Board Meeting Handout

Presentation of Comprehensive Income November 14, 2012

PURPOSE

1. On August 16, 2012, the Financial Accounting Standards Board (FASB) issued proposed Accounting Standards Update, *Comprehensive Income (Topic 220):*Presentation of Items Reclassified Out of Accumulated Other Comprehensive Income (ED). The purpose of this meeting is to provide the Board with a summary of significant feedback received on the ED and to ask the Board to redeliberate certain issues raised by respondents on the ED.

FEEDBACK RECEIVED AND ISSUES TO DISCUSS

Disclosure Requirements

2. The majority of the respondents to the ED strongly agreed with the Board's decision to not reinstate the presentation requirements deferred by Update 2011-12 that required reclassification information and the related impact on net income be presented on the face of the financial statements by line item. Approximately two thirds of respondents agreed that the proposed amendments would provide useful information to users of financial statements and most respondents generally did not believe the proposed disclosures would require significant costs to implement. Respondents who supported the proposed amendments noted that the enhanced disclosures would assist management, as well as users, to easily locate and more fully understand how reclassifications from AOCI impact the financial statements. Some respondents, primarily preparers, also supported the proposed disclosures because they eliminate the "cluttering effect" on the face of the financial

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- statements that would have resulted from the presentation requirements in Update 2011-05.
- 3. However, some respondents disagreed with the requirements in the ED primarily due to concerns about disclosure redundancy. Some also felt that mandating a specific presentation format would be inconsistent with the disclosure framework discussion paper. These respondents suggested that the Board permit more flexibility in formatting the required information to reduce redundancy and to better explain how other comprehensive income affects the financial performance of the entity.
- 4. The staff continues to believe that the proposed amendments will help financial statement users (particularly noninstitutional investors) navigate the various disclosures surrounding items reclassified out of AOCI and their effect on net income. Therefore, the staff recommends that the Board proceed with the proposed disclosure requirements subject to redeliberations on the remaining issues discussed at this meeting.

Question 1 for the Board

Question 1: Does the Board wish to affirm its decision to require an entity to provide enhanced disclosures about items reclassified out of AOCI and their impact on net income line items subject to certain follow-on edits that are discussed in questions 2 and 3?

5. Some constituents questioned whether it was the Board's intent to provide an option for an entity to present on the face of the financial statements the disclosure requirements of paragraph 220-10-45-14A (Table 1) but not provide similar guidance for 220-10-45-17 (Table 2). Additionally, several respondents requested more flexibility when presenting the information required to be disclosed in paragraph 220-10-45-14A (Table 1). While the staff agrees that it is possible for the disclosure requirements in paragraph 220-10-45-14A to be repetitive and that it may be too prescriptive of a format, the staff also acknowledges the benefit of having a consistent disclosure presentation amongst all entities.

Questions 2 and 3 for the Board

Question 2: Does the Board wish to allow an entity to satisfy the disclosure requirements found in paragraph 220-10-45-17 (Table 2) by presenting this information on the face of the financial statements?

Question 3: Does the Board wish to allow an entity flexibility in presenting the disclosure requirements found in paragraph 220-10-45-14A (Table 1) by allowing an entity to provide this information in the notes to the financial statements in a form other than a tabular format (for example, combined with disclosure paragraph 220-10-45-17, etc.)?

Interim Reporting Periods

6. Very few respondents thought that the disclosures should be required for interim periods because most respondents strongly disagreed with the interim requirements. Respondents who disagreed noted that there appears to be a recent trend that often extends annual disclosure requirements to interim reporting. These respondents do not believe that the same level of information should be required in interim financial statements as is required in annual financial statements. However, during the outreach with users of financial statements, some users said that the disclosures are very important during interim periods because they would enable users to identify unusual changes and trends that may not be obvious in condensed interim period statements. As a result, the staff continues to believe that these disclosure requirements are useful for interim reporting periods.

Question 4 for the Board

Question 4: Does the Board wish to affirm its decision to require these disclosures for public entities during interim reporting periods?

Nonpublic Entities

7. Most respondents generally agreed that the amendments should not differ for nonpublic entities. While a few respondents noted that there might need to be different requirements for nonpublic entities. The staff recognizes that nonpublic entities may have difficulty providing paragraph 220-10-45-17 (Table 2) because

it will not have a pension footnote available to cross reference; therefore, nonpublic entities are only fully capable of providing paragraph 220-10-45-14A (Table 1). Accordingly, the staff believes that nonpublic entities should be exempt from the disclosure requirements of paragraph 220-10-45-17 (Table 2).

Question 5 for the Board

Question 5: Does the Board agree with the staff recommendation to exempt nonpublic entities from the disclosure requirements of paragraph 220-10-45-17 (Table 2)?

Transition and Effective Date

- 8. The ED asked constituents if they believe it would be possible for the proposed amendments to be effective for public entities as early as for annual periods ending after December 15, 2012, with an additional year for nonpublic entities. Several respondents disagreed with the year-end effective date and suggested that it be effective for fiscal years (and reporting periods within those fiscal years) beginning after December 15, 2012.
- 9. The staff believes that given the feedback received and the likely timing of a final standard, it would not make sense to make this standard effective for reporting periods *beginning after* December 15, 2012 with an additional year for nonpublic entites. Additionally, the staff recommends prospective transition guidance, consistent with many other recently issued standards requiring enhanced disclosures.

Questions 6 and 7 for the Board

Question 6: Does the Board agree with the staff recommendation to make the guidance effective for reporting periods beginning after December 15, 2012 for public companies with an additional year for nonpublic companies?

Question 7: Does the Board agree with the staff recommendation to provide prospective transition for the required disclosures?

Permission to Draft

10. The staff recommends that if the Board makes decisions on the questions in this draft that the Board proceed to issuing a final Accounting Standards Update to require entities to provide enhanced disclosures about items reclassified out of AOCI and their impact on net income line items.

Question 8 for the Board

Question 8: Does the Board direct the staff to draft a final Accounting Standards Update for ballot that reflects decisions reached at this meeting?

