



Board Meeting Handout

Insurance Contracts

February 20, 2013

PURPOSE OF THE MEETING

1. The purpose of this meeting is to discuss the following:
 - a. Segregated assets related to direct performance-linked insurance contracts
 - b. Accretion of interest on the margin.

ISSUE 1: SEGREGATED ASSETS RELATED TO DIRECT PERFORMANCE-LINKED INSURANCE CONTRACTS

Purpose

2. The purpose of this handout is to address the accounting and presentation for segregated assets related to direct performance-linked insurance contracts including contract holder funds and the insurer's proportionate interest.

Background

3. The types of contracts referred to in this handout are those where the obligation of the insurer to the contract holder is directly linked to the performance of segregated funds, the investments of which are determined by the contract holder. Many of the contracts are structured such that some or all of the benefits are determined by the price of units in an internal or external investment fund (that is, a specified pool of assets held by the insurer or a third party and operated in a manner similar to a mutual fund) and the policy holder account balance is credited with a return that is a direct pass through of the return on the pool of assets, currency units (CU) for CU (that is, there is no discretion). Therefore, the risks and rewards of the performance of those assets are directly passed through to the contract holder. The insurer has an additional obligation for which it is at risk; hence, these are insurance contracts. The FASB did not address this topic in its Discussion Paper, *Preliminary Views on Insurance Contracts*; in its Exposure Draft, *Insurance Contracts*, the IASB referred to these types of contracts as unit linked.

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

4. In the United States, contracts that require separate accounts are an example of the type of contracts to which this handout applies. Separate accounts represent assets that are typically maintained by a life insurance entity for purposes of funding obligations to individual contract holders under fixed-benefit or variable annuity contracts, pension plans, and similar contracts and are one form of contract that is direct performance linked. Subtopic 944-80, Financial Services—Insurance—Separate Accounts, requires “specialized accounting” for arrangements that meet the following criteria:

- a. The separate account is recognized legally; that is, the separate account is established, approved, and regulated under special rules such as state insurance laws, federal securities laws, or similar foreign laws.
- b. The separate account assets supporting the contract liabilities are insulated legally from the general account liabilities of the insurance entity; that is, the contract holder is not subject to insurer default risk to the extent of the assets held in the separate account.
- c. The insurer must, as a result of contractual, statutory, or regulatory requirements, invest the contract holder’s funds within the separate account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies.
- d. All investment performance, net of contract fees and assessments, must as a result of contractual, statutory, or regulatory requirements be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, because a ceiling would prohibit all investment performance from being passed through to the contract holder.

5. The specialized accounting afforded separate accounts that meet the above criteria includes the following:

- a. An insurance entity should not consider any separate account interest held for the benefit of policy holders in an investment to be the insurer’s interests and should not combine those interests with its general account interest in the same investment when assessing the investment for consolidation, unless the separate account interest are held for the benefit of a related party policy holder that requires consideration for consolidation.
- b. The portion of separate account assets representing contract holder funds should be measured at fair value initially and subsequently.
- c. Assets underlying an insurance entity’s proportionate interest in a separate account (seed money or other investment) should be classified and

measured as if the assets were held directly by the general account rather than through the separate account structure. If specified criteria are met, the accounting should be as if holding the asset for sale; other criteria allow assets to be treated as an equity instrument held for trading.

- d. Insurers separately present in the statement of financial position:
 - (1) A liability for explicit account balances that are directly linked to a pool of assets that is equal to the fair value of the pool of assets
 - (2) An asset for the pool of directly linked assets.
- e. In regards to the statement of comprehensive income:
 - (1) Premiums are considered deposits and withdrawals and/or benefit payments are considered a return of the account value.
 - (2) Revenues may include a separate line item for management fee income charged to policy holders for internally managed funds, cost of insurance, mortality, and expense charges, etc.
 - (3) Expenses include commissions, other acquisition costs, etc., associated with explicit account balances which are comingled with insurance contract expenses.
 - (4) Investment income on the pool of assets and interest credits to the policy holder's account value is offset in the statement of comprehensive income.

