



Board Meeting Handout

Insurance Contracts

February 6, 2013

PURPOSE OF THE MEETING

1. The purpose of this meeting is to discuss the accounting for the following:
 - a. Project scope—accounting for guarantees
 - b. Modifications of insurance contracts
 - c. Foreign currency transactions.

ISSUE 1: ACCOUNTING FOR GUARANTEES

Purpose

2. At the March 2, 2011, joint Board meeting, the staff recommended retaining current accounting for guarantees that were not issued by an insurance entity and/or did not meet the definition of insurance. The Board asked the staff to perform additional analysis to identify guarantees that meet the definition of insurance and to determine if there are differentiating characteristics that would support different accounting.
3. The staff presented this analysis in the November 20, 2012, Board meeting handout. In that handout, the staff recommended that guarantee contracts that meet the definition of insurance should be accounted for using the proposed insurance contracts standard except when guarantee contracts have specific characteristics, which the staff noted justified differing accounting treatment, or when the guarantee was specifically addressed in other sections of the Codification.
4. The purpose of this handout is to address the items the Board asked the staff to consider at the November 20, 2012, Board meeting.

Background

5. In the insurance contracts project, the Board defined an *insurance contract* as the following:

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A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policy holder.

6. That definition is synonymous with the definition of guarantees. Therefore, by requiring all entities that write contracts that meet the definition of insurance to be insurance, all guarantees should be accounted for as insurance unless explicitly excluded. That is what the staff recommended in the handout for the November 20, 2012, Board meeting.
7. The primary change coming out of that recommendation is that guarantee contracts that currently fall into Topic 460, Guarantees, and meet the definition of insurance should specifically apply the proposed insurance contracts guidance. Beside those contracts meeting the definition of insurance, the subsequent measurement of the liability would be based on expected cash flows rather than on a best estimate when incurred, which the staff notes is an improvement.
8. However, there were exceptions from having to apply Topic 460. This is not unlike the financial instruments guidance or the revenue recognition guidance or any other guidance in which the Board has made scope exceptions, because it has explicitly deliberated certain topics to come up with the best standard for those particular transactions.
9. It is important to note that the Board has already tentatively made specific scope exceptions, some of which could be interpreted to include certain guarantees, such as the following:
 - a. Product warranties issued by a manufacturer, dealer, or retailer.
 - b. Employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans.
 - c. Contractual rights or contractual obligations that are contingent on the future use of, or right to use, a nonfinancial item.
 - d. Residual value guarantees provided by a manufacturer, dealer, or retailer, as well as a lessee's residual value guarantee embedded in a finance lease.
 - e. Contingent consideration payable or receivable in a business combination.
 - f. Direct insurance contracts that the entity holds (that is, direct insurance contracts in which the entity is the policyholder).

- g. Charitable gift annuities, which possess a donation element and are issued by not-for-profit entities within the scope of Topic 958, Not-for-Profit Entities.
- h. Fixed-fee service contracts that provide service as their primary purpose if they meet all the following criteria:
 - 1. The contracts are not priced on the basis of an assessment of the risk associated with an individual customer.
 - 2. The contracts compensate customers by providing a service, rather than cash payment.
 - 3. The type of risk transferred by the contracts is primarily related to the utilization (or frequency) of services relative to the overall risk transferred.

Staff Analysis

Alternative Scoping Considerations

Consideration of Guarantees Issued in Conjunction with a Sales Transaction

- 10. Some Board members raised concerns about an entity having different accounting upon the transfer of an underlying in a business combination or asset sale while retaining the same risk by issuing a guarantee to the purchaser. For example, an entity could have an obligation, such as environmental exposure on property, which it evaluates in accordance with Topic 450, Contingencies, when it owns the property. However, upon sale and issuance of an indemnification or guarantee regarding the environmental exposure, that same obligation would be accounted for in accordance with the proposed insurance contracts guidance.
- 11. While the nature of the relationship between the entity and the underlying obligation may be altered in a sale transaction, the Board could consider giving a scope exception for indemnifications or guarantees entered into simultaneously with a business combination or sale of a nonfinancial asset allowing the seller to carry forward its prior accounting.

