



## Board Meeting Handout

### Insurance Contracts

March 6, 2013

#### PURPOSE OF THE MEETING

1. The purpose of this meeting is to discuss the following:
  - a. Reconsideration of the treatment of changes in estimated interest crediting rates and interest accretion rates
  - b. Election of fair value option
  - c. Sweep issues.

#### ISSUE 1: RECONSIDERATION OF THE TREATMENT OF CHANGES IN ESTIMATED INTEREST CREDITING AND ACCRETION RATES

##### Purpose

2. The staff believes that the consequences of the November 2012 tentative decision addressing the discount rate for asset-affected cash flows were not fully discussed in the related staff paper or Board discussion. Specifically, the staff and constituents are concerned with the operability of disaggregating contracts' cash flows into asset-affected components and nonasset-affected components for purposes of measurement and presentation. Accordingly, the staff requests the Board consider the additional analysis provided regarding this topic.

##### Background

3. In a November 2012 joint Board meeting, the Board clarified the following:

For cash flows in the insurance contract that are not subject to mirroring and are affected by asset returns, the discount rates that reflect the characteristics of the contract's cash flows should reflect the extent to which the estimated cash flows are affected by the return from those assets. This would be the case regardless of whether the (a) transfer of the expected returns of those assets is the result of the exercise of the insurer's discretion or (b) the specified assets are not held by the insurer.

4. In that meeting, the Board also tentatively decided the following:

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For cash flows in the insurance contract that are not subject to mirroring and that are affected by asset returns, upon any change in expectations of those cash flows (for example, the crediting rate) used to measure the insurance contracts liability, an insurer should reset the locked-in discount rates that are used to present interest expense for those cash flows.

5. As part of the deliberations during the meeting, the Board had briefly discussed whether the reset rate should be used to determine interest expense for (a) only cash flows affected by asset returns or (b) all of the cash flows of a contract whose cash flows are predominantly affected by asset returns. Some Board members expressed concerns that the use of such a threshold would result in the effect of changes in discount rates being presented either fully in net income or fully in other comprehensive income. Ultimately, the Board's tentative decision was that the reset rate should be applied to only cash flows affected by asset returns, which many understood to mean that an insurer would be required to disaggregate the cash flows into two distinct buckets to determine interest expense and other comprehensive income.
6. Subsequent to the November tentative decision, several preparers have reached out to the FASB to share their belief that *requiring* separate discount rates for components of the cash flows that are affected by asset returns poses significant theoretical and operational problems and may lead to incorrect measurement of the insurance liability for a significant portion of the life insurance market.

### **Staff Analysis**

7. The November tentative decisions on discount rates addressed both the rates that (a) would be used for measurement of the time value of money included within the insurance contracts liability and (b) would be used for measurement of interest expense and other comprehensive income.

### **Discount Rates Used for Purposes of Measurement of the Liability**

8. To help illustrate how an insurer might determine the time value of money for a contract with asset-affected cash flows that is not subject to the mirroring decisions, the staff included an example in Appendix C of Memo 95A. That example was intended as and labelled as a simplified example and as one way an insurer "might" determine the time value of money. Some preparers expressed concern that the example suggested an insurer

would be *required* to split the cash flows into two categories, those that are asset affected and those that are not, to measure the insurance contracts liability. Those preparers also opined that, due to the “continuum of real world products with their varying degree of guarantee, risk sharing, and optionality,” detailed implementation guidance should not be provided on this subject, in part because it might be interpreted as prescriptive.

9. Notwithstanding the reference to *cash flows affected by asset returns* in the tentative decision of the Board about determination of discount rates for purposes of measuring the insurance contracts liability, the staff does not think that decision requires disaggregating a portfolio’s cash flows. Neither was it the FASB staff’s intent that an insurer need to do so. The staff considered the reference to cash flows in this decision to instead have been a means to describe the objective and principle for determination of discount rates to be used in measurement of insurance contract liabilities.
10. The staff thinks that application of the principle that discount rates should reflect the characteristics of the contract’s cash flows is not dependent on whether the estimated cash flows are split into multiple components or are, instead, aggregated at a portfolio level for purposes of discounting. Either approach should generally result in the same measurement of the insurance contracts liability for the portfolio. For example, instead of applying the approach illustrated in Appendix C of Memo 95A, an insurer could have reasonably determined the same discount rate based on an evaluation of the correlation between cash flows of the assets and cash flows of the portfolio of insurance contracts, without needing to assess whether individual cash flows are asset affected or not.
11. The staff observes that splitting up the cash flows of a contract into those that are asset affected and not asset affected would be inconsistent with the Board’s tentative decision on the unit of account.
12. The staff thinks that, in many circumstances, distinguishing which specific cash flows within the portfolio are affected by asset returns is operationally complex and might introduce additional (unwarranted) subjectivity into insurance contracts presentation. The following are examples of characteristics of some insurance contracts that would contribute to this complexity:
  - a. The individual cash flows within a portfolio are often interdependent with other cash flows.

- b. Some cash flows are affected by asset returns during some periods but not affected by asset returns during other periods.
- c. Are estimated future premiums that will be used to purchase asset-affected coverage themselves asset-affected cash flows?

### **Staff Recommendation**

13. Because the staff thinks that the objective of determining a discount rate that reflects the characteristics of the cash flows should not be affected by the amount of interim disaggregation in measuring a portfolio's insurance contracts liability, requiring any disaggregation of the cash flows for purposes of measuring the nonmargin component of the insurance contracts liability would not be justified from a cost-benefit perspective. However, the staff does not think that the decision itself (see paragraph 3 above) requires any such disaggregation and, thus, does not think that this decision requires any further consideration at this time. However, in drafting the Exposure Draft, the staff will consider including clarifying language that notes that a single set of yield curves might be appropriate for measuring the time value of money for all cash flows in a portfolio as long as that set of yield curves appropriately reflects the characteristics of the blended cash flows.