Staff Analysis

Recognition of the Assets and Liabilities

- 6. Some constituents have questioned whether insurance contract liabilities that are equal to the value of the pool of assets backing those liabilities should be recognized in an insurer's financial statements along with those assets. The staff reviewed the definitions of *asset* and *liability* from the FASB's Conceptual Framework and analyzed whether or not account balances and the related assets meet the definition and recognition criteria. Based on the analysis, the staff concluded that explicit account balances that are directly impacted by the performance of a pool of assets are liabilities of the insurer and the assets backing those liabilities are assets of the insurer. This conclusion was based on the following:
 - a. Account balances are liabilities of an insurer because:
 - (1) The insurer is legally obligated to pay the policy holder

- (2) The obligation represented by the account balance arises from the creation of the insurance contract
 - (3) The amount of the liability can be reliably measured.
- b. Investments that back an account balance are assets to an insurer because:
- (1) The insurer legally owns and controls such investments
 - (2) The insurer will at some point utilize such assets to settle the insurance liability
 - (3) Such assets can generally be measured reliably.
7. Some constituents have argued that assets that are legally separated and insulated from the general creditors of the insurers should be treated differently and not be recognized in the insurer’s balance sheet because including them distorts the insurer’s financial position.
8. However, the staff notes that the structures are based on jurisdictional laws and does not think that jurisdictional laws should impact the accounting for insurance contract liabilities and assets held, which could result in different accounting for identical insurance contracts.

Staff Recommendation

9. Based on the staff’s analysis, “direct performance-linked insurance contracts” such as unit-linked contracts, variable contracts, separate accounts, segregated funds, and super annuitization funds are liabilities of an insurer and the related assets are assets of an insurer; however, no right of set off exists. These account balances should therefore be recognized in an insurer’s financial statements.

Question 1: Determination of the Presentation of Direct Performance-Linked Insurance Contracts.

Does the Board agree with the staff recommendation that the liability for “direct performance-linked insurance contracts” and the assets directly linked to those liabilities should be reported in the insurer’s financial statements?

Criteria for Specialized Accounting

10. The staff thinks that specialized accounting is appropriate for the portion of segregated assets representing contract holder funds (that is, fair value) when:

- a. The insurer must, as a result of contractual, statutory, or regulatory requirements, invest the contract holder's funds directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies
 - b. All investment performance, net of contract fees and assessments, must as a result of contractual, statutory, or regulatory requirements be passed through to the individual contract holder.
11. To be able to apply the specialized accounting today, the segregated assets need to be recognized legally and/or insulated legally from the general account liabilities of the insurance entity. Several respondents to the Exposure Draft of AICPA Statement of Position No. 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*, expressed a view that the definition and proposed reporting of separate account arrangements do not recognize the unique nature of certain non-U.S. products in which legal insulation may not be achieved.
12. One of the problems cited with U.S. generally accepted accounting principles (GAAP) is the wide range of accounting for and presentation of different types of contracts and/or product features, which limits understandability. The staff thinks that insurance contracts that meet the criteria in paragraph 10 are similar contracts that should be accounted for and presented the same. That is, the contract holder pays premiums, which it directs the insurer to invest in specified investments or in accordance with the specified investment objectives, and receives the pass through of the investment performance.
13. In addition, the Board has tentatively decided in its Investment Companies project that an entity could be, but does not need to be, a legal entity to be an investment company. Therefore, eliminating the legal entity and legal insulation requirement for specialized accounting for insurance segregated assets for contract holder funds would be consistent with the Board's tentative decisions in the Investments Companies project.
14. The staff does not think that eliminating the legally recognized and insulated criteria and clarifying the other guidance will result in a significant change in accounting for contracts issued in the United States. That is because the majority, if not all, the

contracts that meet the criteria in paragraphs 10.a) and 10.b) also were legally recognized and insulated. In addition, one of the primary reasons for including those criteria was because of the single line item presentation in the balance sheet and offsetting the investment income and pass through via interest expense in the income statement, which the staff is recommending should not be required.

15. However, the staff does think that implementation guidance will need to be provided to clarify what is intended by ‘pass through’ of the performance, given there are many types of participating contracts. For example:

- a. The staff does not think that contractual features that give the insurer discretion on the amount or timing of the pass through would meet the criteria. This would include contracts:
 - (1) That only pass through realized gains and losses on the investment portfolio
 - (2) In which the insurer has to declare a dividend in order for an individual contract holder to be eligible to receive the pass through of the investment performance
 - (3) In which there are arrangements in which contract holders’ funds are segregated to fund fixed account options of insurance contracts.
- b. Also, the staff does not think these criteria will be met if actuarial funding is applied because the actual premium paid is not being invested and, thus, the amounts credited to the contract holder are not a pass through of the performance of those investments.

