Overview
During a joint meeting on 13 June 2012, the International Accounting Standards Board and the Financial Accounting Standards Board (respectively, the IASB and the FASB, or collectively, the Boards) re-deliberated the decisions in the IASB's Exposure Draft, Insurance Contracts (ED) and the FASB's Discussion Paper, Preliminary Views on Insurance Contracts (DP). The following topics were discussed:

1. The allocation of cash flows when components are unbundled from the insurance contract
2. Earned premium presentation for contracts measured using the building block approach (BBA)

The IASB held a separate education session to consider when acquisition costs should be recognised in profit and loss and how those costs should be presented in the statement of financial position.

Allocation of cash flows when components are unbundled from the insurance contract
The Boards discussed how insurers should allocate cash flows, both inflows and outflows, amongst components that are unbundled (i.e., split from the insurance contract liability and measured separately under another standard). At their May meeting, the Boards decided on the criteria for determining when certain components, including those for investments and non-insurance goods and services, should be unbundled from the insurance contract. The staffs recommended that insurers should follow a three-step process to allocate cash flows amongst unbundled components:

(1) Cash flows should be allocated to the investment component on a stand-alone basis
(2) The remaining considerations, discounts or supplements should be allocated to insurance components and/or goods and services consistent with the revenue recognition ED
(3) Any outflows related to more than one unbundled component should be allocated on a rational and consistent basis and measured in a way that is consistent with the accounting for that component.

What you should know
• The Boards reached a decision on how to attribute cash flows when investment components or goods and services are unbundled from the insurance contract
• The staffs will further evaluate the use of earned premiums in the building block approach

1 See Insurance Accounting Alert: Boards review OCI, unbundling investment components and recognition of acquisition costs (June 2012); Insurance Accounting Alert: Boards make decisions on the premium allocation approach (March 2012)
A few Board members raised concerns about how to allocate discount effects included in the pricing of the bundled (i.e., entire) insurance contract. It was indicated that if the entity were to allocate the discount effect to the investment component, the resulting cash flows would be inconsistent with issuing the component separately. Some questioned why the investment management fees, which are common in unit linked contracts and mutual funds, should be attributed entirely to the insurance component. The staffs considered that any difference between the initial amount on a stand-alone basis and the carrying amount of the investment component would not be appropriate. However, as a result, a day one loss may arise for the insurance component.

Board members were also concerned about the use of the term “rational and consistent” in the third step because of the potential to apply different measurement attributes to the same types of expenses, for example, between deferred acquisition costs under insurance contract and revenue recognition proposals. They asked the staffs to clarify that allocation of cash flows to multiple components would not be necessary for cash flows attributable to a single component.

The staffs agreed to revise the proposal, including clarification of the objective of “rational and consistent”. Ultimately, the Boards agreed that:

i. An insurer should attribute cash flows to an investment component and to an embedded derivative on a stand-alone basis. This means that an insurer would measure an investment component or embedded derivative as if it had issued that item as a separate contract. The insurer, therefore, would not include the effects of any cross-subsidies or discounts/supplements in the investment component.

ii. After excluding the cash flows related to the investment components and embedded derivatives:

a. The amount of consideration and discounts/supplements should be attributed to the insurance component and/or service component in accordance with the proposals in the exposure draft Revenue from Contracts with Customers

b. Cash outflows (including expenses and acquisition costs) that relate directly to one component should be attributed to that component. Cash outflows related to more than one component should be allocated to those components on a rational and consistent basis, reflecting the costs that the insurer would expect to incur if it issued that component as a separate contract. Once cash outflows are attributed to components, the insurer would account for those costs in accordance with the recognition and measurement requirements that apply to that component.

### How we see it

The Boards’ decision on the allocation of costs when investment components are unbundled from insurance contracts differs fundamentally from the allocation of costs when unbundling goods or services. The basis for unbundling goods or services mirrors the decisions in the revenue recognition guidance. Cash flows for these components would be allocated between the unbundled components based on the relative value of the performance obligation. In the case of unbundled investment components, the Boards’ decision to attribute all the effects of cross-subsidies, discounts and fees to the insurance contract will result in profitability of the insurance component to differ more from a similar insurance contract issued on its own compared to unbundled goods and services.

The proposed allocation is more likely to increase (investment management fees) or decrease (discounts) the profitability of the insurance component. There may also be an impact on the earnings pattern. For example, annual investment fees measured with investment components are more likely to be earned on a straight line basis over the contract. Once attributed to the insurance component, they will be earned in concert with the margin, (in line with the pattern of services, for the IASB, or the release from risk, for the FASB) which may not follow a straight line amortisation pattern. In the case of discounts, insurers should be wary of the potential for the recognition of an onerous contract.