Differentiation between Financial and Nonfinancial Guarantees

- 12. If the Board were to differentiate guarantees between financial and nonfinancial, the guidance would need to define the term *financial*. Based on the definition of *financial* within the Master Glossary of the Codification, all guarantees would be

deemed financial as they are settled in cash, an ownership interest, or some other form of financial instrument.

13. The staff considered limiting the application of the proposed insurance contracts guidance to those items in which the underlying item being guaranteed is financial. Applying that would mean that all guarantees related to leases, real estate, and residual values of other nonfinancial items, as well as indemnifications of any nonfinancial item, would be scoped out of the insurance contracts standard.
14. However, the underlying item being insured in most nonlife insurance contracts is nonfinancial in nature. For example, insurance of automobiles, homes, construction projects, nonfinancial products, health and welfare of workers and/or individuals, etc., are all nonfinancial in nature. In addition, residual value guarantees on nonfinancial items are often provided by a third party in the form of insurance. The staff also notes that this differentiator could have unintended consequences regarding what is within the scope of Topic 815, Derivatives and Hedging, and insurance.
15. To address that issue, the Board could consider a scope exclusion for guarantees of nonfinancial items issued by noninsurance regulated entities. If the Board were to go down this path, the staff would need to define guarantees. Differentiating guarantees from insurance could be challenging because many consider those terms as synonymous with one another. A differentiator could be whether the specified event or condition was under the control of the party whose “performance” is being guaranteed. For example, the party who assumed a loan has the control over whether they pay or do not pay a loan. However, that differentiator could result in excluding some common types of insurance such as surety insurance, workers compensation, etc.
16. The staff also considered limiting the inclusion of guarantees that are currently accounted for outside of the insurance contracts standard to “financial guarantees,” which would include guarantee contracts that provide protection to the holder of a financial obligation from a financial loss in the event of a default. That would result in financial and mortgage guarantees being scoped into the insurance contracts

guidance. However, the staff would need to distinguish between a guarantee and an insurance contract—which, as stated above, is a challenge.

Other Alternatives

17. The staff considered providing a scope exclusion for the items that are currently accounted for in accordance with Topic 460, originally issued as FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, that would require entities to first determine whether their arrangements meet the definition of insurance. If the answer is yes, then entities would need to determine if their arrangements would be accounted for under Topic 460, which is principles based. Under this alternative, the scope exception within the proposed insurance contracts guidance would still be complex because, in addition to listing the items that Interpretation 45 covered, it would need to specify items that Interpretation 45 excluded.
18. The staff considered whether a broad statement scoping out of the current guidance on insurance contracts any guarantees that are specifically addressed elsewhere in the Codification would be sufficient, thus simplifying the scope. However, entities could argue that guarantees are covered by Topic 450 and, therefore, do not account for a potential loss until the criteria in Topic 450 are met. The staff adds that this is a step back because the Board is moving toward an expected loss model for all financial instruments and insurance.
19. Alternatively, the Board could include a list of specific items that it wishes to exclude from the proposed insurance contracts guidance. However, the Board risks not identifying all of those types of guarantees, including new types of guarantees that may be developed subsequent to the issuance of the proposed guidance.
20. The Board also could consider providing a scope exception for guarantees accounted for at fair value based on the election under Topic 825, Financial Instruments. If the Board does this, the staff notes that the scope exception should be allowed for all contracts, and not just “guarantees”. Although the Board has not explicitly decided that contracts that meet the definition of insurance should be required to apply the

guidance on insurance contracts, the staff has been going on the presumption (and recommends) that the fair value option should not be allowed.

21. Another alternative could be to include a scope exception for entities in which the issuance of guarantees is not part of their business model. The advantage of this criterion is that entities that issue “one-off guarantees” would not need to apply the insurance contracts guidance. The disadvantage is the diversity in practice that may evolve due to the judgment required in making this determination.
22. The staff notes that in the November 20, 2012, Board meeting handout, the staff had considered and rejected the following additional criteria for scope exclusion:
 - a. A guarantee of performance other than payment of debt
 - b. Whether the guarantor has the ability to reprice the guarantee based on specific events or changes in variables
 - c. Whether the guarantee is revocable by the guarantor
 - d. Whether the guaranteed asset/liability is not a financial instrument
 - e. Whether the guarantee includes credit risk (that is, adjust the definition of financial risk).