16. Based on this analysis, the staff thinks that the recommended criteria to be able to apply specialized accounting would result in the treatment of similar products the same. The staff does not think that the other two criteria required today (to be recognized legally and/or insulated legally) are differentiating product features that should result in different accounting and presentation.

Question 2: Characteristics to Be Afforded Specialized Accounting

Does the Board agree with the staff recommendation that the guidance in this section applies if the arrangement meets both of the following conditions:

1. The insurer must, as a result of contractual, statutory, or regulatory requirements, invest the contract holder's funds directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies.
 - a. Investment of a portion of the contract holder's funds would not meet this criteria.
2. All investment performance, net of contract fees and assessments, must as a result of contractual, statutory, or regulatory requirements be passed through to the individual contract holder.
 - a. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, because a ceiling would prohibit all investment performance from being passed through to the contract holder.
 - b. Contractual features that give the insurer discretion on the amount or timing of the pass through would not meet these criteria. For example, if performance is passed through to individual contract holders based on realized gains on the investment portfolio or when the insurer declares a "dividend" the investment performance is deemed to not be passed through to the individual contract holder.

Consolidation

17. The staff recommends that the guidance in Subtopic 944-80 regarding an insurer's consideration of segregated assets that meet specified criteria when performing analyses for consolidation under Subtopic 810-10, Consolidation—Overall, should be retained and updated for the staff's recommendation on the criteria for segregated assets.
18. In the project regarding this, the Emerging Issues Task Force (EITF) noted that although the insurer may legally hold a controlling interest in an investment through its management of the separate accounts, it did not think that consolidation of those investments appropriately portrayed the economics of the relationship or that consolidating the investment would provide useful information for financial statement

users. The Task Force also noted that consolidation would unnecessarily increase the complexity of an insurer's financial statements.

19. The staff thinks this basis for conclusions continues to hold true for segregated assets that meet the two criteria recommended by the staff. Those two criteria focus on control and risks and rewards, which are two of the main items in assessing whether consolidation is appropriate.

Question 3: Retention of Clarifying Guidance Regarding Consolidation Analysis

Does the Board agree with the staff recommendation that the guidance in Subtopic 944-80, regarding an insurer's consideration of segregated assets that meet specified criteria when performing analyses for consolidation under Subtopic 810-10 should be retained and updated for the staff's recommendation on the criteria for segregated assets in Question 2?

Measurement of the Segregated Funds When They Are Not Deemed to Be an Investment Company

Financial Instruments

20. The staff thinks that contract holder funds invested in financial instruments should be measured at fair value with all changes in fair value recognized in net income consistent with the guidance in the proposed FASB Accounting Standards Update, Financial Instruments—Overall (Subtopic 825-10):, Recognition and Measurement of Financial Assets and Financial Liabilities.
21. If the contract holder funds are invested in equities or equity funds, the investment would not meet the contractual cash flow characteristics and, therefore, would be required to be accounted for at fair value through net income.
22. If the contract holder funds are invested in debt securities or bond funds and the contractual cash flow characteristics are met, the insurer would need to look to the entity's business model for managing the assets. The assets are held to maximize investment yield for the risk profile. In addition, because the contract holder designates the insurer's investment of their funds, which can be changed throughout the contract life and can be withdrawn, the insurer does not have the ability to hold the financial assets to collect cash flows. Some may argue that an insurer could have

the objective of both holding financial assets to collect contractual cash flows and selling financial assets. However, because the insurer does not have the discretion over when the assets are sold (although they may pay the contract holder out of other funds and retain the assets elsewhere), the staff thinks that the insurer would have to continuously update its impairment allowance.

23. Based on this analysis, the staff thinks that the contract holder funds would fail the business model criteria and, therefore, would be measured at fair value with all changes in fair value recognized in net income. However, the staff recommends the guidance should be specific to minimize or eliminate diversity in practice and to make sure insurers account for these assets based on the Board's intent (currently, there is specific guidance within the insurance standard that states these assets should be recorded at fair value).
24. The staff thinks that when the proposed insurance contracts standard is finalized, the guidance for this specified accounting should be addressed in *the FASB Accounting Standards Codification*[®] with financial assets through a statement that the other comprehensive income (OCI) category is not available for segregated funds that meet the previously discussed criteria. This would be consistent with the guidance for the accounting for investment companies.