### **Question for the Board**

#### **Question 1: Confirmation on Discount Rates Used in the Statement of Financial Position Measurement**

1. Does the Board confirm that its tentative decision from the November 2012 meeting (see paragraph 3) does not require an insurer to disaggregate cash flows of a contract into those affected by returns from assets and those not affected by returns from assets for purposes of determining discount rates that reflect the characteristics of the contract's cash flows? However, the discount rates for the portfolio's cash flows should reflect the extent to which the amount of any estimated cash flows, subject to insurer discretion, are affected by asset returns.

### **Discount Rates for the Measurement of Interest Expense and Other Comprehensive Income**

14. As noted in paragraph 4 above, the Board tentatively decided that, upon any change in expectations of the crediting rate, an insurer should reset the interest accretion rate. The

basis for this tentative decision includes the fact that some movements in interest rates affect the cash flows of universal life and other asset-affected cash contracts and that presenting interest expense based on rates locked at the inception of such a contract would be inconsistent with the variable rate nature of the amounts “borrowed” by the insurer under the contract. As noted in paragraph 5, many constituents and the staff understood that the Board intended that disaggregation of the cash flows into those affected by the return on assets and that those not affected by the return on assets would be *required* for measurement of interest expense and other comprehensive income. Viewed in the context of the portfolio, this achieves what might be called a partial lock in of the discount rate.

15. Each of the above noted points on the complexity of disaggregating cash flows for the purposes of measuring the insurance contract liability on the statement of financial position is similarly relevant for determining the interest accretion in the statement of comprehensive income.
16. As noted in paragraph 5, concerns were expressed in the Board meeting that the use of a threshold such as “predominantly” for resetting previously locked-in rates would result in the effect of changing discount rates being accounted for either fully in profit and loss or fully in other comprehensive income, depending on which side of the threshold a contract falls. The perceived need for a threshold such as “predominant” was to avoid accounting for the full effect of changes in discount rates within net income for a portfolio whose cash flows are only slightly affected by the return on assets. However, the staff thinks that the decision to disaggregate the cash flows was as much attributable to the rate the interest accretion rate is reset to (that is, the current discount rate used to measure the liability) as it is to the use of a trigger to reset the rate. If the rate used to determine interest expense was instead reset to a rate other than the rate used to calculate the liability, the effect of resetting the rate would obviously differ and might mitigate or eliminate any comparability issues. If that rate is instead adjusted to only reflect changes in the estimated interest payments, then resetting the interest accretion rate would *not* result in accounting for the full effect of changes in discount rates within net income for a portfolio whose cash flows are only slightly affected by the return on assets.
17. Based on consideration of examples prepared by the staff, the staff thinks it is important that the degree to which insurers adjust the locked-in interest accretion rates be reflective

of the extent of change in amounts expected to be paid to the policyholder as interest (that is, based on expectations of the crediting rates and the relative value of the account balance to be credited as compared to the total obligation). The staff also thinks that resetting the interest accretion rate to a rate that reflects the estimated remaining interest expense is necessary to ensure the total interest expense recognized over the life of the contract is accurately portrayed. Resetting the rates on an effective interest-rate basis achieves comparability with the measurement of interest in Subtopic 835-30, Interest—Imputation of Interest.

18. The staff considered the tentative decisions reached during the May 2012 joint Board meeting about the use of other comprehensive income (OCI) for contracts whose cash flows are not affected by the return on assets. That decision is paraphrased as follows:
  - a. Present as Accumulated Other Comprehensive Income (AOCI) the difference between the insurance contracts liability on the statement of financial position and the amount the insurance contract liability would be if it were determined at the interest accretion rate locked in at inception of the insurance contract.
  - b. Present in profit or loss interest expense using the discount rate locked in at inception of the insurance contract.
19. Resetting the locked-in interest accretion rate for the contracts addressed in this handout to an amount that reflects the extent of asset dependency enables the measurement of these contracts to follow consistent principles to those applied to nonasset-affected contracts (that is, changes in the insurance liability arising from changes in the discount rate are reflected in OCI for both subsets of contracts and the interest accretion rates are only reset to reflect any variable rate nature of financing).

### **Presentation of Changes in Expectations of Interest Crediting**

20. All changes in estimates of the present value of future cash flows will be reflected in the insurance contracts liability immediately. Additionally, all changes in estimates of the present value of future underwriting cash flows will be reflected in net income immediately for both contracts with and without asset-affected cash flows.
21. Arguments for recognizing any changes in the estimates of future cash flows resulting from changes in expectations of the amount of interest to be credited immediately in net income include the following:

- a. Changes in other fulfillment cash flows are recognized immediately in net income. Treating changes in cash flows arising from changes in interest crediting would treat all insurance contracts cash flows equally.
  - b. OCI might be more easily understood if it is limited to the effect of changes in discount rates and the differences between interest on the insurance contracts liability determined at the current discount rate used in the measurement of the liability and the interest accretion recognized in net income (that is, the unwind of the effect of changes in discount rates).
22. Arguments for recognizing any changes in the estimates of future cash flows resulting from changes in expectations of the amount of interest to be credited initially in OCI include the following:
- a. Immediate recognition of the changes in future interest crediting in interest expense would overstate or understate the cost of financing incurred both during current and future periods. Users have expressed the importance of being able to compare investment income earned from premiums and the cost of “borrowing” implicit or explicit in those contracts. As these additional costs are reflective of expected interest to be credited, generally as part of the investment components, recording any effect of these changes in underwriting income seems equally inappropriate.
  - b. Resetting the interest accretion rate to reflect future interest expense better reflects the relationship between changes in the crediting rate and that interest expense. Absent such a change, the spread presented between the interest expense and the interest credited might vary significantly over the life of a contract as expectations change, which might mislead users as to this relationship.
  - c. The amounts recorded in OCI would meaningfully represent the change during the period in the difference between the insurance contracts liability calculated using current discount rates and the liability calculated using the interest accretion rates, attributable to changes in discount or crediting rates. Although those changes reflect changes in the estimates of actual cash flows and, thus, need to be eventually reflected in the income statement, similar to the effect of changes in discount rates, those amounts will reverse out of OCI as interest is accreted on the liability at a level yield.