Board Meeting Handout Technical Corrections and Improvements

November 14, 2012

Purpose

1. The staff is proposing that the Technical Corrections and Improvements project have the following three components: (1) Master Glossary amendments, (2) benefit plan illustrative guidance amendments, and (3) other Codification amendments. With respect to the Master Glossary amendments, this handout details the staff's recommended scope and recommendations for amendments to eliminate duplicate terms, where feasible, and provide links between accounting guidance and the glossary term in the Master Glossary.

Scope

2. As mentioned above, the staff proposes that this project be separated into three sections; Master Glossary amendments, benefit plan illustrative guidance, and other Codification amendments. Given the scope of the Master Glossary and the fact that this was scoped out of the first Technical Corrections and Improvements project, the staff believes that it would be prudent to separate it into its own proposed Update. Furthermore, each of the three sections have the potential for numerous consequential amendments, providing for large and comprehensive documents. Therefore, the staff thinks it would be better to issue three separate Updates to better manage the complexity and volume for stakeholders. A brief discussion of the remaining sections is in paragraphs 13 and 14 of this handout. Until the staff provides the Board with further analysis of the remaining two

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sections, the Board is only being asked at this time whether it agrees to separate the glossary term amendments from the other two sections.

Question 1 for the Board

1) Does the Board agree with the staff recommendation to separate the Master Glossary amendments from the other components of the Technical Corrections and Improvements project, that is, benefit plan illustrative guidance amendments, and other Codification amendments?

Master Glossary Items

- 3. During Board meetings for the prior Technical Corrections project, individual Board members suggested including improvements to the Master Glossary within the scope of TC2013. Based on that input, the staff has identified the following items related to the scope of the Master Glossary within the scope of TC2013:
 - (a) Unlinked terms
 - (b) Duplicate terms
 - (c) Fair value.

Unlinked Terms

- 4. The staff has identified 57 unlinked glossary terms. This means the term exists in the Codification's Master Glossary but is not linked anywhere in the Codification. For each unlinked term, the staff has identified the legacy literature from which the term is sourced, then determined a course of action. *Note:* Any linking of terms does not include finding additional instances where this term exists and attempting to link legacy definitions to new guidance as the staff believes that this could have unintended consequences.
- 5. Within this section, the staff has divided the group further to assist the Board's understanding of the terms. These groups are as follows:

- (a) Add links (I). Items that link Master Glossary terms to Codification literature because the definition and Codification literature come from the same legacy literature.
- (b) Add links (II). Items that link Master Glossary terms to Codification literature but the definition and Codification literature do not come from the same legacy literature; however, the staff is comfortable with linking the two because the definitions are appropriate in the context in which the term is used in the Codification.
- (c) **Delete.** Terms that are not used in the Codification.
- (d) **Other.** Items that require other miscellaneous changes.
- 6. The staff prepared Appendix A of the Board memo which contains a table divided into the four groups above. The table lists each term, the paragraphs where the term is used/the staff is proposing linking the term to (if applicable), sources of term definition and Codification literature, staff's proposed action, and any applicable explanation to assist the Board in understanding the proposed action.

Question 2 for the Board

2) Does the Board agree with the staff recommendation to draft the proposed Master Glossary amendments in accordance with Appendix A of the Board memo?

Duplicate Terms

7. The staff has identified 191 individual duplicate Master Glossary terms. In order to more efficiently address the terms, the staff is proposing scoping out any terms related to current projects on the Board's agenda (that is, Revenue Recognition, Definition of a Nonpublic Entity, Accounting for Financial Instruments, etc.), which would bring the number of duplicate terms to be addressed in the current project to 87. This will eliminate the possibility of making multiple amendments and/or deleting terms that would have to be reinstated by a current project. The staff prepared Appendix B which lists 79 duplicate terms, the legacy literature

source, its definition, each Subtopic it is used in, and the staff's recommendation for resolving the redundancy.

Questions 3 and 4 for the Board

- 3) Does the Board agree with the staff recommendation to scope out terms related to current projects?
- 4) Does the Board agree with the staff recommendation to draft the proposed Master Glossary amendments in accordance with Appendix B of the Board memo?
- 8. The remaining terms are related to two additional issues that the staff believes require Board action as follows: (1) defined benefit plans and (2) defined contribution plans. The above two issues have terms that are related and could be amended to reduce the redundancy. The staff has laid out the alternatives below along with a staff recommendation for the Board.
 - (a) <u>Defined Benefit Plans</u>: The staff has identified five definitions related to defined benefit plans. These are (1) Defined Benefit Health and Welfare Plans [SOP 92-6], (2) Defined Benefit Pension Plan [FAS 35], (3) Defined Benefit Pension Plan [FAS 87], (4) Defined Benefit Plan [SOP 94-4], and (5) Defined Benefit Postretirement Plan [FAS 106].
 - (i) The staff believes that there are three possible courses of action. First, the Board could choose to not address any of the defined benefit plan definitions within this project.

 Second, the Board could only delete one of the 'defined benefit pension plan' (that is, number 2 or 3 above) definitions, eliminating the only exact duplication. Lastly, the Board could combine all of the definitions into one broad defined benefit plan definition with bullet points below for items unique to specific types of plans.

(ii) The staff recommends the latter option. The staff believes that this is the most complete solution and would provide the clearest picture for users of the Codification.

Question 5 for the Board

- 5) Does the Board agree with the above staff recommendation to combine all of the defined benefit plan definitions into one?
- (b) <u>Defined Contribution Plans</u>: The staff has identified three definitions related to defined contribution plans. These are (1) Defined Contribution Health and Welfare Plans [SOP 92-6], (2) Defined Contribution Plan [SOP 99-3], and (3) Defined Contribution Postretirement Plan [FAS 106].
 - (i) The staff notes that the same three options exist for these as outlined above for defined benefit plans. The staff recommends the same option as well.

Question 6 for the Board

6) Does the Board agree with the staff recommendation above to combine the three definitions related to defined contribution plans into one?

