Overview

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

1. Accounting for acquisition costs in the pre-coverage period
2. How to account for insurance contracts at transition

The IASB held a separate session to consider the accretion of interest on the residual margin, disclosure requirements and whether to re-expose its proposals.

Acquisition costs

The Boards discussed the staffs' joint proposal for recognition of acquisition costs in the pre-coverage period. This was predicated on the Boards' decision to initially recognise insurance liabilities at the beginning of the coverage period, in contrast to the proposal in the ED and DP (which required recognition when the insurer became a party to the contract).

The Boards were given four alternative treatments for acquisition costs:

1. Not recognised until the coverage period
2. Recognised as an expense when incurred
3. Recognised as a separate prepayment asset
4. Recognised when incurred as a part of the insurance liability for the portfolio of contracts in which the contract will be recognised

The staffs proposed, and the Boards ultimately agreed with alternative four. Alternative one and two were viewed as inconsistent with the measurement concepts of acquisition costs and alternative three was viewed as an operationally complex approach. A contributing factor to the selection of the fourth alternative was the Boards' view that only a minor portion of the expenses meeting the criteria for acquisition costs occurs prior to the coverage period.

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1. This could result in expensing the cost in one period, reversing it in a subsequent period only to expense the item again in a future period through amortisation of acquisition costs.
How we see it

The Boards’ decision highlights that regardless of the timing of when an insurance-related cash-flow item occurs (e.g., paying employees to underwrite an insurance contract before its coverage period), this should not affect whether it is included in the measurement of the insurance liability. Margin amortisation issues may arise, as these types of acquisition costs may be added to an existing portfolio prior to the other related cash flows. The contract itself will normally not be recognised until the coverage period begins. Another factor to consider is that certain costs associated with the underwriting process may meet the definition of acquisition costs. Therefore, the amount of acquisition costs in the pre-coverage period may be greater than initially anticipated by the Boards.

Transition

As only a few areas remain open for re-deliberation, the Boards discussed how to account for insurance contracts at transition. Specifically, they reviewed when and how to measure the margin, determine the discount rate, and other related disclosure requirements.

The Boards also decided that the insurance liability should be measured at the beginning of the earliest period presented in the following way:

1. The present value of the fulfilment cash flows using current estimates effective on the date of transition
2. Acquisition costs determined in accordance with the Boards’ previous decisions; any existing balances of deferred acquisition costs not meeting the current decisions would be de-recognised.

Because of the potential subjectivity inherent in the residual (IASB) and single (FASB) margins, the Boards focused on developing a method for estimating the margin at transition. Six alternatives were proposed by the staffs for contracts written prior to the transition date (e.g., the earliest date presented):

1. No margin would be recognised
2. Set the margin to the difference between the new measurement of the fulfilment cash flows and the previous carrying value
3. Retrospective application using existing accounting guidance
4. Retrospective application with a practical expedient for portfolios of contracts written prior to the earliest period practical to apply the guidance
5. Set the margin to the difference between the fair value of the portfolio of contracts and the new measurement of the liability
6. Set the margin to the difference between the hypothetical price and the new measurement basis, i.e., based on the fulfillment value of the portfolio

The Boards evaluated each alternative using the following three objectives:

- Achieving measurement consistency with the decisions made to date
- Allowing for the comparability of preparer’s earnings
- Ensuring the benefits outweigh the costs

There was wide agreement that the first two transition alternatives were the most cost beneficial. However, the Boards were concerned that they lacked comparability with the proposed standard, and would create a significant run-off period where results would not be comparable. For example, certain life insurance contracts existing at transition will be in-force for many years. Alternatives five and six above were dismissed as they were inconsistent with the proposed measurement model and would still be subjective, impairing the comparability of earnings for future periods.

The Boards also dismissed alternative three and instead focused on alternative four. The staffs proposed applying one of the following options for a practical expedient to be applied for the periods prior to which retrospective application is practicable:

a. Write-off the margin
b. Set the margin to the difference between the new measurement model and current value
c. Estimate the margin

After evaluating these practical expedients, the following approach was approved by eleven IASB members (opposed by four) and all seven FASB members:
Insurers must determine the single or residual margin for a portfolio of contracts at the beginning of the earliest period presented, as follows:

a. By retrospectively applying the new accounting principle to all prior periods, unless it is impracticable to do so.

b. If it is impractical to determine the cumulative effect of applying that change in accounting principle retrospectively to all prior periods, the insurer is required to apply the new policy to all contracts issued after the start of the earliest period for which retrospective application is practicable (i.e., apply retrospectively as far back as possible).

c. For contracts issued in earlier periods for which retrospective application would normally be considered impracticable (because it would require significant estimates not based solely on objective information), an insurer should estimate what the margin would have been if it was possible to apply the new standard retrospectively. In this case, an insurer does not need to undertake exhaustive efforts to obtain objective information, but should take into account all information that is reasonably available.

d. If it is impractical to apply the new accounting policies retrospectively for other reasons, an insurer should apply the general requirements IAS 8/ASC Topic 250-10 that are relevant to situations in which there are limitations on retrospective application (i.e., measure the margin by reference to the carrying value before transition).

After deciding on transition for the single/residual margin, the Boards discussed how to determine the discount rate that reflects the characteristics of insurance liabilities. Based on the earlier decision to lock in the interest rate at inception to determine the impact on the statement of comprehensive income, preparers would need to develop historical inception date discount rates. Therefore, the staffs proposed that insurers could calculate the discount rate by studying, at minimum, three years of historical discount rates. When those rates are consistent with observable rates, preparers could directly utilise those historical rates instead. If observable rates are not an exact match with the study, insurers may calculate the rate by approximating the historical spread between the calculated and observable rates. For example, if on average, a portfolio of contracts had a discount rate applied of 50 basis points less than the AA corporate bond rate, this rate would be applied retrospectively. Some Board members noted that issues may arise due to the recent spread compression and may not represent the actual economics. However, they ultimately agreed it would be the best feasible solution. An insurer would recognise the cumulative effect of the difference between reference yield curve applied at the start of the earliest period to which retrospective application is applied and the discount rate determined at the transition date in other comprehensive income.