### **Staff Recommendation**

23. The staff recommends the following:
- a. For insurance contracts that are affected by asset returns, upon any change in expectations of the crediting rate used to measure the insurance contracts liability an insurer should reset the interest accretion rates in a manner that recognizes any changes in estimated interest crediting and related ultimate

expected cash flows on a level-yield basis over the remaining life of the contracts.

- b. For insurers, present as part of AOCI the difference between the insurance contracts liability on the statement of financial position and the amount the insurance contract liability would be if it were determined at the interest accretion rates.

24. The staff thinks that resetting the interest accretion rate to such a rate would do the following:

- a. Most faithfully represent the cost of financing implicit in contracts with cash flows affected by the return from assets
- b. Be reflective of the extent of change in amounts expected to be paid to the policyholder as interest without requiring the use of any arbitrary thresholds
- c. Avoid the complexity associated with disaggregating cash flows solely for determining the interest accretion in the statement of comprehensive income
- d. Not preclude the use of OCI for changes in discount rates, thus enhancing comparability with contracts without cash flows affected by the return from assets.

25. The staff thinks that the recommendation related to what is recorded as part of AOCI is consistent with the Board's tentative decision discussed in paragraph 18 on the use of OCI for contracts not affected by the returns from assets. Although that may often result in the effect of some changes in future cash flows recorded in OCI, those amounts will reverse out through OCI as interest is accreted on the liability, which would help ensure that the interest expense better reflects the implicit costs of borrowing for the period. Because an insurer will continue to be required to recognize any changes in what the amount of the liability would be if it were determined at the interest accretion rate, use of OCI would be limited to amounts that would ultimately unwind into interest expense.

## Questions for the Board

### Questions 2 and 3: Resetting Interest Accretion Rate and Recognition of Changes in Estimated Interest Crediting (That Is, Ultimate Expected Cash Flows)

Does the Board confirm the following for insurance contracts that are affected by asset returns:

2. Upon any change in expectations of the crediting rate used to measure the insurance contracts liability, an insurer should:

(a) Reset the interest accretion rates in a manner that recognizes any changes in estimated interest crediting and related ultimate expected cash flows on a level-yield basis over the remaining life of the contracts?

(b) Record the difference between the prior expected cash flows discounted at the prior interest rate and the revised expected cash flows discounted at the reset interest accretion rate to net income?

The degree to which the interest accretion rate for the portfolio is adjusted should reflect the relative value of the account balance to be credited and the extent changes in expected amount to be credited to those account balances are the result of changes in expected asset returns.

3. Apply the following tentative decision on AOCI for nonasset-affected cash flows: insurers present as part of AOCI the difference between the insurance contracts liability recorded on the statement of financial position (using the current discount rate) and the amount the insurance contract liability would be if it were determined at the interest accretion rates?

## ISSUE 2: ELECTION OF FAIR VALUE OPTION

### Purpose

26. The purpose of this issue is to address the accounting for items that an entity may choose to measure at fair value under current Topic 825, Financial Instruments, in light of current projects. Specifically, this issue addresses whether the fair value option should be retained for insurance contracts, including guarantees and warranties that are currently not accounted for as insurance but that will be under the proposed insurance contracts guidance. In addition, this issue addresses other financial instruments that are outside the scope of or related to the proposed FASB Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities*, and the proposed

insurance contracts guidance in which an unconditional fair value option is allowed under current U.S. generally accepted accounting principles (GAAP).

## **Background**

27. Paragraph 825-10-15-4 states that all entities may elect the fair value option for any of the following eligible items:

- a. A recognized financial asset and financial liability (with specified exceptions)
- b. A firm commitment that would otherwise not be recognized at inception and that involves only financial instruments (for example, a forward purchase contract for a loan that is not readily convertible to cash; that commitment involves only financial instruments—a loan and cash—and would not otherwise be recognized because it is not a derivative instrument).
- c. A written loan commitment.
- d. The rights and obligations under an insurance contract that has both of the following characteristics:
  - (1) The insurance contract is not a financial instrument (because it requires or permits the insurer to provide goods or services rather than a cash settlement).
  - (2) The insurance contract's terms permit the insurer to settle by paying a third party to provide those goods or services.
- e. The rights and obligations under a warranty contract that has both of the following characteristics:
  - (1) The warranty is not a financial instrument (because it requires or permits the insurer to provide goods or services rather than a cash settlement).
  - (2) The warranty's terms permit the insurer to settle by paying a third party to provide those goods or services.
- f. A host financial instrument resulting from the separation of an embedded nonfinancial derivative from a nonfinancial hybrid instrument under paragraph 815-15-25-1, subject to the scope exceptions in the following paragraph (for example, an instrument in which the value of the bifurcated embedded derivative is payable in cash, services, or merchandise but the debt host is payable only in cash).

28. The proposed Update on financial assets and liabilities, would limit when a fair value option is permitted for financial instruments within its scope.

**825-30-15-2** All entities may apply the **fair value** option to a group of financial assets and financial liabilities for which both of the following conditions are met:

- a. The entity manages the net exposure relating to the financial assets and financial liabilities (which may be **derivative instruments** subject to Topic 815) on a fair value basis.
- b. The entity provides information on a net exposure basis to its management.

**825-30-15-3** All entities may apply the fair value option to a hybrid financial liability provided that neither of the following conditions exists:

- a. The **embedded derivative** or derivatives do not significantly modify the cash flows that otherwise would be required by the contract.
- b. It is clear with little or no analysis when a similar **hybrid instrument** is first considered that separation of the embedded derivative or derivatives is prohibited.

**825-30-15-4** All entities may apply the fair value option to a financial asset that meets the contractual cash flow characteristics in paragraph 825-10-25-17 and is managed together with other financial assets within a distinct business model in accordance with paragraph 825-10-25-25(b).

**825-30-15-5** All entities may apply the fair value option to a nonfinancial hybrid liability provided that an entity determines that the hybrid nonfinancial liability contains an embedded derivative subject to bifurcation and separate accounting in accordance with Subtopic 815-15. If an entity elects not to use the fair value option for a hybrid nonfinancial liability, the financial liability host contract that results from the separation of the nonfinancial embedded derivative shall be accounted for in accordance with the guidance in paragraph 825-10-35-10.