Fair Value

- 9. The last project had a section of conforming amendments to reflect the fair value definition found in Topic 820. Currently, there are two definitions; one originating from SFAS 157 and one originating from SFAS 123(R). One issue is whether to clarify that the SFAS123(R) definition is not 'fair value' but rather a fair value-based measurement.
- 10. The staff notes that SFAS 123(R) established **fair value** (as defined below) as the measurement objective in accounting for share-based payment arrangements and requires all entities to apply a *fair value-based* measurement method in accounting for share-based payment transactions with employees except for equity instruments held by employee share ownership plans¹. The Statement also established fair

¹ SFAS 123(R) cross-referenced to SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans,* for ESOP guidance. The definition of fair value in SOP 93-6 is that of the one used in SFAS 123(R).

value as the measurement objective for transactions in which an entity acquires goods or services from nonemployees in share-based payment transactions.

Fair Value: The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. [SFAS 123(R)]

- 11. The staff has found 32 paragraphs in which the term is linked. These are in two Topics, 505 Equity and 718 Compensation—Stock Compensation. Furthermore, there are seven Subtopics in which they occur; 505-50 Equity-Based Payments to Non-Employees, 718-10 Overall, 718-20 Awards Classified as Equity, 718-30 Awards Classified as Liabilities, 718-40 Employee Stock Ownership Plans, 718-50 Employee Share Purchase Plans, and 718-740 Income Taxes.
- 12. The staff has identified two different terms that the Board could use to rename the SFAS 123(R) definition. First, the Board could rename it to 'share-based payment value.' The staff chose this as an option because it comes from the specific language used in SFAS 123(R) to describe the scope. The other alternative is 'equity compensation value.' The staff chose this as an option because the fair value term is used in ESOP guidance as well (that is, not just share-based payment guidance) and equity compensation value may be considered a broader term.

Questions 7 and 8 for the Board

- 7) Would the Board like to rename the SFAS 123(R) fair value term?
- 8) If so, what would the Board like to rename it?

Remaining Sections

Amendments to Implementation Guidance and Illustrations of Defined Benefit Pension Plan and Health and Welfare Benefit Plans

13. Section 960-205-55, Defined Benefit Pension Plans—Presentation of Financial Statements—Implementation Guidance and Illustrations, and Section 965-205-55, Plan Accounting—Health and Welfare Benefit Plans—Presentation of Financial

Statements—Implementation Guidance and Illustrations, contain examples illustrating the annual financial statements and notes to the financial statements of these plans. The staff has begun reviewing this guidance to ensure that it reflects current disclosure requirements, particularly those of Topic 820, *Fair Value Measurement*. Following this review, the staff expects to begin drafting a proposed Update of Sections 960-205-55 and 965-205-55.

Codification Amendments

14. The staff has begun addressing the items related to other codification amendments. For this project, there are about 50 items that the staff will present to the Board for exposure. Each of the items has been given to a subject matter expert and will be fully vetted amongst the staff, the respondent, and the firms to determine current practice and necessary actions.

Next Steps and Permission to Draft

15. Once the Board has made decisions regarding the above Master Glossary terms, the staff is prepared to begin drafting a proposed Update on just the Master Glossary corrections. The staff notes that as this project is headed toward an Exposure Draft, it is necessary to touch on the complexity and cost/benefit issue. The staff believes this project will not result in any unintended complexity; in fact, it should reduce the complexity of the Codification by streamlining the Master Glossary. Furthermore, the staff believes the benefit of making the Master Glossary more user-friendly will far outweigh any costs. The staff also notes that there should be little to no costs to the preparer as a result of this project because there will be little change to the Codification literature.

Question 9 for the Board

9) Does the Board direct the staff to begin drafting a proposed Update consisting of Master Glossary amendments to ballot as described?

16. The staff notes that this document should be ready for exposure in January 2013. In recommending a comment period, the staff has considered two factors. First, the comment period would begin during the year end reporting cycle. Second the comment period would likely overlap with the comment periods for exposure documents on other projects (for example, Repurchase Agreements and Accounting for Financial Instruments; Impairment and possibly Classification and Measurement). In order to provide enough time for stakeholders wishing to provide a comment letter to the Board to do so, the staff is proposing a 90-day comment period.

Question 10 for the Board

10) Does the Board agree with the staff recommendation to provide a 90-day comment period on the proposed Update?

Board Meeting Handout Insurance Contracts November 14, 2012

PURPOSE OF THE MEETING

- 1. The purpose of this meeting is to discuss the accounting for the following:
 - (a) Ceding commissions
 - (b) Contracts acquired through business combinations and portfolio transfers
 - (c) Participation features of mutual insurance companies.

Issue 1: Ceding Commissions

- 2. Some reinsurance contracts provide for a ceding commission, which is structured such that the reinsurer reimburses the cedant for the costs it incurred to sell and underwrite the contracts.
- 3. The amount of the ceding commission is usually a percentage of the reinsurance premium. It is made by the reinsurer to compensate the cedant for part or all of its acquisition and other administrative costs. The ceding commission also may include an amount for operating expenses (general and administrative expenses such as taxes, licenses, and fees) and a profit factor that is the excess of the commission received by a cedant over its actual costs incurred in producing the business ceded. In some contracts, the ceding commission, the override commission, and the profit commission are separate.
- 4. Based on the FASB Discussion Paper, *Preliminary Views on Insurance Contracts*, a cedant should not offset reinsurance assets¹ against related insurance liabilities. That position is based on the argument that reinsurance contracts in which a cedant is not relieved of the legal liability to its policyholders should not result in removal of the related assets and liabilities from the cedant's financial statements.

¹ Reinsurance recoverables are comprised of two components: unpaid losses and paid losses. The former is based on actuarial assessments and the latter is based on actual claims experience.