Staff Recommendation

23. After performing an analysis of various alternatives, the staff notes that the recommendation included in the November 20, 2012, Board meeting handout (with the deletion of the phrase “settlement of the guarantee creates a new transaction”) continues to be appropriate. The Board may consider adding the following scope exceptions to address some specific concerns:
 - a. Guarantees of nonfinancial items entered into simultaneously with a business combination or asset sale
 - b. Guarantees that are not part of an entity’s business model.
24. While the staff recommendation appears to be complex because of the specificity of the scope exclusions, those scope exclusions are carried over from current guidance. The staff notes that this is an inherent issue the broader the scope of the individual guidance.

25. The staff also recommends that implementation guidance should be provided to address typical guarantees that are not in the proposed insurance contracts standard because the guarantee does not meet the definition of insurance.

Question for the Board

Question 1: Scope of the Insurance Contracts Guidance for Guarantees

Does the Board agree with the staff on the following:

The proposed guidance on insurance contracts should not apply to guarantee contracts that have any of the following characteristics:

- a. The insurer is not exposed to risk throughout the term of the guarantee. That is from inception of the contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.
- b. A guarantee or an indemnification is of an entity's own future performance.
- c. The guarantee is addressed in the following areas of the Codification:
 1. Guarantees addressed in Topic 840, Leases:
 - (a) A lessee's guarantee of the residual value of the leased property at the expiration of the lease term.
 - (b) A contract that is accounted for as contingent rent.
 - (c) A seller-lessee's residual value guarantee if that guarantee results in the seller-lessee deferring profit from the sale greater than or equal to the gross amount of the guarantee.
 - (d) A sales incentive program in which a manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, if that guarantee prevents the manufacturer from being able to account for a transaction as a sale of an asset, as described in paragraphs 840-10-55-12 through 55-25. (Because a manufacturer continues to recognize the residual value of the equipment it guaranteed [it is included in the seller-lessor's net investment in the lease], if the sales incentive program qualified to be reported as a sales-type lease, it still would not be within the scope of Topic 840 because Topic 840 does not apply to a guarantee for which the underlying is related to an asset of the guarantor.)
 2. A contract that provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party or based on the volume of purchases by the buyer that are discussed in Topic 605, Revenue Recognition.
 3. A guarantee or an indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or

recognize in earnings the profit from that sale transaction. This would include, among other items, the following:

- (a) A transaction that involves the sale of a marketable security to a third-party buyer with the buyer having an option to put the security back to the seller at a specified future date or dates for a fixed price, if the existence of the put option prevents the transferor from accounting for the transaction as a sale, as described in paragraphs 860-20-55-20 through 55-23.
- 4. Guarantees addressed in Topic 360, Property, Plant, and Equipment:
 - (a) A seller's guarantee of the return of a buyer's investment or return on investment of a real estate property.
 - (b) A seller's guarantee of a specified level of operations of a real estate property,
- 5. A guarantee for which the guarantor's obligation would be reported as an equity item rather than a liability under Topic 480, Distinguishing Liability from Equity, and Topic 505, Equity.

Considerations for Guarantees Amongst or On Behalf of Related Entities

26. At the November 20, 2012, Board meeting, the staff recommended changing current guidance to require that guarantees on behalf of or between related parties or entities under common control should be recorded in an entity's stand-alone financial statements. The reasoning behind that is, as previously stated, the definition of guarantees is synonymous with the definition of insurance. The staff stated that intracompany insurance and reinsurance arrangements should be recorded in the stand-alone financial statements of each of those entities as is required under current guidance. In addition, the staff was unable to identify other areas of U.S. generally accepted accounting principles (GAAP) that would allow entities under common control to not account for related party transactions, including intercompany derivatives.
27. An alternative to requiring all entities to account for intra-entity guarantees could be to provide a scope exception for guarantees issued by nonpublic, noninsurance regulated entities, on behalf of or between related parties or entities under common control. However, that would require differentiating between guarantees and insurance, would reintroduce entity-specific guidance, and would result in nonpublic insurance regulated entities being required to account for intra-entity guarantees that are identical to those issued by nonpublic, noninsurance regulated entities.