29. Paragraph BC31 in the proposed Update on financial assets and liabilities states the following about investments accounted for by the equity method:

The amended guidance on a fair value option would provide a fair value option only if specified criteria are met. *No such option would be available for an investment accounted for by the equity method.* Instead, paragraph 323-10-15-20 would establish specified indicators for an equity method investment to

be considered held for sale and measured at fair value with all changes in fair value recognized in net income. [Emphasis added.]

30. Therefore, since the equity method investments that are held for sale are within the scope of the classification and measurement guidance, the staff believes that this decision would overwrite the guidance in paragraph 825-10-15-4 that allows the fair value option for equity method investments.

## **Staff Analysis**

### **Guarantees and Other Contingencies**

31. Guarantees and other contingencies typically meet the definition of a financial liability because they are settled in cash, an ownership interest, or some other form of financial instrument. While Topic 825 did not specifically mention guarantees, other than in reference to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease, entities could elect the fair value option for any type of guarantee or contingency (unless explicitly excluded from the guidance).
32. At the February 6, 2013, Board meeting, the Board tentatively decided that the proposed insurance contracts standard should apply to all guarantee contracts that meet the definition of an insurance contract except those that meet certain characteristics. Those characteristics include the following:
- a. The insurer is not exposed to risk throughout the term of the guarantee.
  - b. A guarantee or an indemnification is of an entity's own future performance.
  - c. Guarantees issued by an entity that are both (1) unusual or nonrecurring and (2) unrelated to the type of risk that is the subject of other guarantees issued by the entity.
  - d. The guarantee is addressed in the specified areas of the *FASB Accounting Standards Codification*<sup>®</sup>.
33. Based on that tentative decision, any guarantee that meets the definition of insurance and does not meet any of the scope exceptions would be accounted for in accordance with the proposed insurance contracts standard.
34. However, if any guarantee accounted for in accordance with Topic 460, Guarantees, or contingency accounted for in accordance with Topic 450, Contingencies, that meets the definition of a *financial asset* or a *liability* is not brought into the guidance

within the proposed Update on financial assets and liabilities or the proposed insurance contracts guidance, it would appear the fair value option would still be available to be elected without explicit Board action.

### **Staff Recommendation**

35. For guarantees and other contingencies that will not be within the scope of the insurance contracts guidance, a fair value option is currently available and new guidance overriding that option is not being developed in any current project. For those items, the staff believes that the reasons for providing the fair value option in FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, have not changed and, therefore, the staff recommends retaining the fair value option election.
36. However, if the Board decides to eliminate the fair value option for these contracts, the staff recommends that the effective date and transition provisions for those specific guarantees and contingencies should default to the guidance in the proposed Update on financial assets and liabilities. If the fair value option was previously elected, the staff recommends that entities be allowed to continue to fair value those items given that they would not otherwise need to reevaluate the accounting. Because the fair value option was elected on an instrument-by-instrument basis (except in specific areas), entities would apply the relevant existing U.S. GAAP to any new instruments.

### **Questions for the Board**

#### **Questions 4–5: Guarantees and Other Contingencies**

4. Would the Board like to retain or eliminate the fair value option election for guarantees and other contingencies accounted for in accordance with Topic 460 or contingency accounted for in accordance with Topic 450 that meets the definition of a financial asset or a liability (and that would not be in the scope of the guidance in the proposed Update on financial assets and liabilities or the proposed insurance contracts guidance)?

5. If the Board decides to eliminate the fair value option election, does the Board agree with the staff recommendation that:

(a) The effective date should be consistent with the effective date provisions for the Proposed ASU, *Recognition and Measurement of Financial Assets and Financial Liabilities*?

(b) Entities should adopt prospectively for guarantees and contingencies first recognized subsequent to the effective date eliminating the fair value option?

## **Rights and Obligations of Insurance Contracts and Warranties**

### **Insurance Contracts**

37. Paragraph 825-10-15-4(d) allows entities to elect the fair value option for insurance contracts.

38. The staff understands that insurers rarely elected the fair value option. It was most commonly elected by insurance subsidiaries of banks, although that was not consistent across all banks. In addition, some insurance entities elected fair value for small blocks of business and/or where they thought the hedging results would be better if the insurance contracts were reported at fair value through net income. One of the primary reasons insurers did not elect the fair value option in more circumstances was because of the requirement to consider nonperformance risk and the rate that would be required to be used to discount the liabilities.

39. In the 2007 Invitation to Comment, *An FASB Agenda Proposal, Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper*, Preliminary Views on Insurance Contracts, the IASB proposed that insurers should measure their insurance contracts at current exit value, representing the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. Virtually all respondents had concerns about significant aspects of the model and its proposed objective of a current exit value. The primary reasons for the objection included the following:

- a. A transfer objective is the wrong principle for items that will not be, and often cannot be transferred, even if current exit value might often be very close for a fulfillment value in practice.
  - b. Reference to estimates of the cash flows that would arise for market participants would be confusing and would produce less relevant information than cash flows that would arise for the insurer itself.
  - c. Objection to the inclusion of nonperformance risk.
  - d. Objection to using the risk-free rate to discount cash flows arising from insurance contracts.
40. Based on the feedback, the Boards tentatively decided that current fulfillment value and not fair value is the most relevant measurement attribute for insurance liabilities. Because of the conscious decision by the Boards to not measure the insurance contract liability at fair value, the staff does not believe an insurer should have an option to do such and, thus, recommends that paragraph 825-10-15-4(d), which allows entities to elect to measure their insurance contracts at fair value, be eliminated.

### **Warranties**

41. Paragraph 825-10-15-4(e) allows entities to elect the fair value option for the rights and obligations under a warranty contract.
42. The Board tentatively decided that an entity should apply the proposed insurance contracts guidance to all contracts that meet the definition of insurance, except for those that the Board has explicitly scoped out of the proposed insurance contracts guidance. Therefore, warranties that meet the definition of insurance, including those that are currently accounted for under Subtopic 460-10, would be accounted for under the proposed insurance contracts guidance except for product warranties issued by a manufacturer, dealer, or retailer, which are accounted for under Topic 605, Revenue Recognition.
43. Based on the staff's recommendation in paragraph 40, the fair value option should not be allowed for warranties accounted for in accordance with the proposed insurance contracts guidance.