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- 5. At the October 2012 meeting, the Board tentatively decided that an insurer should disaggregate the insurance contracts liability into the expected cash flows to fulfill the insurance obligation and the margin, in the statement of financial position, with acquisition costs reported 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).
- 6. In addition, at the October 2012 meeting, the Board tentatively decided that acquisition costs should be recognized in the statement of comprehensive income in a way that is consistent with the proposed allocation of the single margin, which is when the insurer satisfies its performance obligations to stand ready to compensate the policyholder if a specified uncertain future event adversely affects the policyholder, which is when the insurer is released from exposure to risk as evidenced by a reduction in the variability of cash outflows. The margin recognized should be grossed up for the amount of acquisition costs recognized. ²
- 7. The Board could require that ceding commissions for reinsured contracts be accounted for in one of the following ways:
 - (a) Reduce ceded premiums by the amount of the ceding commissions (alternative 1).
 - (b) Account for ceding commissions in the same manner as the cedant's acquisition costs (that is, against the margin) (alternative 2).
 - (c) Account for ceding commissions in the same manner as the cedant's acquisition costs to the extent that (i) the commissions reimburse the cedant for its acquisition costs and (ii) any amounts in excess of acquisition costs should reduce ceded premiums (alternative 3).³

² This decision also applies to the premium allocation approach because the single margin is implicit in the liability for remaining coverage. Thus, acquisition costs would be released in line with the pattern of the release of the liability for remaining coverage, or the unearned premium. That is consistent with the notion that the premium allocation approach recognizes the unearned premium (that is, liability for remaining coverage) as the proportional release of each of the building blocks in the statement of comprehensive income.

³ Other administrative costs (nonclaims fulfillment costs) would be part of the reinsurance recoverable because they are part of the expected cash flows.

Alternative 1 (Reduce Ceded Premiums by the Amount of the Ceding Commissions)

- 8. Under this approach, the cedant would present ceding commissions as a reduction of ceded premium. Therefore, the ceded premium amount included on the statement of comprehensive income would represent the net amount transferred to/from the cedant and reinsurer (ceded premiums less ceding commissions). This approach was proposed in the IASB Exposure Draft, *Insurance Contracts*. The approach is based on the assumption that ceding commissions are economically part of the ceded premiums and are inherent in the pricing of the reinsurance contract.
- 9. The advantages of this approach include the following:
 - (a) It is consistent with the notion that the ceding commissions represent a pricing component of the reinsurance contract and, therefore, are best reflected net against the ceded premium, which reflects the consideration for the reinsured business.
 - (b) It treats ceding commissions included in both proportional and nonproportional contracts the same way. To the extent that nonproportional contracts do not have stated ceding commissions but instead the costs to cover acquisition costs or other costs are implicit, treating ceding commissions in the same manner as other acquisition costs would result in different accounting for the two types of contracts. However, to the extent that nonproportional contracts do not have a stated ceding commission and do not cover the cedant's acquisition costs, aligning the accounting for the two types of contracts is less important because the underlying economics are different for the two types of contracts.
 - (c) Unlike the cedant's direct acquisition costs, which are paid to a third party, the premiums and ceding commissions are exchanged between the same counterparties (the cedant and the reinsurer), are part of the same contract, include a right of offset (balances due under a reinsurance

- agreement may be netted against recoverables under the same agreement), and are paid on a net basis.
- (d) It addresses the concern that ceding commissions may not match the actual costs incurred by the cedant to acquire the underlying contracts; that is, anchoring the ceding commission to acquisition costs incurred on the underlying business may be inappropriate if they are not matched one to one.

10. The disadvantages of this approach include the following:

- (a) It does not allow the ceded premium to be recorded in an amount equal to and offsetting the gross premiums earned by the cedant on the reinsured risk. If those amounts are offset in this way, it essentially reflects the combined effect of the direct and reinsurance transactions as a passthrough of the risk.
- (b) It also does not address several respondents' concerns suggesting that the premium amount will be distorted by the inclusion of ceding commissions. This approach also would skew current insurance performance indicators.
- (c) To the extent that ceding commissions include a profit component (the excess of the commission received by a cedant over its actual costs incurred in producing the business ceded), that amount should arguably not be reflected as part of the ceded premium (that is, recognized immediately versus over the contract).

Alternative 2 (Account for Ceding Commissions in the Same Manner As the Cedant's Acquisition Costs)

11. Under this approach, the cedant would recognize and present ceding commissions in the same manner as other acquisition costs. Therefore, for the FASB, ceding commissions should be reported as part of the margin and recognized in the statement of comprehensive income in a way that is consistent with the proposed allocation of the single margin

- 12. The advantages of this approach include the following:
 - (a) It is consistent with the view that the ceded premium amount should accurately reflect the price of the risk of the underlying policies (or the reinsurer's proportional risk) without a reduction for the cedant's costs to acquire those policies. It is based on the view that ceding commissions are a reimbursement of the cedant's acquisition costs, and that those amounts should not interfere with the ceded premium amount on the statement of comprehensive income.
 - (b) To the extent that ceding commissions reflect a profit component for the cedant related to the reinsurance contract, including them as acquisition costs is consistent with the notion that the cash flows relating to acquisition costs impact an insurer's profit.
 - (c) Because ceded premiums are not reduced by ceding commissions, this approach allows the insurers' performance indicators that are based on ceded premiums to continue to provide useful information.
 - (d) It is essentially used currently under U.S. generally accepted accounting principles (GAAP), although acquisition costs are treated as an asset today.
 - (e) More importantly, it allows the ceded premium to be recorded in an amount equal to and offsetting the gross premiums earned by the cedant on the reinsured risk. Similarly, this approach also allows easier comparison of a cedant's cost of acquiring its policies and the cost to reinsure those policies.

13. The disadvantages of this approach include the following:

(a) It ignores the arguments that ceding commissions represent a pricing component of the reinsurance contract and, therefore, are best reflected net against the ceded premium, which reflects the consideration for the reinsured business. However, the staff notes that acquisition costs are considered part of the premium (consideration received from policyholders for the direct or underlying contracts), and the Board has

- tentatively decided to show the gross consideration in the income statement and the acquisition costs expense separately.
- (b) It would not treat ceding commissions included in both proportional and nonproportional contracts the same way. To the extent that nonproportional contracts do not have stated ceding commissions, and the costs to cover acquisition costs or other costs are implicit, treating ceding commissions in the same manner as other acquisition costs would result in different accounting for the two types of contracts, which may confuse users of financial statements.