Nonfinancial Instruments

25. The staff also thinks that contract holder funds invested in nonfinancial instruments should be recorded at fair value with all changes in fair value through net income. In general, the nonfinancial instrument alternative available to contract holders is typically real estate. However, there is no specific guidance in U.S. GAAP regarding the accounting for investments in real estate.
26. Subtopic 944-80 indicates that the portion of segregated assets that meet the specified criteria representing contract holder funds shall be measured at fair value, regardless of the type of assets segregated. Absent guidance elsewhere within U.S. GAAP, the guidance regarding fair valuing through net income the portion of segregated nonfinancial assets that meet the specified criteria representing contract holder funds will need to be retained in the guidance for accounting for insurance contracts.

Insurer's Proportionate Interest

27. Current accounting could result in some insurers not recognizing their proportionate interests in the segregated funds at fair value through net income. That is because current accounting requires insurers to classify and measure those assets as if the assets were held directly by the general account rather than through the segregated fund structure. However, an insurer may account for the assets of the separate account underlying the insurance enterprise's proportionate interest in the separate account:
- a. In a manner consistent with the accounting for similar assets held by the general account that the insurance enterprise may be required to sell if:
 - (1) The separate account arrangement allows contract holders to invest in additional units in the separate account or the insurance enterprise is marketing contracts that permit funds to be invested in the separate account
 - (2) An insurance entity's interest in the separate account represents 20 percent or greater of the separate account interest or the underlying investments are other than securities under Subtopic 320-10, cash and cash equivalents or equity securities that do not have readily determinable fair value
 - b. As an investment in an equity securities measured as trading if the insurance entity's proportionate interest in the separate account is less than 20 percent of the separate account and the underlying investments consist of securities under Subtopic 320-10, Investments—Debt and Equity Securities—Overall, cash and cash equivalents, or equity securities that do not have readily determinable fair value.
 - c. Finally, if the assets underlying the insurer's proportionate interest are nonfinancial instruments, the insurer should account for those in a manner consistent with similar assets held by the general account and in many situations as if they are held for sale.
28. Some have indicated that all of this guidance results in insurers recording their proportionate interests in segregated funds at fair value through net income in most situations.
29. In considering the proposed guidance for financial instruments and the business model considerations as well as the accounting for the contract holder's interest in the segregated funds, the staff thinks the Board should simplify the guidance and require insurers to report their proportionate interests at fair through net income.

Question 4: Measurement of the Segregated Assets

Does the Board agree with the staff recommendation that if the conditions in Question 2 are met and the criteria for an investment company are not met insurers should record the contract holder funds and its proportionate interest in the segregated funds at fair value through net income?

Presentation and Disclosures

Statement of Financial Position

30. If the assets and liabilities are recorded in the insurer's financial statements, some constituents have questioned whether the balances should be offset in the statement of financial position. Because (a) the investment component does not represent the entirety of the insurance obligation, (b) there is no relinquishment of ownership of assets, but. Rather. the execution of a contract pursuant to which the insurance enterprise agrees to pass through the account investment results to the policy holder, (c) the assets in the statement of financial position of the insurance entity do not represent a receivable from the same counterparty for which the liability is owed, and (d) the contract executed between the contract holder and the insurance enterprise creates an obligation of the insurance enterprise that is not defeased by the segregation of funds in a legally segregated separate account, the staff thinks that the explicit account balance should not be offset with the assets backing the liability, whether legally segregated or not.
31. Other constituents have questioned whether the assets and liabilities should each be presented as a single item on the statement of financial position. While, in most jurisdictions, the assets and liabilities for segregated funds are presented as a single line item current, it is important to note that, generally, these types of insurance contracts are currently measured as the account balance (excluding the portion of the insurance contract liability representing the insurance and guarantees), whereas the Boards have tentatively decided to measure these types of contracts using the present value of expected future cash flows, including all features of the contract. During the March 21, 2012, joint meeting, the Boards tentatively decided that the insurance contract should be measured as one liability and that the investment component, which includes explicit account balances net of expected surrender charges, should

not be separately presented in the statement of financial position. This tentative decision was at least partially based on the notion that there should not be a line item on the statement of financial position if that line item does not provide a meaningful representation of a liability (that is, cannot be calculated as a free-standing liability). The staff does not think there should be an exception to this tentative decision for segregated funds that meet specified criteria.