44. Product warranties issued by a manufacturer, dealer, or retailer are outside of the scope of the guidance in both the proposed Update on financial assets and liabilities and the proposed insurance contracts guidance. The rights for product warranties would be accounted for in accordance with the guidance in proposed FASB Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*, while the obligation generally is determined in accordance with Topic 450. Under the proposed Update on revenue recognition, if a warranty cannot be purchased separately and does not provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the warranty is not accounted for as a separate performance obligation and, therefore, there is no separate right to be accounted for. If it is determined that the warranty is a separate performance obligation, paragraphs 70–76 of the proposed Update on revenue recognition provides guidance on how to determine the separate right, none of which is fair value. Therefore, the staff thinks that the ability for entities to fair value the rights for product warranties that are outside the scope of the proposed insurance contracts guidance is disallowed by the proposed Update on revenue recognition. See the *Guarantees and Other Contingencies* section above for the obligation for those product warranties.

### **Staff Recommendation**

45. The staff recommends that the fair value option not be allowed, unless explicitly decided on by the Board in their relevant projects, for the following items:
- a. Paragraph 825-10-15-4(d) through (e): rights and obligations under an insurance contract and a warranty that will be accounted for in accordance with the proposed insurance contracts guidance
  - b. Paragraph 825-10-15-4(e): Rights under a warranty that will be accounted for in accordance with the guidance in the proposed Update on revenue recognition
46. Furthermore, the staff recommends that the removal of the ability of entities to be able to elect fair value option should be effective at the same time the respective proposed standards are effective with the respective transition provisions.

## Questions for the Board

### Questions 6–7: Rights and Obligations of Insurance Contracts and Warranties

Does the Board agree with the staff recommendation to eliminate the fair value option election for the following items from Topic 825 and, if so, the staff recommendation on effective date and transition:

6. In paragraph 825-10-15-4(d) through (e): rights and obligations under an insurance contract and a warranty that will be accounted for in accordance with the proposed insurance contracts guidance with an effective date and transition provisions the same as in that proposed guidance?

7. Paragraph 825-10-15-4(e): rights under a warranty that will be accounted for in accordance with the guidance in the proposed Update on revenue recognition with an effective date and transition provisions the same as in the guidance in that proposed Update?

### Written Loan Commitments

47. Paragraph 825-10-15-4(c) allows entities to elect the fair value option for written loan commitments. Paragraph 825-10-35-20 of the proposed Update on financial assets and liabilities proposes the following accounting model for written loan commitments:

**825-10-35-20** Paragraph 825-10-25-28 requires a creditor to classify a loan commitment, a revolving line of credit, or a commercial letter of credit for which the probability of exercise is not remote in accordance with the classification of the underlying loan to be made under the commitment. Thus, if the underlying loan, when originated, is measured at fair value, the loan commitment also would be measured at fair value. If the underlying loan is measured at amortized cost, the creditor shall defer the commitment fee received, if any, and recognize it over the life of the funded loan in accordance with the guidance in Subtopic 310-20.

### Staff Recommendation

48. The guidance in the proposed Update on financial assets and liabilities could be viewed as establishing a new accounting model for written loan commitments, therefore, overriding paragraph 825-10-15-4(c) and eliminating the fair value option for written loan commitments. However, some note that a large population of written

loan commitments will remain off balance sheet as a result of the proposed Update (that is, those for which it is not remote that the commitment will be exercised and the related loan will be measured at amortized cost plus those for which it is remote that the loan will be drawn) and, therefore, the fair value option should remain available.

49. If the Board decides to eliminate the fair value option for written loan commitments, the staff believes that the effective date and transition provisions should follow the guidance in the proposed Update on financial assets and liabilities.

### Question for the Board

#### Question 8: Written Loan Commitments

Would the Board like to retain or eliminate the fair value option election for loan commitments that are not required to be measured at fair value in accordance with the guidance in the proposed Update on financial assets and liabilities (those for which exercise is remote and those for which exercise is not remote and the related loan would be carried at amortized cost)?

If the Board decides to eliminate the fair value option for written loan commitments, does the Board agree with the staff recommendation on effective date and transition for written loan commitments currently eligible for the fair value option?

### Firm Commitments

50. Paragraph 825-10-15-4(b) includes the following type of firm commitment as an eligible item for the fair value option election:

A firm commitment that would otherwise not be recognized at inception and that involves only financial instruments (for example, a forward purchase contract for a loan that is not readily convertible to cash—that commitment involves only financial instruments—a loan and cash—and would not otherwise be recognized because it is not a derivative instrument).

51. A firm commitment would be eligible for the fair value option only if it does not meet the definition of a derivative or qualifies for a scope exception from Topic 815, Derivatives and Hedging. If a contract meets the definition of *both* a derivative instrument and a firm commitment, then it must be accounted for as a derivative instrument (unless one of the scope exceptions from Topic 815 applies). An example of that is a firm commitment to purchase loans not readily convertible to cash.

52. The guidance in the proposed Update on financial assets and liabilities does not explicitly address the accounting for firm commitments of that type. Because they involve a purchase of a financial instrument, and because the guidance in that proposed Update does not provide a specific scope exception for these firm commitments, it may be presumed that such firm commitments are within the scope of the guidance in the proposed Update on financial assets and liabilities.
53. As part of the project leading to the issuance of the proposed Update on financial assets and liabilities, the Board decided to carry forward a specialized model for forward and option contracts (with no intrinsic value at inception) to purchase certain debt and equity securities and to expand that specialized model to nonmarketable equity securities. The model applies to those forward and option contracts to purchase securities that do not meet the definition of a *derivative* in Topic 815 and that will be physically settled. Under this model, the accounting for the forward or option contract would follow the classification of the security to be purchased.
54. At this time, to address firm commitments to purchase loans currently eligible for the fair value option, the Board could clarify that this model **also** would apply to forward and option contracts (with no intrinsic value at inception) to purchase loans that do not meet the definition of a derivative and that will be physically settled. The staff believes this model would then capture firm commitments to purchase loans that do not meet the definition of a derivative in Topic 815, which the staff believes is essentially the population of firm commitments currently eligible for the fair value option.