Alternative 3 (Account for Ceding Commissions in the Same Manner As the Cedant's Acquisition Costs, to the Extent That the Commissions Offset the Cedant's Acquisition Costs)

- 14. This approach could be considered a compromise between the other two alternatives because it is consistent with the advantages of considering ceding commissions as part of acquisition costs and reflects the pricing notion arguments included in alternative 1, to the extent that the ceding commissions contain amounts in excess of those to reimburse the cedant for acquisition costs. This approach would address the concern identified in paragraph 9(d) that ceding commissions may (a) compensate the cedant for more than the amount of acquisition costs it incurred on its direct policies and (b) represent a pricing mechanism in the reinsurance contract. Alternative 3 also would be consistent with the view that the ceded premium amount should accurately reflect the price of the risk of the underlying policies (or the reinsurer's proportional risk) without a reduction for the cedant's costs to acquire those policies.
- 15. This approach would require insurers to determine the amount of acquisition costs included in the ceding commission and record the profit component against the premium (could be viewed as a deferred gain). This may be more complex for nonproportional contracts without a stated ceding commission, especially for reinsurance contracts with multiple layers of coverage (that is, different percentages of premium are shared between the cedant and reinsurer for different layers of losses incurred), because the cedant would have to input the amount of the

ceded premium related to acquisition costs and the amount related to a pricing or a profit component. However, in some nonproportional contracts, the reinsurance is not based on coverage for the cedant's individual underlying contracts. Rather, the cedant is buying protection for peak risks. In those cases, a reimbursement of acquisition costs is not included in the contract and, therefore, it would not include an implicit ceding commission. In these cases, this approach also would result in the same accounting treatment for proportional and nonproportional contracts.

16. Therefore, based on the analysis of the alternatives above, the staff supports alternative 3, which states that ceding commissions should be treated in the same way as acquisition costs to the extent that the amount reimburses the cedant for its acquisition costs. The staff notes that including the entire amount as a reduction in premium would misrepresent the portion of premium ceded.

Question 1: Ceding Commissions for Reinsurance Contracts

Does the Board agree that ceding commissions should be treated in the same way as the cedant's underlying costs that the commissions cover?

Therefore, to the extent that the ceding commissions reimburse the cedant for its acquisition costs, that amount should be treated in the same way as acquisition costs (that is, as part of the margin)?

To the extent that the ceding commissions are in excess of acquisition costs, that amount should be recorded as a reduction in the ceded premium (for-profit components)?

Issue 2: Contracts Acquired through Business Combinations and Portfolio Transfers

Business Combinations

- 17. The economics of a business combination is that the acquirer will generally pay less than the measurement of the insurance contracts. This means that the acquirer is willing to take fewer assets from the acquiree because they expect additional cash inflows from policyholders, profit on the contracts, and a spread on the investments acquired. If the acquirer only expects a spread on the investments then there would be no margin (that is, projecting and discounting the spread would result in zero margin). However, if the acquirer expects to also recognize profit then there should be a margin because there is inherent expected profit.
- 18. The staff notes that an insurer should 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, which 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).
- 19. The staff also notes that this discount rate that reflects the characteristics of the liability at the date the insurance contract liability became part of the acquirer's entity (that is, the acquisition date) should be used to determine the base rate or locked-in rate at which interest is accreted in the statement of comprehensive income for the portfolio of insurance contracts acquired. Subsequently, the impact from changes in the discount rate should be reported to other comprehensive income unless the portfolio of insurance contracts meets the criteria for *mirroring* or, for the FASB, if the insurers' contractual obligation is based on fair value.
- 20. One of the primary challenges is determining the hypothetical premium for the insurance contracts acquired (that is, written prior to the acquisition date) to determine the single margin. Once the hypothetical premium is determined, an insurer can determine the single margin by subtracting the measurement of the present value of expected cash flows. However, that allocation is based on fair

- value concepts that are different from the Board's tentative decisions made in the insurance contracts project.
- 21. One alternative is to consider the allocation of the purchase price to the insurance contracts liability as the hypothetical premium. U.S. GAAP guidance on business combinations requires an allocation of 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 *FASB Accounting Standards Codification*® Topic 820, Fair Value Measurement, which starts with the premise that the price paid by the acquiring entity represents fair value. That guidance requires that a fair value measurement include a risk premium reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows. Otherwise, the measurement would not faithfully represent fair value.
- 22. Subtopic 820-10, Fair Value Measurement—Overall, and IFRS 13, *Fair Value Measurement*, discuss three present value techniques that differ in how they adjust for risk and in the type of cash flows they use. For example:
 - (a) The discount rate adjustment technique uses a risk-adjusted-discount rate and contractual, promised, or most likely cash flows.
 - (b) The expected present value technique:
 - (i) Method 1 uses risk-adjusted-expected-cash flows and a risk-free rate.
 - (ii) Method 2 uses expected cash flows that are not risk adjusted and a discount rate adjusted to include the risk premium that market participants require. That rate is different from the rate used in the discount-rate-adjustment technique.
- 23. To stay consistent with current business combinations guidance (which requires the insurance contracts liability to be measured in accordance with the insurer's accounting policies for insurance contracts that it issues) and so that the insurance contracts liability measurement is consistent for all of the acquirer's contracts, the staff notes that insurers would use either the discount-rate-adjustment technique or

the discount rate adjusted to include the risk premium that market participants require. That would result in the insurer being able to establish expected cash flows that are not risk adjusted and is consistent with the first building block in the building block approach. This allocation would result in the fair value of the insurance contract liabilities.