28. Another alternative explored by the staff would be to provide a scope exception for intra-entity guarantee transactions not deemed to be arm's length. Generally, related parties do not pay one another for intra-entity guarantees whereas intra-entity insurance and reinsurance transactions are typically transacted at a market price. For example, a parent entity guarantees the debt of its subsidiary. The borrowing rate of the debt is typically the parent entity's borrowing rate versus the subsidiary's standalone borrowing rate. While the subsidiary is not paying its parent for the difference between its borrowing rate and its parent's borrowing rate, the parent ultimately benefits in its consolidation of the subsidiary. However, in the stand-alone financial statements, the subsidiary's results do not reflect the transaction either through an expense to its parent or through higher borrowing rates.

Question for the Board

Question 2: Guarantees Amongst or On Behalf of Related Entities

Does the Board agree with the staff that the insurance contracts guidance should provide a scope exception for guarantees on behalf of or between related parties or entities under common control that are not deemed to be arm's length in the stand-alone financial statements?

ISSUE 2: MODIFICATIONS OF INSURANCE CONTRACTS

Purpose

29. The purpose of this meeting is to ask the Board to consider which, if any, additional modifications of the terms of insurance contracts should result in extinguishment accounting.

Background Information

30. The Board discussed contract modifications in the April 18, 2012, joint Board meeting as part of Memo No. 82G. The Board tentatively decided on the following:
- a. An insurer should derecognize an existing contract and recognize a new contract (under the applicable guidance for the new contract) if it amends the contract in a way that would have resulted in a different assessment of

either of the following items had the amended terms been in place at the inception of the contract:

1. Whether the contract is within the scope of the guidance on insurance contracts
2. Whether to use the premium allocation approach or the building-block approach to account for the insurance contract.

31. Agenda Paper 82G’s recommendation included a third criterion for derecognition of “which portfolio the insurance contract would be included in.” The IASB supports that recommendation in its entirety, but the FASB indicated that the third criterion would result in the extinguishment of too many contracts and, therefore, rejected that portion of the recommendation. However, the Board said that criteria (1) and (2) above were not sufficient on their own and requested that the staff consider additional modifications that would result in contract extinguishment. Specifically, the Board suggested a closer analysis of the conditions indicating substantial change as outlined in Subtopic 944-30, Financial Services—Insurance—Acquisition Costs, originally issued as AICPA Statement of Position No. 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*.

Staff Analysis

32. The consequence of accounting for a modification as a substantial modification, for which insurers derecognize the original contract and recognize a new contract, is that any difference between the actual consideration to be received (or already received for the remaining obligations, adjusted for any previously recognized changes in estimates of the remaining benefits) for the new or modified contract and the price that the insurer would hypothetically charge the policyholder for a contract equivalent to the newly recognized insurance contract (that is, the aggregation of the original obligations still remaining and any new ones added) would be treated as an extinguishment gain or loss. To the extent the insurer reunderwrote the entire contract and charged a rate commensurate with the risk and there had not been previously recognized changes in estimates of the benefits, there would not be any gain or loss. If not, the gain or loss would reflect the premium or discount associated with the original coverage on a basis similar to an experience adjustment. Because of the requirement to utilize a hypothetical price, the application of

extinguishment accounting introduces some cost and complexity and accordingly would not be cost beneficial to apply to all modifications, many of which have little to no economic effect on the pre-existing contracts.

33. Statement of Position 05-1 notes that the AICPA Accounting Standards Executive Committee (AcSEC) had considered providing quantitative guidance similar to EITF Issue No. 96-19, “Debtor’s Accounting for a Substantive Modification or Exchange of Debt Instruments,” now included in Subtopic 470-50, Debt—Modifications and Extinguishments. AcSEC ultimately concluded that such analysis would not be reliable in reaching a conclusion concerning contract similarity because of the potential subjectivity of assumptions and complex nature of many insurance and investment contracts. Rather, AcSEC adopted a qualitative analysis to be used in determining whether the replacement or modification of an insurance or investment contract results in the contract being considered substantially unchanged.
34. The staff analyzed each of those criteria. One of the conditions that Statement of Position 05-1 required to be met to avoid extinguishment accounting was that there was no change to the amortization method or revenue classification of the contract. The proposed insurance contracts model eliminates the various product-specific models that exist under current U.S. GAAP and the criteria already tentatively decided on by the Boards address the possibility that a modified contract would be better accounted for under a different model (for example, building-block approach vs. premium allocation approach financial instruments). Additionally, the Board has tentatively decided that the margin should be released on the basis of reduced variability in cash flows (with the evaluation of the reduction in variability being an ongoing assessment) and that acquisition costs for all contracts measured under the building-block approach should be amortized in a way that is consistent with the release of the margin. Accordingly, the staff notes that these criteria will not be required.