### **Staff Recommendation**

55. The staff recommends that the Board clarify that the proposed model for forward and option contracts to purchase debt securities and marketable and nonmarketable equity securities also applies to forward and option contracts to purchase loans as described above. The staff believes that because the guidance in the proposed Update on financial assets and liabilities does not distinguish the accounting for loans and investments in debt securities, the accounting for forward and option contracts to purchase debt instruments also should be consistent.

56. Similar to written loan commitments, the staff believes a fair value option could be retained for those forward contracts to purchase loans for which the loans will be measured at amortized cost.
57. If the Board decides to clarify that forward and option contracts to purchase loans should be accounted for consistently with the specialized model for forward and option contracts to purchase securities, the staff believes the effective date and transition provisions must follow those in the proposed Update on financial assets and liabilities.
58. However, if the Board decides to scope these firm commitments out of that proposed Update and eliminate the fair value option for these firm commitments, the staff believes that the effective date should be consistent with the effective date of that in the proposed Update on financial assets and liabilities, and the accounting change should be prospective with grandfathering permitted.

### Questions for the Board

#### Questions 9–11: Firm Commitments

9. Does the Board agree with the staff recommendation to extend the proposed model for forwards and options to purchase securities to those firm commitments? If so, does the Board agree with the staff's recommendation on effective date and transition (that is, the effective date and transition provisions must follow that in the proposed Update on financial assets and liabilities)?
10. If the Board agrees with the staff recommendation, does the Board wish to retain or eliminate the fair value option for firm commitments that are not required to be measured at fair value because the loans to be purchased will be carried at amortized cost (as described in paragraph 56 above)?
11. If the Board decides these firm commitments to purchase loans should be excluded from the scope of the proposed Update on financial assets and liabilities, should the fair value option be retained or eliminated? If the Board believes it should be eliminated, does the Board agree with the staff recommendations about the effective date and transition for firm commitments currently eligible for the fair value option (that is, the effective date should be consistent with that of the effective date of the proposed Update on financial assets and liabilities and the accounting change should be prospective with grandfathering permitted)?

## **ISSUE 3: SWEEP ISSUES**

### **Purpose**

59. The purpose of this handout is to consider various sweep issues that have been raised in the deliberation process or otherwise raised by respondents to the 2010 Discussion Paper.

### **Staff Analysis**

#### **Criteria to Account for Contracts under the Premium Allocation Approach**

60. At the February 27, 2012, joint Board meeting, the Board tentatively decided the following regarding the criteria to be required to account for contracts under the premium allocation approach:

- a. It is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfill the contract; or
- b. Significant judgment is required to allocate the premium to the insurer's obligation to each reporting period. That may be the case if, for example, significant uncertainty exists about:
  - (1) The premium that would reflect the exposure and risk that the insurer has for each reporting period; or
  - (2) The length of the coverage period.

61. In the October 17, 2012, joint Board meeting, the Board decided that premiums presented in an insurer's statement of comprehensive income should be measured by applying an earned premium approach. Based on the Board's tentative decision on recognizing premium under the building-block approach, the criteria in paragraph 60(b) no longer makes sense.

### **Staff Recommendation**

62. The staff recommends that criteria in paragraph 60(b) be eliminated from the proposed guidance. Therefore, the staff recommends that the eligibility criteria to apply the premium allocation approach to a portfolio of insurance contracts should be revised as follows:

Insurers should apply the premium allocation approach if it is unlikely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfill the contract.

63. Although not voted on at the February 2012 Board meeting, the staff included application guidance in Memo No. 79E to clarify aspects of the criteria based on Board member and constituent feedback. That included the following:

- a. The existence of guarantees or options may indicate the likelihood of a significant change in expected cash flows, if there is no corresponding change in premiums.
- b. Some cash flow changes are likely, but will not significantly change expectations at contract inception. Other circumstances could cause expected cash flows to change significantly, but may not be likely at contract inception.
- c. At contract inception, if an insurer expects that, during the contract's coverage period, it will significantly change premium pricing for future contracts written with similar or identical risks, that could indicate a significant change in net cash flows for the existing contract.
- d. The longer the coverage period of a contract, the more likely it is that there will be a significant change in the expected net cash flows.

64. The staff thinks that with the inclusion of the implementation guidance, the criterion for when the premium allocation approach should be applied is clear.

### Question for the Board

#### Question 12: Criteria to Account for Contracts under the Premium Allocation Approach

Does the Board agree with the staff recommendation to remove the following criterion that, if met, an insurer would not be allowed to apply the premium allocation approach:

*Significant judgment is required to allocate the premium to the insurer's obligation to each reporting period?*

### Related Party Guarantees

65. At the February 6, 2013, Board meeting, the Board tentatively decided that the proposed insurance contract standard should not apply to “a guarantee between related parties or entities under common control when the issuer of the guarantee is also not issuing similar guarantees to third parties.”

66. An unintended consequence of that decision is that captive insurers that only write insurance for their parent and affiliated entities would not account for their insurance contracts as insurance in their standalone financial statements. A captive insurance company is an entity established with the specific objective of insuring risks emanating from their parent group or groups. Typically, the primary business purpose of a captive insurance company is to provide risk mitigation services for its parent company although they sometimes insure risks of the group's customers as well.

### **Staff Recommendation**

67. If not clarified in the guidance, captive insurers could potentially account for insurance written to its parent and affiliates using Topic 450 or Topic 460. Under current U.S. GAAP, captive insurers account for such contracts as insurance. The staff does not think that the Board's intent was to allow captive insurers to not account for insurance provided to its parent and affiliates using the insurance contracts model. Therefore, the staff recommends clarifying the language as follows:

A guarantee between related parties or entities under common control when the issuer of the guarantee is also not issuing similar guarantees to third parties, **unless issuance of such guarantees is the primary business purpose of the issuing entity.**

### **Question for the Board**

#### **Question 13: Related Party Guarantees**

Does the Board agree with the staff recommendation to clarify the language in the previous decision as outlined in paragraph 67 above?