- 24. However, insurance contracts are not recorded at fair value based on the Board's tentative decisions. If insurers were to determine the hypothetical premium and, thus, the single margin based on the consideration allocated through the purchase accounting allocation, which implicitly includes a higher discount rate than a discount rate that reflects the characteristics of the liability, the hypothetical premium and single margin may be understated and inconsistent with the single margin recorded for future contracts written by the combined entity and the acquirer's insurance contracts previously written.
- 25. Given that the staff notes that the expected cash flows should be determined using a discount rate that reflects the characteristics of the liability at the acquisition date, a second alternative is to use that same rate to determine the hypothetical premium and, thus, the single/residual margin. The Board tentatively decided that the difference between the premiums and the present value of the expected cash flows should be recorded as a single margin.
- 26. Therefore, the staff observes that the hypothetical premium should be determined based on the allocation of the purchase price using the discount rate that reflects the characteristics of the liability and that is used to determine the present value of expected cash flows of the insurance contract liability. The single margin would then be calculated as the difference between the hypothetical premium and the present value of the expected cash flows.
- 27. However, as previously noted in paragraph 23, because the discount rate used to allocate the purchase price to the insurance contracts liability would be different from the discount rate to determine the insurance contracts liability, there will be a difference between the fair value allocated to the insurance contracts liability and the measurement of the insurance contracts liability. The staff notes that, in all

situations, the discount rate applied to the allocation of the purchase price will be higher than the discount rate used in the measurement of the liability because of the inclusion of a risk premium in the former. Therefore, the present value of the insurance contracts liability (the expected cash flows plus the margin) will always be in excess of the purchase price allocated to the insurance contract liability.

- 28. Some may consider the difference between the present value of the insurance contracts liability and the purchase price to be goodwill, and the IASB Exposure Draft recorded it as an addition to goodwill. 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."
- 29. Because the insurer allocates the purchase price to the insurance contracts liability, the staff notes 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. The staff also notes that this difference represents the amount paid by the acquiring entity to obtain the portfolio of insurance contracts and the future profits and, therefore, is analogous to acquisition costs.
- 30. To be consistent with the Board's tentative decisions to recognize the consideration received from the policyholder and the acquisition costs separately, the staff notes that recording that difference as an acquisition cost and thus recognizing it in accordance with the Board's tentative decisions will provide comparability to contracts written in the future and the accounting for the acquiree's in-force contracts.

Question 2: Accounting for Business Combinations Involving Insurance Contracts

Does the Board agree with the following staff recommendation?

An insurer shall, at the acquisition date, measure at fair value the insurance liabilities assumed and *insurance assets* acquired in a business combination, the components of which shall be measured as follows:

- (a) Expected net cash flows measured in accordance with the insurer's accounting policies for insurance contracts that it issues using current assumptions. The discount rate determined at the acquisition date should be deemed the locked-in rate at which interest expense is accreted and presented in the statement of comprehensive income.
- (b) Single margin: A proxy to determine the single margin is to measure the difference between the allocation of the purchase price to the insurance contract liability (that is, the hypothetical premium) using the discount rate applied to the expected net cash flows and the expected net cash flows determined in (a) above.
- (c) An implied acquisition cost measured as the difference between the allocation of the purchase price to the insurance contract liability in accordance with guidance in Subtopic 805-10, Business Combinations—Overall, and in (a) plus (b) above.

Portfolio Transfers

31. Acquisitions of insurance business occur through various forms. One such form that is popular is portfolio transfers. Portfolio reinsurance is the transfer of an insurer's entire liability for in-force policies or outstanding losses, or both, of a segment of the insurer's business. There is little guidance in U.S. GAAP or International Financial Reporting Standards (IFRS) to determine what qualifies as an acquisition of an insurance business, regardless of form. A persistent issue in the industry has been the definition of what constitutes the *purchase of a business* versus an assumed reinsurance transaction from an accounting perspective, the answer to which might yield a different accounting result. In theory, one potential difference between a portfolio transfer and business combination is that the acquirer obtains a controlling interest of the acquired business along with any synergistic effects in a business combination and not in a portfolio transfer.

- 32. The staff notes that if a portfolio transfer meets the requirements in the respective business combinations guidance to be accounted for as a business combination, then that accounting should be applied. However, if a portfolio transfer or any other form of business acquisition does not meet the requirements in the respective business combinations guidance, then an insurer would treat a portfolio transfer the same as reinsurance (that is, assumed reinsurance is treated the same as direct insurance written). In the majority of cases, that will be when the coverage provided by the reinsurance contract is for past events.
- 33. This recommendation gives the same results as the proposal in the IASB Exposure Draft. That is, the portfolio of insurance contracts acquired in a portfolio transfer are measured at the higher of the following:
 - (a) The consideration received (after adjusting the consideration for any other assets and liabilities acquired in the same transaction, such as financial assets and customer relationships). The excess of that consideration over the present value of the fulfillment cash flows establishes the single margin at initial recognition.
 - (b) The present value of the fulfillment cash flows. If that amount exceeds the consideration received, the insurer would recognize that excess immediately as an expense.
- 34. This recommendation also gives the same results as the staff's recommendation in Question 2.

Question 3: Accounting for Portfolio Transfers Involving Insurance Contracts

Does the Board agree with the following staff recommendation?

An insurer shall measure a portfolio of insurance contracts acquired in a portfolio transfer that does not meet the definition of a business combination in accordance with the accounting for reinsurance.

A Combination of Entities or Businesses under Common Control

- 35. Subtopic 805-10, Business Combinations—Overall, exempts a combination of entities or businesses under common control from applying the business combinations guidance and specifically addresses the accounting for such transactions.
- 36. The staff notes that insurance contracts that are acquired through a combination of entities or businesses under common control should apply the guidance in Subtopic 805-10.

Question 4: Accounting for Insurance Contracts Acquired through a Combination of Entities or Businesses under Common Control

Does the Board agree with the following staff recommendation?

Insurance contracts that are acquired through a combination of entities or businesses under common control should apply the guidance in Subtopic 805-10.