Staff Recommendation

35. The staff recommends incorporating criteria 1 through 5 outlined in Statement of Position 05-1, included in paragraph 36 below as additional modifications of the terms of insurance contracts that should be accounted for as a substantial modification for which

insurers derecognize the original contract and recognize a new contract under the applicable guidance for the new contract. The staff notes that a modification that significantly changes the kind of risks insured (criterion (1)) is virtually tantamount to extinguishing the original contract and replacing it with new coverage. Similarly, changes in amount of consideration relating to the remaining original coverage (criterion (3)) and changes in the value of surrender benefits (criterion (4)) that are not pursuant to the original terms of the contract indicate notable changes in the economics for which a transaction gain or loss and recalibration of the margin should allow for a more relevant depiction of the profitability of the amended contract. The staff adds that any changes in the participation rights (criterion (5)) or the nature of investment return rights accounted for as part of the original insurance contract (that is, vs. unbundled [criterion (2)]) also represent fundamental changes to an insurance contract.

36. The staff thinks that the recommendation, combined with the previously identified extinguishments, establishes a meaningful threshold that is both familiar to users and preparers and appropriately balances the costs and benefits of best reflecting the economics of the modified transactions.

Question for the Board

Question 3: Which Modifications Should Be Accounted for As Extinguishments

Does the Board agree with the following:

- a. An insurer should derecognize an existing contract and recognize a new contract (under the applicable guidance for the new contract) if it amends the contract in a way that would have resulted in a different assessment of either of the following items had the amended terms been in place at the inception of the contract:
 1. Whether the contract is within the scope of the insurance contract standard?
 2. Whether to use the premium allocation approach or the building-block approach to account for the insurance contract?
- b. Additionally, an insurer should derecognize an existing contract and recognize a new contract if any the following conditions do not exist:
 1. The insured event, risk, or period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.
 2. The nature of the investment return rights (for example, whether amounts are determined by formulae specified by the contract, pass through of actual performance of referenced investments, or at the discretion of the insurer) accounted for as part of the insurance contract, if any, between the insurance enterprise and the contract holder has not changed.
 3. No additional deposit, premium, or charge relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract, is required to effect the transaction; or if there is a reduction in the original benefit or coverage, the deposit, premiums, or charges are reduced by an amount at least equal to the corresponding reduction in benefits or coverage.
 4. Other than distributions to the contract holder or contract designee or charges related to newly purchased or elected benefits or coverages, there is no net reduction in the contract holder's account value or the cash surrender value, if any.
 5. There is no change in the participation or dividend features of the contract, if any.

ISSUE 3: FOREIGN CURRENCY TRANSACTIONS

Purpose

37. The exchange rate to be used in the remeasurement for foreign currency transactions (that is transactions denominated in a currency other than the entity's functional currency) is dependent on the classification of the account as monetary or nonmonetary. Accounts classified as monetary are remeasured using the current rate and, thus, the effect of changing currency prices on the carrying amounts of assets and liabilities are recognized each reporting period; accounts classified as nonmonetary are remeasured using historical exchange rates. Following remeasurement at the appropriate rate, any necessary remeasurement adjustment would be included in the calculation of the entity's net income and reflected on the entity's income statement.
38. At this meeting, the Board will be asked whether specific components related to insurance contracts reported in an insurers financial statements should be considered monetary or nonmonetary, resulting in remeasuring those accounts at the current rate or historical exchange rates.