### **Accounting for the Excess of the Insurance Liability Measurement over the Fair Value of the Insurance Contracts in a Business Combination**

68. Based on current guidance for business combinations and the Board's tentative decisions at the November 14, 2012, Board meeting, in a business combination, an insurer would do the following:

- a. Allocate the purchase price to identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition date fair values. That fair value is determined in accordance with Topic 820,

which includes a risk premium reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows.

- b. Measure the present value of the unbiased probability weighted estimate of expected cash flows consistent with the Board's tentative decisions in the insurance contracts project that would reflect updated assumptions at the acquisition date, including a discount rate that reflects the characteristics of the liability as of that date (therefore, "day 2" accounting would be the same as "day 1" accounting).
- c. If the fair value of the insurance contract liability (that is, the hypothetical premium) exceeded the measurement of the liability (that is, present value of expected cash flows), the insurer should record a single margin for the difference.

69. However, based on the Board's tentative decisions at that meeting not to record an implicit acquisition costs, the accounting for the excess of the present value of fulfillment cash flows over the fair value of the insurance contract liability remains unanswered. The staff has considered two alternatives: (a) record the difference as an increase in goodwill or (b) record goodwill as if there were no difference and recognize a loss for the difference.

70. The staff notes that paragraph 805-20-30-12 includes a list of other assets and liabilities that do not follow the measurement principle in the guidance on business combinations (that is, fair value at the date of acquisition) including income taxes, employee benefits, and share-based payment awards, among others. The basis behind those exceptions includes avoidance of any immediate gain or loss under the applicable guidance for subsequent measurement (that is, on a basis other than fair value) of the assets and liabilities. Based on the guidance provided in Subtopic 805-30, Business Combinations—Goodwill or Gain from Bargain Purchase, Including Consideration Transferred, goodwill captures any differences between the applicable measurements of the assets or liability and their fair values and no loss would be recognized.

71. However, goodwill is defined in U.S. GAAP as an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized. Because the insurer allocates the purchase price to the insurance contracts liability, one could argue that

the difference between that allocation and the measurement of the insurance contracts liability is individually identified as part of the insurance contract liability and therefore should be recorded as such, rather than with goodwill.

72. In addition, it seems counterintuitive to increase goodwill when the assets acquired for the liability are lower than the liability itself. That could be analogized to an insurer charging too little premium for the expected cash flows of the contract, which the Board has tentatively decided should be recorded as a day 1 loss. Subsequent to the initial recognition of the goodwill, the goodwill would need to be tested for impairment. It would be hard to argue that the goodwill is not impaired if the portfolio of insurance contracts was the entity's only business. However, when combined with the rest of the reporting unit, the goodwill may not be impaired.

### **Staff Recommendation**

73. While one would not expect a loss to be recognized for a business combination, it also seems counterintuitive to increase goodwill for what otherwise would be considered an onerous contract. Therefore, the staff recommends that if the fair value of the insurance contracts liability is less than the present value of the fulfillment cash flows, a loss should be recognized when the business combination takes place. The staff thinks that this approach more accurately reflects the fact that the insurer has acquired an obligation that it expects to fulfill and that the present value of that obligation is larger than its fair value. Additionally, the staff thinks that this approach provides a more faithful representation of an entity's goodwill because it does not artificially inflate goodwill for what many would view as a negative circumstance.

### **Question for the Board**

**Question 14: Accounting for the Excess of the Insurance Liability Measurement over the Fair Value of the Insurance Contracts in a Business Combination**

Does the Board agree with the staff recommendation to record any excess of the asset and liability balances related to insurance contracts measured in accordance with the proposed guidance above the fair value of those assets and liabilities (i.e., the hypothetical premium), as a loss upon combination?

74. At the October 20, 2011, joint meeting, the Boards tentatively decided that for contracts measured using the premium allocation approach, all insurance contract rights and obligations should be presented on a gross basis in the statement of financial position. Subsequent to that decision being made, some constituents have asked whether or not insurers should include future expectations, such as cancellations, when determining the amount to record for the liability for remaining coverage as well as the insurance contracts premium receivable.
75. The premium allocation approach is considered by many to be a different and simplified model from the building-block approach. A significant part of the simplification is that the liability for remaining coverage is not updated each reporting period for changes in expectations on expected cash flows. Rather, an onerous contract test is performed if qualitative factors exist and a liability is recorded for the amount of expected cash outflows that exceed the liability for remaining coverage. Therefore, some would argue that cancellations should not be considered given that a contract is not written with the intent of canceling it.
76. The Board tentatively decided that if there is a reduction in the original benefit or coverage and the deposit, premiums, or charges are reduced by an amount at least equal to the corresponding reduction in benefits or coverage then the change is not a substantial modification. The Board also tentatively decided that an insurer should account for nonsubstantial modifications as follows:
- a. If the modification eliminates the insurer's obligation to provide some of the benefits that the contract would previously have required it to provide, the insurer should derecognize that portion of its obligation (including any related portion of the residual/single margin).
77. While not redeliberated, the staff indicated that it would carry over the guidance for derecognition. The Discussion Paper states that “an insurer would remove an insurance liability (or part of an insurance liability) from its statement of financial position only when it is extinguished (that is, when the obligation specified in the insurance contract is discharged, cancelled, or expired). At that point, the insurer would not be at risk and, therefore, would not be required to transfer any further

economic resources to satisfy the insurance contract.” That would imply that the insurer should adjust its financial statements only when the cancellation occurs.

78. This guidance would require insurers to update their liability for remaining coverage and receivables each reporting period based on data submitted by the policyholder.
79. It is important to point out that upon a cancellation, most contracts accounted for using the premium allocation approach return premium for the unused portion of coverage. That is different than most contracts accounted for under the building-block approach in which the return of premium, if any, is not based on unused coverage but, rather, on a buildup of an investment component in the form of a cash surrender value or an account value. Therefore, any adjustment to the liability for the remaining coverage also would be made to the receivable or, if the premium was received upfront, the insurer would need to establish an allowance for cancellations. The staff thinks that this would complicate the model. In addition, if cancellations were initially considered in the measurement of the liability for remaining coverage and not updated throughout the coverage period, there could be a substantial amount of premium to be earned and reversal of the allowance for returned premium at the end of the contract when cancellations did not occur.

