whether the liability includes a minimum provision for risk. The composite approach is seen as less subject to manipulation (referred to in the meetings as the "CEO effect"), although proponents of the two-margin model believe that a disciplined approach to determining the adjustment for risk would prevent such manipulation.

¹ In previous discussions, the Boards have tentatively decided that the measurement objective for the risk adjustment would be the amount that the insurer requires for bearing the uncertainty that arises from the fulfillment of the net obligation arising from the insurance contract.

In the discussion, several ideas for reaching a common view were suggested, including:

- ▶ The IASB approach can be seen as a way to release the composite margin in two parts - one in relation to risk and the other in relation to performance, while keeping with the principles of revenue recognition
- ▶ Possibly extending the run-off of the residual margin to the claims period, if it could be rationalised that claims adjudication was a part of the performance under the contracts
- ▶ Recalibrating the composite margin periodically when certain indicators pointed to a change in the pattern of release from risk
- ▶ Adding an onerous contract test to the composite margin approach, which would ensure that the composite margin included a sufficient provision for risk

The Boards discussed the possibility of allowing insurers to choose between the two approaches, with a reconciliation of the reported numbers to the figures under the other approach. This suggestion met with some strong opposition from several Board members, but was not fully discarded.

Although the discussions were quite lengthy, they did not result in a consensus. Instead, the vote resulted in a majority of the IASB Board members favouring the two-margin model. This adjustment would be determined independently from the premium and re-measured in each reporting period. Because the talks focused on the choice between one or two margins, the IASB still has to address which techniques can be used for estimating the risk adjustment, and the type of disclosures needed.

The majority of FASB members favoured the composite margin being re-measured or recalibrated so previously recognised margin will not be affected (i.e., changes in the pattern of release of the composite margin will only be made prospectively). Satisfaction of this performance obligation leads to a decline in exposure to risk and will be evidenced by a reduction in the perceived variability of cash outflows. The FASB also decided that a change in exposure to risk should not result in the composite margin being re-measured or recalibrated to recapture previously recognised margin (i.e., adjustments to the composite margin will only be made prospectively). In a future meeting, they will also consider whether to incorporate an onerous contract test with a risk adjustment.

Given the impasse evidenced by the voting results, the Boards directed the staff to develop a reconciliation of the approaches for possible disclosure. This reconciliation may be needed if the ultimate standards turn out to be different, or if the two margin approach were to be made optional in a converged standard.

Next steps

The Boards continue to work towards completing their discussions on the major issues and will hold their next discussion on 31 May. Insurance is also expected to have a fairly large time allocation during the June meetings, but the topics have not been announced yet.

How we see it

Despite extensive discussions, the Boards have not yet bridged the gap between their different perspectives on margins, but have not given up the idea of a common approach. However, by broaching the idea of a reconciliation of the approaches in the disclosure notes, they are allowing for the possibility of never reaching agreement for measurement. As the timing of the amortisation of the composite margin will not be the same as the combined re-measurement of the risk adjustment and amortisation of the residual margin, profits will emerge differently between the two models. Conversely, analysing the differences through a process of looking for a solution through a reconciliation disclosure may provide the insight needed to ultimately resolve their differences.

The issue of one versus two margins is a key element in the design of the model. Accordingly, the Boards devoted a significant amount of time to discussing this topic. However, the Boards' time and resources are limited, and there are other unsettled issues related to margins that they have not addressed. In particular, they must decide if the residual or composite margin would be allowed to 'float' to offset the effects of changes in the estimates of future cash flows in both directions and, perhaps, discount rates as well. In addition, if the Boards agree on a modified model (unearned premium approach) the FASB will have to determine how to make the composite margin works with the modified model. This seems inherently challenging, because the modified model does not establish a composite margin at the beginning of the contract. Presumably, the measurement will have to start picking up a margin upon transition to an incurred claims liability.



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