32. When considering the segregated assets that directly impact the insurance contract liability, the staff does not think the Board should require or prohibit separate presentation in the statement of financial position. The measurement of these assets will be in accordance with the applicable U.S. GAAP and, therefore, the reason for not separately presenting the liability does not apply to the assets.

Statement of Comprehensive Income

33. The staff reviewed the definitions of income and expense from the FASB's Conceptual Framework and analyzed whether or not income and expense related to direct performance-linked insurance contracts that are directly impacted by the performance of a pool of assets, as well as the income and expenses related to that pool of assets, meet the definition and recognition criteria. Based on the analysis, the staff concluded that an insurer's statement of comprehensive income should be affected by direct performance-linked insurance contracts as follows:

- a. Revenues including management fee income charged to policy holders for internally managed funds, cost of insurance, mortality and expense charges, etc.
- b. Investment income
- c. Expenses including commissions, other acquisition costs, etc., associated with explicit account balances
- d. Interest credits.

34. In regards to investment income and interest credits, there are two different views:

- a. Some note that the most meaningful presentation would be to net the investment income and expenses to zero. The AICPA articulated this rationale as it pertained to legal separate accounts in SOP 03-1 as follows:

...the offsetting of investment performance and corresponding amounts credited to the contract holder provide the most meaningful presentation to the users of financial statements... that presentation allows financial statement users to more readily analyze investment returns of insurance enterprises by excluding amounts that are legally insulated from the general account and not available to shareholders.

- b. Conversely, some note that investment income (that is, interest and dividend income, unrealized gains and losses, and realized gains and losses) generated by segregated assets should be included in an insurer's statement of comprehensive income. Although this type of activity does pass through to the policy holder, it is first allocated to the assets of the insurer. The insurer then allocates the performance to the policy holder's account balance. Furthermore, this information is useful in determining how well an insurer manages its assets, a measure that is reported to the policy holder. Although in most cases the policy holder chooses its investment strategy, the insurer is responsible for either actually managing the assets or selecting the investment manager. In addition, excluding the investment income for segregated assets that meet specified criteria when the assets are on an insurer's statement of financial position, and are not necessarily disaggregated, would result in misleading investment yields on the insurer's assets.

35. Based on the analysis above, the staff thinks:

- a. The liability account balance should be recognized in an insurer's financial statements as part of the insurance contract liability and not be offset against the related assets because the right of set off criteria is not met.
- b. In regards to the assets, insurers may separately present or include these with the insurers other assets (which may require splitting the segregated funds amongst line items). While the Board does not like options, this recommendation is not impacting the measurement of the assets but, rather, is allowing insurers to further disaggregate the assets. The staff also thinks that insurers should disclose the segregated assets that meet the specified criteria disaggregated between (1) those assets that are insulated legally from the general account and (2) those that are not.
- c. Because of the Board's tentative decisions to treat all insurance contracts the same, the staff thinks the revenues (including management fee income charged to policy holders for internally managed funds, cost of insurance, mortality and expense charges, etc.) and expenses (including commissions, other acquisition costs, etc.) associated with direct performance-linked insurance contracts should not be required to be separately presented in the statement of comprehensive income. Based on the Boards' tentative decisions, these revenue and expense items are the same as that being

presented in the statement of comprehensive income for other types of contracts as well.

- d. The staff thinks that investment income generated from the assets directly linked to the insurance contract liability should be presented with investment income in the statement of comprehensive income and the pass through of that investment income should be recognized as interest credits.
- (1) The staff reviewed the definitions of income and expense in the conceptual framework and concluded that they should be recognized.
 - (2) Although this type of activity does pass through to the policy holder, it is first allocated to the assets of the insurer. The insurer then allocates the performance to the policy holder's account balance.
 - (3) Furthermore, the staff thinks if the assets are on the books then the income generated from those assets should be as well.

However, the staff does not think that insurers should be prohibited from presenting these items separately. If presented together with the investment income and expenses for other items, the staff recommends that insurers disclose the amount of investment income earned on the segregated assets, which would be equivalent to the amount passed through to the contract holder.