### **Staff Recommendation**

80. Based on the analysis above, the staff recommends that the Board clarify that for contracts reported under the premium allocation approach, an insurer should not include expectations of future changes in coverage (for example, policyholder cancellations) in the expected cash flows. That is consistent with how U.S. GAAP is currently applied for the significant majority of insurance contracts accounted for under the short-duration model.

## Question for the Board

### Question 15: Whether or Not to Include Expectations in the Liability for Remaining Coverage under the Premium Allocation Approach

Does the Board agree with the staff recommendation to clarify that for contracts reported under the premium allocation approach, an insurer should not include expectations of future changes in coverage (for example, policyholder cancellations) in the cash flows?

### Recognition Point for Deferred Annuity Contracts

81. At the March 15, 2011, joint meeting, the Boards tentatively decided that insurance contract assets and liabilities should initially be recognized when the coverage period begins. Some constituents asked the IASB how this decision applies to deferred annuities (no insurers have raised this issue to the FASB staff).
82. An annuity contract is an arrangement under which the contract holder is guaranteed to receive benefits over a fixed period of time or over the contract holder's lifetime. A deferred annuity has two separate phases: the accumulation phase and the payout phase. The accumulation phase is the period of time from the commencement of the contract to when the payout begins. The date that benefit payments begin is referred to as the annuitization date, after which the contract is in the payout phase.
83. Under current U.S. GAAP, those two phases are accounted for separately. An insurance company accounts for the accumulation phase as an investment contract and accounts for the payout phase as an insurance contract that begins when the annuitization option is chosen.
84. Under the Board's tentative decisions, insurance contracts should be looked at in their entirety and all features of the contract should be accounted for. However, because the insurer is not exposed to mortality risk during the accumulation phase, some view the coverage period beginning when the payout period begins.
85. At their January meeting, the IASB tentatively decided that the recognition point should be revised to clarify the recognition point for deferred annuities while not changing the recognition point for other insurance contracts.

## Staff Recommendation

86. The FASB staff believes that the tentative decision made in March 2011 on an insurer recognizing assets and liabilities related to an insurance contract when the coverage period begins is sufficient. One of the primary reasons for that decision was because that point is when the insurer is on risk to the policyholder. The staff believes that basis holds true for deferred annuities; the insurer is on risk to the policyholder when the contract first begins, which also is when the annuitization options have been committed to by the insurer. The staff thinks this can be clarified in implementation guidance.
87. The staff also is concerned about adding criteria linking the recognition to cash flows because this could result in unintended consequences for other contracts. The staff spoke with several issuers of deferred annuities who shared the staff's concerns.

## Question for the Board

### Question 16: Recognition Point for Deferred Annuity Contracts

Does the Board agree with the staff recommendation to not revise the recognition point of insurance contracts and to include implementation guidance regarding concerns raised for deferred annuity contracts?

## Treatment of Income Tax Payments and Receipts

88. At the February 18, 2011, joint meeting, the Board tentatively decided to clarify that all costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts should be included in the cash flows used to determine the insurance liability. The Board also confirmed that costs that do not relate directly to the insurance contracts or contract activities should be recognized as expenses in the period in which they are incurred.
89. Some comment letters to the IASB questioned whether income tax payments and receipts should always be excluded from the fulfillment cash flows. Some would argue that in certain cases, policyholders' tax directly relates to the insurance contract or contract activities and should be included in the fulfillment cash flows. In particular, those respondents noted that a distinction needs to be made between taxes

imposed on the profits of an insurer and taxes that are charged to the insurer as a proxy for taxing the policyholders directly. Accordingly, those respondents suggest that the proposed guidance be amended to clarify that it excludes taxes on the profits of an insurer from the fulfillment cash flows but includes taxes paid on behalf of policyholders.

90. Certain products pass through returns on assets invested on behalf of policyholders. However, in some cases, the return passed through is less tax expense on the return (commonly referred to as I-E or income less expense). For example, assume that an insurer earns a 6 percent gross return on its investments and an after tax return of 5.25 percent—all of which is passed through to the policyholder. Essentially, what happens is the policyholder pays the insurer .75 percent for the expense and the insurer pays the taxing authority for the amount, resulting in no expense to the insurer (similar to a cost plus arrangement).
91. At its January meeting, the IASB tentatively decided to clarify in the proposed guidance that cash flows relating to tax payments should be evaluated and treated like any other cash flows. Thus, those cash flows that are related to fulfilling the contract would be included in the measurement of the liability.

### **Staff Recommendation**

92. The staff does not think that tax obligations of the insurers should be included in the measurement of the liability, even if the insurer is reimbursed for those expenses. Some contend that a decision to include those taxes in the measurement of the liability will be contained only to specific jurisdictions, however, the staff believes that insurers in all jurisdictions will question how much of the income tax burden is being borne by the policyholders through the pricing mechanisms. For example, if insurers are passing along the tax consequence of the operations supporting the insurance contracts via the pricing or crediting rates, insurers in those other jurisdictions may question whether they could include in their measurement of the liability what now is part of their normal income taxes, which would be included on a present value basis.

93. If the Board agrees with this position, the staff intends on clarifying it in the implementation guidance.

### **Question for the Board**

#### **Question 17: Treatment of Income Tax Payments and Receipts**

Does the Board agree with the staff recommendation to clarify in the implementation guidance that cash flows excluded from the measurement of the liability should include income tax payment obligations of the insurer even if the insurance contract permits the insurer to charge back those amounts to policyholders. However, any tax obligations that are incurred by the policyholder and in which the insurer pays those obligations in a fiduciary capacity should be included in the present value of fulfillment cash flows along with any amounts the insurer expects to receive from the policyholder related to those tax amounts.