In an effort to increase comparability, the staffs proposed a set of disclosures required at transition. The Boards decided that insurers should disclose the following transition information:

- If full retrospective application is not feasible:
  - The earliest date retrospective application is practicable
  - The method used for estimating the residual or single margin for portfolios of contracts prior to the earliest practicable date
  - What objective information was used in estimating the margin and the extent to which that information was not objective
  - Methods and assumptions used to determine the interest rate during the retrospective period

Furthermore, the Boards decided that preparers would not need to disclose previously unpublished information about claims developments that occurred five years before the end of the first financial year in which the new guidance applies.
Accretion of interest on the residual margin (IASB only)

The IASB separately discussed the accretion of interest on the residual margin. The ED proposed that an insurer should recognise a residual margin that eliminates any gain at inception and that an insurer should accrete interest on the carrying amount of the residual margin. The staff recommendation was that the IASB should confirm the proposal in the ED that an insurer be required to accrete interest on the residual margin. The reasons for this include:

1. Accreting interest on the residual margin is consistent with the treatment of other components of the insurance liability.
2. The residual margin is implicitly discounted — because it is the difference of discounted cash inflows and outflows.
3. Not accreting interest on the residual margin would distort the pattern of profit recognition.

Some IASB Board members argued that accreting interest on the residual margin would create unnecessary complexity, while others noted there is a need to balance what is conceptually sound with simplicity. Those that desired a conceptually sound approach noted that readers of insurers’ financial statements are specialists who are capable of unpacking the reported number.

On the issue practicality, the staff explained that currently, there is accreting interest on amounts under other accounting models, for example, US GAAP. Furthermore, the residual margin for various portfolios would require detailed tracking under the proposed model, and accreting interest should not add significant extra effort.

The IASB decided to accrete interest on the carrying amount of the residual margin, and deliberated on which rate should be used. The staff provided arguments for accreting interest at a rate updated at each reporting period (‘current rate’) or using a rate determined at inception (‘locked-in rate’). The staff recommended that: (i) the IASB confirm the ED proposal that an insurer should accrete interest on the residual margin using the discount rate of the liability determined when the contract is initially recognised (i.e., a locked-in rate); and (ii) that no further guidance on determining the rate to use when accreting interest to the residual margin will be provided.

The IASB members had differing views on whether to use a locked-in discount rate or a current rate. Those supporting a locked-in rate argue that this would simplify the approach and not cause additional presentational issues. Some IASB members expressed concern that using a locked-in rate (with all changes going through P&L) would cause mismatches, and result in differences within the model that uses current discount.

Ultimately, the IASB tentatively decided that an insurer should accrete interest on the residual margin using the discount rate of the insurance liability determined at initial recognition (i.e., a locked-in rate) and there would be no need for further guidance.

Disclosures (IASB only)

The staff presented their disclosure recommendations and asked the Board to consider the overall package. The objective of the disclosure requirement is to enable users of financial statements to understand the nature, amount, timing and uncertainty of future cash flows arising from insurance contracts. While some ED requirements were presented with little or no modification, there were significant changes to the disclosure requirements in the following areas:

1. Requirement to disclose gains and losses arising on contract modification, commutation and de-recognition.
2. Reconciliation from the opening to the closing balance of the components of the aggregate carrying amounts of insurance contract liabilities, insurance contract assets and components of reinsurance assets arising from reinsurance contracts held.

3. The components of the aggregate carrying amounts of insurance contract liabilities, insurance contract assets and components of reinsurance assets.

4. A reconciliation of the carrying amounts of onerous contract liabilities recognised in the pre-coverage period.

5. Level of disaggregation.

6. Removal of the ED requirement to disclose incurred claims.

7. Removal of the requirement to disclose information about the impact of regulatory frameworks in which the insurer operates.

Review draft or re-expose (IASB only)

The IASB decided to re-expose the ED, inviting only limited questions on key areas that have changed significantly in comparison with the original ED. These relate to proposed requirements for:

1) Treatment of participating contracts
2) Presentation of premiums in the statement of comprehensive income
3) Unlocking the residual margin to offset changes in estimates of future cash flows
4) Presenting, in other comprehensive income, the effect of changes in the discount rate used to measure the insurance contract liability
5) The approach to transition

The Board agreed that the objective of targeted re-exposure and limiting the questions would be to avoid re-opening issues that have been re-deliberated upon and where decisions have been reached.

How we see it

With the decision to re-expose, the IASB clearly intends to balance two important factors:

(a) The need to seek feedback on key aspects of the model, particularly where those key aspects differ from the 2010 ED
(b) To avoid unnecessary delay by re-opening aspects where it believes its discussions have been sufficient.

While the deliberations following the targeted re-exposure will be limited, the decision to re-expose will inevitably have an impact on the timing of completion of the final standard. It will also place further pressure on alignment with the adoption of other standards such as IFRS 9 Financial Instruments.

The FASB plans to issue its first exposure draft and solicit comprehensive comments. Both Boards will have to consider how comments each receives on their respective exposures will impact the coordination of the joint deliberation process going forward.

Next step

Discussions in October and November will seek to address the topics on participating contracts and presentation of premiums on the statement of comprehensive income.

The IASB plans to issue a revised exposure draft in the first half of 2013 and it will establish a publication date for the final standard in due course. The FASB currently aims to issue its exposure draft in the same period as the IASB.
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