Background

39. Many entities that issue insurance contracts have multinational operations. U.S. domiciled insurance entities typically have subsidiaries in the countries in which they transact business; therefore, there are no or minimal transactions in a foreign currency. However, there are some U.S. domiciled insurance entities that have branches rather than subsidiary entities in foreign countries and, thus, there are foreign currency transactions. There are also insurers domiciled outside the United States (that is, Bermuda and other countries) that follow U.S. GAAP where foreign currency transactions are more common. Finally, because of the expanded scope of the proposed guidance on insurance contracts to noninsurance entities there may be additional entities that write insurance business that transact in a foreign currency.

Staff Analysis

40. As explained above, the classification of specific account balances as monetary or nonmonetary impacts the exchange rate to be used in the remeasurement process. The exchange rate used in remeasurement will subsequently impact the account balances. Thus, the determination of whether an account is considered to be monetary or nonmonetary will have an impact on the amounts represented on an entity's financial statements.
41. The staff is presuming that the following items will be accounted for as monetary items, consistent with current accounting, and therefore has not performed a full analysis of these items in the sections below:
- a. The liability for incurred claims under the premium allocation approach is analogous to today's loss reserves on short-duration contracts. That is currently deemed to be a monetary item because the liability will be settled in cash. In addition, that liability does not fall into any of the categories of the list of common nonmonetary items in Topic 830, Foreign Currency Matters.
 - b. The insurance contract liability for contracts accounted for under the building-block approach is analogous to today's accounting for long-duration life insurance contracts. That is, the measurement of the liability includes all expected cash outflows and cash inflows. That is currently deemed to be a monetary item because the components of the liability are settled in cash (receipts and payments). In addition, that liability does not fall into any of the categories of the list of common nonmonetary items in Topic 830.

Liability for Remaining Coverage

42. It is important to point out that the measurement of the liability recorded for contracts accounted for under the building-block approach includes expected cash outflows and cash inflows. In contrast, for contracts accounted for under the premium allocation approach, the expected cash inflows for premiums from policyholders is recorded as a separate receivable from the liability for remaining coverage and, thus, cash receipts have no impact on the measurement of the liability; that receivable is treated as a monetary asset. In addition, unlike the liability for insurance contracts accounted for under the building-block approach, which is one liability (except for the margin),

under the premium allocation approach there are two distinct liabilities: the liability for remaining coverage and the liability for incurred claims.

Classify As a Nonmonetary Item

43. Under current accounting, most consider the liability for remaining coverage as a deferred income item because it represents the reserve for premium written but not yet earned and cash transactions do not impact the measurement of the liability. As stated in paragraph 830-10-45-18, deferred income is considered a nonmonetary item for remeasurement purposes.
44. Another argument to treat the liability for remaining coverage as nonmonetary is that the Board tentatively decided to not remeasure the liability for remaining coverage each reporting period. However, the Board also tentatively decided that insurers should recognize an additional liability if a portfolio of contracts is deemed to be onerous. While those decisions were made to simplify the model, especially when the liability for remaining coverage is typically earned within a short time frame, the impact of those decisions is essentially that an insurer would unlock the implicit margin within the liability for remaining coverage for any changes in assumptions until the margin is fully absorbed, at which time a loss would be recorded.

Classify As a Monetary Item

45. The liability for remaining coverage could be considered a proxy for the reserve because, as it is earned, a significant percentage of the liability for remaining coverage (depending on the product) is recorded as a liability for incurred claims that will be settled in cash. Therefore, the liability for remaining coverage should be deemed a monetary item.
46. Another argument for the liability for remaining coverage to be considered a monetary item is that the assets backing the liabilities, which are either cash or a receivable, are monetary items. The insurer expects to use part of the cash from, or receivable for, premiums to pay claims denominated in that foreign currency. Therefore, there could be a potential accounting mismatch if the liability for remaining coverage is considered nonmonetary.

47. In addition, the Board tentatively decided to discount and accrete interest on the liability for remaining coverage to reflect the time value of money for contracts that have a significant financing component. Typically, interest is not accreted on nonmonetary items.

48. This also would be consistent with the accounting for insurance contracts accounted for under the building-block approach. That approach treats the entire insurance contract liability, which includes a liability for remaining coverage, liability for incurred claims, and expected cash receipts, as monetary.