Transition—Prior Business Combinations

- 37. U.S. GAAP recognizes an *intangible asset* for the excess of the fair value of the insurance contracts acquired and the liability measured in accordance with the acquirer's accounting policies. The Board's tentative decisions will change the acquirers' accounting policies for the majority of insurance contracts, which will change the initially recorded intangible asset. Those changes will depend on the type of insurance contracts. In addition, for several types of contracts, the insurance contract liability included implicit profit, which the Board has tentatively decided should be recorded separately.
- 38. At the September 24, 2012, joint meeting, the Boards tentatively decided that insurers should (a) measure the present value of the fulfillment cash flows using current estimates at the date of transition and (b) determine the margin through retrospective application of the new accounting principle to all prior periods.
- 39. Based on those tentative decisions and the staff's recommendations in Question 2, insurers would be required to go back to their purchase accounting allocations and

determine at that date the margin, acquisition costs, and the base or locked-indiscount rate. The information required to determine those components should be readily available in the support for the initial purchase accounting. This recommendation has no impact on the attribution of the purchase price consideration to the insurance contracts liability (and, therefore, has no impact on previously recorded goodwill); however, it will result in the elimination of any previously recognized intangible asset.

Question 5: Transition—Acquisitions Prior to the Effective Date

Does the Board agree with the following staff recommendation?

For prior business combinations, applying this guidance retrospectively will require insurers to reallocate the components of the purchase price allocated to the insurance contracts liability in accordance with decisions reached herein as of the acquisition date.

ISSUE 3: PARTICIPATION FEATURES OF MUTUAL INSURANCE COMPANIES

- 40. A mutual insurance company is an insurance company owned entirely by its policyholders. Any profits earned by a mutual insurance company are paid to policyholders in the form of dividend distributions or reduced future premiums. In contrast, a stock insurance company is owned by investors that have purchased company stock; any profits generated by a stock insurance company are distributed to the investors without necessarily benefiting the policyholders. Some insurers describe the right of policyholders as a right similar to that of a company shareholder.
- 41. Insurance contracts issued by mutual insurers are identical to insurance contracts issued by nonmutual insurers in that the policies provide all policyholders the right to receive the benefits guaranteed under the policy. In addition, many of those insurance contracts allow policyholders to share in the experience of the insurer, whether it be wholly or partly on the performance of other assets (sometimes specified and sometimes not) or liabilities of the insurer or the overall results of

the insurer. Those features are sometimes guaranteed via contractual, legal, or regulatory terms and other times are at the discretion of the company (in amount and/or timing). In addition, the performance sharing may be for only current policyholders or may benefit future policyholders. Typically, features that benefit a community of policyholders are guaranteed and are based on legal or regulatory terms that require the insurer to share a portion of the performance with policyholders and/or cannot be distributed to shareholders. If insurers have discretion over the timing of when to share the performance via a declaration of a dividend, lower future premiums or some other means, only those policyholders whose contracts are in force at that time will benefit; in other words, policyholders whose policies lapse prior to that date are not entitled to anything and new policyholders will benefit.

- 42. However, certain policies issued by mutual insurers also give the policyholders the expectation of receiving dividends based on emerging experience for the class of policies to which the contract belongs as well as membership rights that include the right to vote for the company's board of directors and, by extension, to receive value upon the dissolution or conversion of the company to another form.
- 43. Under the mutual insurance structure, policyholders are eligible to receive an equitable portion of the company's divisible surplus as a dividend. Policyholder dividends are discretionary and generally determined annually by the board of directors/trustees and are paid annually. Divisible surplus is the amount paid out after the company sets aside the funds required to meet its obligations, operating expenses, contingencies, and for general business purposes. Dividends are set on a basis in which the company retains an appropriate amount of surplus for unforeseen risks, growth, etc., and there is no obligation or intention to ever pay out all surplus when the entity is a going concern. Dividends are a function of business strategy, a desired financial strength, and a forward-looking view of risk; essentially a component of company philosophy and risk management. The insurer has an expectation of the dividends it intends on paying to current and future policyholders, which can be ratcheted up or down based on the insurer's performance each year. It is important to understand that to pay dividends

- divisible surplus must be achieved. In fact, many jurisdictions have minimum surplus/capital that must be maintained.
- 44. When determining the dividend payout for an individual policy, many life insurers follows the *Contribution Principle*, which allocates divisible surplus to eligible participating policyholders to reflect the portion that each specific policy is considered to have contributed to surplus. Policyholders can typically elect to receive the annual policy dividends in cash or use it to do the following:
 - (a) Reduce premiums
 - (b) Purchase paid-up additional insurance
 - (c) Accumulate interest
 - (d) Purchase one-year-term insurance
 - (e) Repay policy loan or loan interest.
- 45. Nonlife participating policyholders typically receive their dividends in cash or the dividends can be applied to reduce premiums payable in subsequent years.
- 46. Mutual insurers would apply the Board's tentative decisions to measure their insurance liabilities. Therefore, the measurement of the expected cash flows would be accounted for in accordance with the Board's previous tentative decisions.
- 47. Some argue that the Board's tentative decision, which states that if the amount, timing, or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the measurement of the insurance contract should reflect that dependence, would result in the *notional* surplus being recorded as part of the liability. However, the staff notes that the tentative decision applies to contracts in which there is a direct linkage (that is, the assets increase and therefore the liability increases by the same amount, thus, the value of the liability mirrors the asset value). Generally, this would apply to contracts in which the insurer can measure the liability by first measuring the assets and then applying some participation percentage to arrive at the measurement of the liability. That is common in unit-linked and variable-

annuity-universal-life-insurance contracts. Those contracts, while typically eligible for dividends, do not generally expect to pay dividends because the insurer can instead change the cost of insurance and mortality and expense charges, within certain parameters (that is, reduce the expected costs charged). Other types of contracts that are typically eligible for dividends include whole life, term life, long-term care, annuities (except for single premium immediate annuities), and disability income contracts as well as nonlife insurance contracts. The liability for those contracts cannot be measured by the guidance above (that is, by first measuring the assets).