Question 5: Determination of the Presentation of Direct Performance-Linked Insurance Contracts and Related Assets and Disclosures

Does the Board agree with the staff recommendation that:

- a. The liability for "direct performance-linked insurance contracts" should be reported with the liability for insurance contracts?
- b. The assets directly linked to those liabilities should be presented separately in the statement of financial position or disclosed in the notes? In addition, insurers should disclose the disaggregation of the segregated assets for those that are insulated legally from the general account and those that are not?
- c. The revenues and expenses related to direct performance-linked insurance contracts should be presented with revenues and expenses for other insurance contracts in the statement of comprehensive income?
- d. The investment income generated from the assets directly linked to the insurance contract liability and the interest credited to contract holders as a pass through of that investment income should be presented separately as part of investment income and interest expense in the statement of comprehensive income or disclosed in the notes?

ISSUE 2: ACCRETION OF INTEREST ON THE MARGIN

Purpose

36. The purpose of this handout is to ask the Board to consider accreting interest on the margin in light of the Board's decision regarding revenue recognition.

Background

37. The FASB's Discussion Paper states the following regarding accretion of interest on the margin:

...the Board's preliminary view is that interest would not be accreted on the composite margin. The majority of Board members have said that interest expense should not be recognized because it will increase the composite margin and result in additional revenue recognized. Some Board members also do not believe that interest expense should be recognized because they view the composite margin as a noncash item that eliminates day one gains, rather than as an obligation (that is, expected future net cash flows). Therefore, a majority of the Board members noted that accretion of interest on the composite margin would not be appropriate.

38. The FASB's Discussion Paper asked respondents whether they agreed that interest should be accreted on the margin. Most respondents agreed that interest should not be accreted on the margin, as expressed in the Discussion Paper. Those respondents noted that, generally, it overcomplicates the model to accrete interest and then amortize it, given that those respondents view the margin as a deferred credit. Other respondents disagreed, some stating that accreting interest on the margin better represents the emergence of profits and release of risk over time and that the margin is calculated from a present value measurement while some others noted the absence of accretion would overstate investment margins and understate underwriting margins. Since the tentative decision to measure revenue by applying an earned premium approach, the staff held discussions with some of the respondents who previously opposed accreting interest on the margin. Many of these respondents voiced their support for accretion of interest on the margin if interest is accreted on the remainder of the revenue, which, as noted below, is a consequence of the earned premium model.

39. In October 2012, the Boards tentatively decided the following:

Premiums and claims presented in an insurer's statement of comprehensive income should be measured by applying an earned premium presentation, whereby premiums are allocated to periods in proportion to the value of coverage (and any other services) that the insurer has provided in the period, and claims are presented when incurred.

Staff Analysis

Accretion of Interest on Consideration Attributable to Benefits and Expenses

40. The Board tentatively decided on an earned premium model, which, as currently envisioned, includes accretion of interest on the consideration (premium) attributed to funding the costs of claims and other fulfillment costs in order to reflect the time value of money for the period between premium receipt and provision of the corresponding coverage. Similarly, based on the tentative decisions of the Board, claims are measured at their present value at the date on which claims are incurred. Accordingly, these amounts implicitly include both the discounted amounts used to measure the initial contract liability (and any subsequent changes in estimates of future incurred claims) and the interest accreted between the dates these claims are initially recognized in the insurance contracts liability and the dates that claims are incurred.

41. Including accretion of interest in the determination of insurance contracts revenue for contracts accounted for under the building block approach is consistent with the Board's tentative decision for contracts accounted for under the premium allocation approach. That is, discounting and interest accretion, to reflect the time value of money, should be required in measuring the liability for remaining coverage for contracts that have a significant financing component, as defined according to the characteristics of a significant financing component under the guidance in the proposed FASB Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*.

42. Paragraph 58 of the proposed Update on Topic 605 states that "the objective when adjusting the promised amount of consideration to reflect the time value of money is

for an entity to recognize revenue at an amount that reflects what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that they are transferred to the customer.” Applying this objective to the insurance model, the accretion of interest on the premium ensures that insurance contract revenue is measured on the same measurement date as the claims and expenses in which it is attributable.