### Earned premium presentation of the BBA

The Boards held a non-decision making, education session to discuss presentation for BBA approach contracts on the statement of comprehensive income. Although the ED/DP proposed a summarised margin approach, the Boards decided at the October 2011 meeting that if insurance contracts are a significant portion of the reporting entity’s business, volume information should be presented on the statement of comprehensive income. Reasons for incorporating volume information identified at the meeting included comparability with the premium allocation approach (PAA) and the income statements in other industries.

In an effort to provide volume information and align more closely with the PAA, the following three alternatives to the summarised margin were presented:

1. **Premiums written** - expected revenues for the term of the contract are recognised at inception
2. **Premiums due** - revenue based on the billings of premiums to policyholders
3. **Premiums earned** - recognises revenue based on completion of the performance obligation supported by expected losses and recognition of margins over the contract period

While none of the proposals were officially endorsed or rejected, the Boards focused on the premiums-earned proposal. Some Board members expressed concern that issuing a contract or being scheduled to receive payment met the criteria to recognise revenue. The earned premium proposal derives premium revenue proportionate to expected claims and margin release (and, for the IASB, the risk adjustment, too) over the coverage period. Under this proposal, the objective is to allocate the consideration received from the policy as revenue as the insurer performs over time. That allocation would be determined by utilising elements of the liability measurement based on the BBA.

Although the majority of Board members were in favor of exploring the earned premium proposal further, a few were skeptical that users would find such volume information of any more use on the face of the financial statements than in the notes. Other members questioned whether implementation costs would outweigh user benefits. However, they acknowledged that
they should not rule out a non-traditional approach because history has shown that a new presentation proposal in other areas did not initially represent its ultimate benefit to financial statement users. In fact, users often needed several reporting periods to understand new reporting requirements and reap the benefits when the value was not as apparent at the initial adoption.

While reviewing the examples provided by the staffs, the Boards asked for more detail on the mechanics as they continue exploring the proposal. They intend to request input from the IASB's Insurance Working Group. At that meeting, the staff will likely explore numerous issues with respect to earned premiums including, the appropriate unit of account, interaction with acquisition costs, treatment of non-claims costs, whether the premiums should be locked-in at inception and, ultimately, whether the benefits to the users of the financial statements would exceed the operational costs to track the additional information necessary to produce the earned premium amounts.

How we see it
The Boards did not endorse the proposal during the education session. Their interest in the earned premiums could ultimately result in a combined presentation within the statement of comprehensive income for insurers, reducing the complexity for multi-line insurers. It appears the Boards' apparent preference for earned premiums, rather than premiums due or written, is primarily because of a better alignment with the concepts from the revenue recognition proposals.

Recognition and presentation of acquisition costs
The IASB separately held a non-decision making session covering the timing of recognition of acquisition cost and related recovery of those costs. The focus was within the context of the discussions on the earned premium proposal. The IASB discussed both presentation of acquisition costs, either as a separate asset or as a contra-liability to the deferred margin, and how to recognise acquisition costs in the statement of comprehensive income.

Several IASB members expressed concerns about the recommendation that resulted in premium revenue being driven by incurring acquisition costs. They noted that the pattern of incurring those costs does not relate to an insurer's performance under the contract, and they could not understand why it should create revenue. The IASB, therefore, considered an alternative that would recognise acquisition costs as incurred, while recording the amount of premium covering those costs as revenue based on the pattern of the residual margin release. Recognising the part of the premium covering acquisition costs in line with the margin release would in the view of many IASB members, offer the best reflection of the revenue recognition principles. Several Board members briefly revisited the idea of expensing all acquisition costs as incurred to avoid the operational complexities, but this idea did not gain much traction.

How we see it
While no decisions were made, it appears the IASB is moving towards aligning with suggestions made by the FASB at the May meeting. The Boards' primary concern seemed to be that, under a premiums-earned approach, incurring acquisition costs could result in the immediate recognition of premium revenue. By eliminating deferred acquisition costs as a separate asset, there will be no need for a separate impairment assessment for this asset. Ultimately, any decision will need to follow future discussions on the earned premium presentation.

Next Steps
The IASB plans to issue a revised exposure draft or a review draft of the final standard in the second half of 2012 and will establish a publication date in due course. The FASB aims to issue its exposure draft in the same timeframe.

The Boards will have their next discussion on insurance during the July Board meetings, the last before the August holiday. Although no topics have been formally announced, we expect discussions on margin presentation and acquisition costs to be on the agenda.
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