- 48. Therefore, those contracts would be measured using the building block approach or the premium allocation approach. However, the question that arises is whether there is any remaining surplus after accounting for expected dividends, whether contractual or discretionary, and considering payments to future policyholders.
- 49. The following summarizes two views on the present value of expected future dividends:
 - (a) View 1—The present value of expected future dividends will equal any apparent surplus earned in the year. Consequently, a mutual insurer has no equity.
 - (b) View 2—The present value of expected future dividends will equal the amount that the mutual insurer expects to pay to policyholders after considering the amount of surplus it expects to retain. Therefore, mutual insurers will always retain some portion of their performance in the year and, consequently, the present value of expected future dividends will always be less than the apparent surplus. Consequently, a mutual insurer has equity.
- 50. The staff recommends View 2 for the following reasons:
 - (a) Insurers should measure their insurance contract liabilities using the building block approach, which is based on expected cash flows, or the premium allocation approach. The insurer has an expectation of the

dividends it intends on paying to current and future policyholders, which can be ratcheted up or down based on the insurer's performance each year. There is no obligation or intention to ever pay out all of the mutual insurers' net performance or *notional surplus* when the entity is a going concern.

- (b) Policyholder dividends are discretionary and are set on a basis in which the company retains an appropriate amount of surplus for jurisdictional minimum capital plus an excess amount for projected growth (and, thus, would be needed) and for ratings (that is, in the U.S. AM Best's ratings) as well as an amount for budgeted expenditures that are not recorded as liabilities and unforeseen risk. Mutual insurers typically run various stochastic scenarios to determine their economic capital needs and to ensure the level of capital that is retained is sufficient. Those scenarios include expected future investment income that may result in an increase in the expected distribution percentages because the insurer expects to retain any future earnings on its surplus. Those that support View 1 note that earnings on the retained surplus would be included in future years' performance, a percentage of which is distributed to policyholders.
- (c) Expected future performance of the insurer such as expected future underwriting results and operating costs should not be considered in measuring the liability. Therefore, the expected amount of surplus that needs to be retained should be recorded as such. Those that support View 2 note that surplus is *recycled* because any notional surplus that was earned in year 1 would have been paid out and replaced by new notional surplus, which would ultimately be expected to be paid out.
- (d) If one were to assume the mutual insurer operated into infinity, there would be a surplus at the end unless the insurer voluntarily decided to change its structure or to stop selling insurance or involuntarily became a going concern.

- (e) It is more meaningful to have expected future capital needs and unforeseen risks to be deducted from an entity's surplus when those expenses are incurred rather than being deducted from the expected cash flows of the insurance contracts liability that would occur under View 1.
- (f) The mutual ownership in which the policyholders are also the *owners* is similar to a shareholder-owned entity.
- (g) Insurance contracts issued by nonmutual insurers in many instances are identical to the eligible participating insurance contracts issued by mutual insurers.
- (h) Recording the net performance of the insurer as part of the insurance contracts liability does not provide useful information to users of the mutual insurer's financial statements because it would not provide information regarding the insurers':
 - (i) Underwriting results
 - (ii) Financial strength, including the insurers capital compared to its regulatory required capital
 - (iii) Ability to absorb future adverse development or shocks
 - (iv) Working capital to grow the business.

Question 6: What Is Included in the Measurement of the Insurance Contract Liability

Does the Board agree with the following?

In measuring the insurance contracts liability, discretionary payments to current future policyholders as a result of a contractual participation feature should be based on the insurers' expectation (considering the entity is a going concern) thus resulting in an amount of the net performance or *notional surplus* not being included in the measurement of the insurance contract liability, regardless of whether the insurer is structured as a mutual entity.

Accounting for the Net Performance of a Mutual Insurance Company if Not Included in the Insurance Contract Liability

- 51. If the Board tentatively decides that the insurance liability should include the expected cash flows without the notional surplus that mutual insurers expect to retain, then the question that arises is whether the net performance (that is, the amount not included in the liability measurement) meets the definition of a liability under U.S. GAAP.
- 52. If there is no present contractual obligation to deliver cash or another financial assets to the policyholder arising for their participation, then the remaining surplus would meet the definition of equity.
- 53. The mutual insurer is not obligated to pay the policyholders any amounts in excess of the insurance contract liability. In fact, in many jurisdictions, there are limitations on dividends that are guaranteed and that can be paid. In the event of the entity's liquidation, the policyholders are entitled to a pro rata share of the insurer's net assets after deducting all other claims on the insurer's assets and the policyholder's surplus is subordinate to all other classes of instruments of the insurer.
- 54. Some staff members argue that the mutual ownership in which the policyholders also are the *owners* is similar to a shareholder-owned entity. The policyholders' equity cannot be distributed unless the insurer declares a dividend from the equity amount above a minimum requirement or if the structure of the entity is changed; for example, either a demutualization or a liquidation or bankruptcy of the mutual insurer.
- 55. In addition, some staff members said that they do not think that recording the policyholders surplus as a liability provides useful information to users of the mutual insurer's financial statements because of the following:
 - (a) Users of financial statements need the opportunity to assess the insurer's financial strength and ability to withstand shocks. That requires the user to understand which capital is available to absorb shocks. That information would not be provided if the insurer presents only a single

insurance contract liability that combines the capital available to absorb shocks with amounts that the insurer pays that are not subject to discretion.

- (b) Although part of the mutual's surplus will be returned to current and future policyholders by the performance-linked features, the insurer will always retain some permanent capital to meet regulatory capital requirements, to provide working capital, to provide a safety margin against shocks, and to be able to expand the business. Those arguing in favor of reporting at least some equity would find it misleading to include all cash flows to the policyholders, regardless of whether they are paid in their capacity as owners or customers, in the measurement of the liability.
- (c) Demutualizations have demonstrated that the payment to the policyholder in these situations can be determined and isolated as the portion that is a settlement to give up the membership rights.

Question 7: Accounting for the Net Performance of a Mutual Insurance Company if Not Included in the Insurance Contract Liability

Does the Board believe that the net performance or *notional surplus* not included in the measurement of the insurance contract liability of a mutual insurance company should be presented as equity?