Single Margin under the Building-Block Approach

49. The Board has tentatively decided that an insurer should not recognize any expected gain at inception of an insurance contract. Instead, that expected gain is to be recorded as a single margin for contracts accounted for under the building-block approach, separately from the cash flows expected to fulfill the insurance obligation. The Board also tentatively decided that the liability for incurred claims for contracts accounted for using the premium allocation approach should be measured as the present value of unbiased expected cash flows (statistical mean) without a single margin. Therefore, this section is only relevant for contracts accounted for under the building-block approach.

50. It is important to note that under current U.S. GAAP, insurers do not recognize day one gains. Instead, a portion of the profit margin is earned as premium is recognized and a portion is implicit in the measurement of the insurance contract liability.

Classify As a Nonmonetary Item

51. The single margin essentially represents the expected deferred gain. The guidance provided in Topic 830 clearly indicates that “deferred income” is considered a nonmonetary item. In addition, the release of the single margin is based on the insurer’s release from risk and is not directly based on cash settlement.

Classify As a Monetary Item

52. Under current accounting guidance, the margin is *implicit* in the insurance contract liability, which is deemed to be a monetary item. The staff notes that, while *explicitly* reported under the proposed model, this classification should remain the same because the recognition is closely related to the settlement of the insurance contract liability, which is a monetary item. That is the argument for why the Board initially gave an exception to accounting for acquisition costs for life insurance contracts as nonmonetary.
53. One of the reasons for classifying an item as nonmonetary is because the cash is transacted at a historical rate and, therefore, the resulting asset or liability and the recognition of those items in the statement of comprehensive income should be at the historical rate. However, in regards to the single margin, the cash has not necessarily been transacted. That means that the single margin is based on the expected cash inflows and cash outflows. However, the insurer may receive premiums over the life of the contract and therefore cash is transacted at those current rates. Splitting the margin into expected profit on cash received and expected profit on cash not yet received would be complex, if not impossible, given that the margin is determined based on the insurance contract as a whole.

Policy Acquisition Costs

54. Prior to discussing whether policy acquisition costs should be deemed a monetary or nonmonetary item, it is important to note that the proposed accounting for acquisition costs is significantly different than current accounting.
- a. Under current accounting, expected acquisition costs on long-duration contracts are included in the insurance contract liability until paid, at which time the costs are recorded as a separate asset. Subsequent to recognition as an asset, the acquisition costs are amortized in the statement of comprehensive income either in proportion to the premium recognized or estimated gross profits.
 - b. As part of its tentative decisions, the Board has decided that expected acquisition costs will be:
 1. Reported in the liability as part of the margin (that is, the margin includes the acquisition costs expected to be paid and is reduced

when those acquisition costs are paid) for contracts accounted for under the building-block approach.

2. Reported in the liability for remaining coverage and reduced as acquisition costs are paid, for contracts accounted for under the premium allocation approach.
3. Separately recognized in the statement of comprehensive income based on the same pattern as the release of the margin or the release of the liability for remaining coverage.

55. After acquisition costs are paid, they are not recognized in the statement of financial position. Thus, there is no asset or contra liability to deal with. However, the recognition of those costs in the statement of comprehensive income needs to be decided upon. Because the recognition of acquisition costs in the statement of comprehensive income should be based on the same pattern as the release of the margin or the release of the liability for remaining coverage, an argument exists that acquisition costs should be treated the same as those items—whether monetary or nonmonetary.

Classify As a Nonmonetary Item

56. The guidance from paragraph 830-10-45-18 states that deferred charges and credits, and the amortization thereof, are among those items commonly classified as nonmonetary—except for those related to life insurance companies, which are specifically excluded from the guidance. While the acquisition costs paid are not recorded in the statement of financial position, the recognition of those costs in the statement of comprehensive income is essentially the amortization of deferred charges or credits. Presumably, the reasons for treating the amortization of deferred charges or credits as nonmonetary is because when those charges were incurred, they were recognized at the current rate at that time. Subsequent recognition of those deferred charges does not involve cash settlement and, therefore, those charges should be recognized at the historical rate. The staff note that this reasoning holds true for all acquisition costs and that there should not be an exception for life insurance contracts should the Board classify these as nonmonetary. In addition, if this exception were to be carried forward, it would need to be expanded to all contracts applying the building-block approach.

