

Background

The joint goal of the IASB and FASB is to develop a new accounting standard for insurance contracts, with an Exposure Draft expected in the second quarter of this year and a final standard expected in June 2011. The effective date will likely be 2013, and the change will affect both in force and new business.

In December the two boards met jointly and made good progress on how to measure insurance liabilities. (You can find notes on the December meeting at www.polysystems.com.)

On Tuesday, January 5, the FASB and IASB met jointly via video conference to discuss topics that were not covered in December. This meeting was in addition to the IASB's normal monthly meeting. The meeting lasted about 2.5 hours and covered these three topics:

- Unbundling (December paper 7D)
- Presentation (December paper 7E)
- Embedded Derivatives (December paper 7C)

Let me point out that the term “unbundling” appears in the following discussion and the IASB papers, and it has at least two meanings. One use of “unbundling” is to declare that features of a single contract are split and subject to different accounting rules. I have heard actuaries use the term “bifurcation” in this sense.

A second use of “unbundling” describes separating changes in balance sheet quantities into components such as cost of insurance fees, policy loads, and interest credits. This use of the term is similar to how it is used in FAS97 reporting.

Unbundling (Bifurcating)

The boards now plan to have separate accounting standards for insurance contracts and financial contracts and a new standard called Revenue Recognition for contracts that are neither insurance nor financial contracts.

The boards are concerned about firms trying to move contracts from one accounting standard to a different standard by merely adding minor unrelated provisions, a situation that the staff worries might lead to an abuse of the insurance accounting standard. Thus the proposal is that “non-interdependent” features would be unbundled and accounted for under separate standards. Traditional insurance contracts of all types would be considered “interdependent” and therefore would not have to be unbundled.

The boards then discussed three questions from paper 7D:

- Question 1 asked whether insurance contracts **must** be split up into different components, even if the components are interdependent, and thus measured under different standards. The staff recommended a “no” vote and the IASB agreed, voting 11-4 that unbundling should be limited to non-interdependent features. FASB voted 3-2 the other way. The FASB is not necessarily in

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disagreement with the IASB; rather the 3 FASB members wanted a better idea of how it would work in practice.

- Question 2 asked whether to **permit** the splitting of interdependent insurance contracts into different components. For example, some in the insurance industry believe there is an advantage to accounting for the “deposit” portion of an insurance contract as a financial instrument. Both IASB (13-2) and FASB (5-0) voted against this option.
- The boards deferred the last question, how to treat the “deposit” as part of the financial statement presentation, to the next topic.

Presentation

Paper 7E discussed 5 potential income statement presentations of revenue:

1. Written Premium: revenue equals premium when due.
2. Earned Premium: revenue equals premium earned over the time period that the premium covers.
3. Unbundled (Fee): revenue equals the sum of the charges for insurance coverage. Regarding presentation, the goal of the unbundled income statement presentation is to show the pieces that make up an insurance contract, even if the contract is interdependent.
4. Summarized Margin: revenue is limited to risk adjustment and residual margin released. The risk adjustment, formerly known as the risk margin, is the amount above the present value of cash flows an insurer would pay to be relieved of the risk. The residual margin is the balancing item so that there is no day one profit. Present value of contract cash flows would not be part of revenue.
5. Expanded Margin: revenue equals risk adjustment and residual margin released plus insurance losses and expenses.

Under each of these options the bottom line is the same. An example of how these options would work for a particular policy can be found in Paper 7E’s appendix.

The IASB and FASB voted overwhelmingly (14-1 and 5-0, respectively) to follow the staff recommendation to eliminate Option 1: Written Premium, even though it is widely used globally. Written premium is the presentation method used for FAS 60 in the U.S.

The boards deferred the second staff proposal that an insurer should not report as revenue the premium that relates to future repayments to the same policyholder.

FASB favored keeping Option 2: Earned Premium for short term (typically P&C) contracts and possibly for long term contracts. The advantage of Option 2 is all premiums eventually end up as revenue. Some IASB members do not support Option 2.

FASB remains open to having different models for different types of contracts, such as Option 3: Unbundled for UL, where the fees are split out in the contract. For non-UL life, there was support for

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Option 5: Expanded Margin. Option 4: Summarized Margin has some support, but it does not provide as much information to investors as the other options.

I found the comments of Peter Clark interesting. He is the IASB staff member who has been working on insurance for over 10 years. He likes having both Option 2: Earned Premium and Option 5: Expanded Margin available. He is not completely happy with Option 5 because revenue is not directly defined. Another IASB staff member suggested that revenue for Option 5 could equal premiums minus deposits, but both Peter and a FASB board member thought that for many contracts the deposit would be hard to quantify precisely.

The boards did not make any decisions regarding presentation.

Embedded Derivatives

The staff proposal is to measure derivatives embedded in an insurance contract using the same measurement approach applied to an insurance contract. This means that insurance contracts would not be bifurcated.

The proposed revisions to financial instrument accounting eliminate the need to bifurcate financial instruments. If a financial instrument has an embedded derivative, the entire contract must be measured at fair value. Contrast that to current accounting standards, in which embedded derivatives are bifurcated from the host contract and measured at fair value.

Perhaps as a result of a long meeting crossing many time zones, there was confusion in the discussion about whether embedded derivatives are evaluated after evaluating the contract for unbundling. The argument in favor of not bifurcating an insurance contract into a host contract measured as insurance and an embedded derivative measured at fair value is that the insurance measurement is a current measurement, a measurement that is updated each reporting period, and therefore gives an answer that is close enough to fair value to avoid bifurcating. The IASB split 7-7, thus providing no resolution on whether an embedded derivative in an insurance contract should be measured using the insurance standard or fair value.

Next Steps

The current goal is to publish an Exposure Draft in May with a four month comment period, but today's topics need additional discussion before the boards can resolve them. Therefore, unbundling, presentation, and embedded derivatives will be added to the February agenda. The agenda for the January 19 IASB/FASB meeting includes policyholder behavior and measurement, including risk adjustments and residual margins.

The current timetable proposes the following additional topics for February and March:

- Reinsurance
- Policyholder accounting
- Participating, variable, and UL contracts

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- Field test results on acquisition costs, contract boundaries, discount rates, and earned premium approach
- Level of aggregation
- Disclosures
- Recognition and de-recognition
- Business combinations

As always, please feel free to contact me with any questions. I can also provide sources for the IASB papers.

Doug Van Dam

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