Classify As a Monetary Item

57. The majority of the financial statement components are classified as monetary. The acquisition costs are closely related to those items and therefore should be deemed monetary as well.

Summary and Staff Recommendation

58. The consequence of classifying financial statement items as monetary is that the current exchange rate will be used in remeasurement versus using a historical exchange rate if they are classified as nonmonetary.

59. Some staff members recommend that the Board look to the individual components related to insurance contracts. Therefore, the following implies:

- a. For contracts accounted for under the premium allocation approach:
 1. The liability for remaining coverage (including the implicit margin less the expected acquisition costs) and the recognition of the acquisition costs in the statement of comprehensive income would be deemed nonmonetary.
 2. The liability for incurred claims and the expected acquisition costs (recorded in the liability for remaining coverage) would be deemed monetary.
- b. For contracts accounted for under the building-block approach:
 1. The single margin (less the expected acquisition costs) and the recognition of the acquisition costs in the statement of comprehensive income would be deemed nonmonetary. However, one could argue that the proportion of the single margin related to premium not yet received could be deemed monetary.
 2. The expected acquisition costs (included in the single margin) and the liability for expected cash flows would be deemed monetary.

60. This would follow the theory behind the classification between nonmonetary and monetary. Items should be remeasured at the rate at which the cash was transacted. Therefore, the liability for remaining coverage and the single margin should be considered nonmonetary items for purposes of remeasurement because those items are not settled in cash and represent deferred profit. In addition, the recognition of

policy acquisition costs in the statement of comprehensive income should be considered nonmonetary because they represent the recognition of deferred charges.

61. Other staff members recommend that all of the components related to insurance contracts reported in the statement of financial position and the statement of comprehensive income should be considered monetary items for purposes of remeasurement for the following reasons:

- a. Consistent accounting for the various components related to insurance contracts:
 1. For contracts accounted for under the premium allocation approach this means:
 - (a) Insurers would not need to split out the expected acquisition costs included in the liability for remaining coverage.
 - (b) The portion of the liability for remaining coverage that represents the expected cash outflows, or the liability for incurred claims, would be treated consistently throughout the life of the contract.
 - (c) An accounting mismatch would be eliminated if the receivable for the premiums is remeasured at the current rate (under the building-block approach, the receivable is recorded with the liability for expected cash flows and therefore is treated the same as the rest of the liability)
 2. For contracts accounted for under the building-block approach this means:
 - (a) The entire single margin could be accounted for the same way
 - (b) Insurers would not need to split out items for which cash has not yet been transacted, including the expected acquisition costs and the proportion of the single margin for which cash has not yet been received.
- b. Consistent accounting for all types of insurance contracts regardless of the Board's tentative decisions on presentation in the financial statements. While not disaggregated in the financial statements, the liability for expected cash flows under the building-block approach has a portion that is eventually recognized as revenue (equivalent with the liability for remaining coverage under the premium allocation approach) and a portion that is eventually paid out as claims (equivalent with the liability for incurred claims under the premium allocation approach). The difference is that the receivable for premiums is recorded as an asset under the premium allocation approach while it is netted with the liability for expected cash flows under the building-block approach. Therefore, each of the approaches have the same components. The staff notes that the components

should be treated the same regardless of how they are presented in the financial statements.

- c. Simpler from the perspective of treating all components the same.
- d. Eliminates an accounting mismatch if cash is held in the foreign currency and is remeasured at the current rate.
- e. Convergence with the IASB.

Questions for the Board

Questions 4 and 5: Determination of the Classification of Specific Insurance Components As Monetary or Nonmonetary.

Does the Board agree with the staff *presumption* that the following items should continue to be accounted for as monetary items:

- a. Liability for incurred claims for contracts accounted for under the premium allocation approach?
- b. Insurance contract liability for contracts accounted for under the building-block approach?
- c. Expected policy acquisition costs and the amortization thereof for contracts accounted for under the building-block approach?

Does the Board believe the following items should be classified as monetary items (which will require amendments to Topic 830) or as nonmonetary items:

- a. Liability for remaining coverage for contracts accounted for under the premium allocation approach?
- b. The single margin for contract accounted for under the building-block approach?
- c. The recognition of expense for policy acquisition costs?