43. Additionally, accretion on insurance contract revenue is mechanically necessary if:
- a. Underwriting income is to be equal to the sum of the margin release and changes in estimates of cash flows
 - b. After all changes in estimates of future incurred claims, etc., have unwound, the cumulative underwriting income is to equal the excess of cumulative revenue over cumulative claims and expenses.

Accretion of Interest on the Portion of Revenue Attributable to the Margin

44. Based on tentative decisions reached to date, accretion of interest will occur on at least a portion of the revenue. This raises the question as to whether interest should be accreted on the remainder of the insurance contracts revenue (that is, the portion attributable to the margin).
45. The primary argument for accreting interest on the margin, which is part of the overall insurance contract revenue, is that the total amount of revenue recognized for the contract would not otherwise equal the amount of consideration to which the entity was entitled under the contract (once consider the time value of money associated with all premiums). If interest is accreted on both the liability for remaining coverage and the margin, the amount presented as insurance contract revenue is more easily explained; it is the present value of the premiums received attributable to the insurance component at the time the coverage is provided. However, as a practical matter, it would be unusual for premium to be payable on the exact dates that correspond to the coverage because at that time, the uncertainty would be removed and the policy holder would not pay a profit.
46. Accretion of interest on the premium attributable to the margin would be consistent with the treatment of time value of money by the premium allocation approach and

proposed Update on Topic 605, which should enhance comparability of insurance contract revenue, including with revenue from other transactions.

Effect on the Statement of Financial Position

47. On the statement of financial position, accreting interest on the margin will result in a larger margin when compared to not accreting. Part of the basis for the Board's previous tentative decision to not accrete interest on the margin is that some Board members view the margin as simply a noncash item that eliminates day one gains rather than as an obligation. Consistent with this thought process, a number of comment letter respondents noted they view the margin as a deferred credit. However, if the margin is viewed in the context of deferred revenue and one accepts that entities should adjust the amount of consideration to reflect the time value of money, accreting interest on the margin might be an appropriate means to make this adjustment.
48. Because the margin is the difference between two discounted amounts (the present value of the cash inflows and the present value of the cash outflows), the margin itself is implicitly discounted at contract recognition. Accreting interest on the margin would help ensure that the underwriting profit the margin represents reflects a measurement date corresponding to the periods in which the margin is released.

Effect on Underwriting Income and Interest Expense

49. Pursuant to past tentative decisions of the Board, the measurement of claims and related expenses are based on their present value as of the date that claims are incurred (adjusted for any subsequent changes in estimates) and, thus, is unaffected by whether interest is accreted on the margin. Accordingly, and because the ultimate profitability arising from an insurance contract needs to equal the excess of cash inflows over cash outflows, an increase in total revenue for accretion of interest on the margin needs to be offset by an equal decrease in some form of expense. This expense is interest expense (that is, the unwinding of the discount on the margin). Accordingly, a decision to accrete interest on the margin will increase underwriting income and equally increase interest expense. However, as illustrated in examples

prepared by the FASB staff, accreting interest has the effect of decreasing pretax income in earlier years and increasing it in later years.

50. To evaluate whether the pattern of interest expense would result from accreting interest on the margin, the staff modeled the interest expense together with investment income that might be earned on the cash receipts related to the margin. The recognition of interest expense for the unwinding of the discount on the margin results in net investment income (that is, investment income less interest expense) equal to the amount of investment income that would have been earned absent a financing component to premiums attributable to the margin (ignoring any spread between the asset yield and discount rate). Accordingly, the staff thinks that accretion of interest on the margin *improves* rather than distorts the interest expense presented for an insurance contract.
51. Although the margin is associated with both past and future cash flows, some have questioned whether accreting interest on the portion of the margin associated with future premiums is appropriate or whether an adjustment is required to back out such accretion. In order to do so, an insurer would need to split the margin into components, a process which would be both complex and implicitly arbitrary given that the margin is simply the present value of all of the cash inflows and outflows and not attributable to any specific cash flows. Additionally, the staff notes that one needs to consider the entirety of the net interest expense on the contract in assessing its appropriateness and that the resulting interest expense meaningfully represents the time value of money associated with the net cash flows.

Staff Recommendation

52. The staff recommends that an insurer should be required to accrete interest to unwind the discount on the margin because:

- a. Based on tentative decisions reached by the Board, interest is accreted on the portion of revenue attributable to funding the costs of claims and related expenses. Accreting interest on the remainder of the premium ensures consistency and provides meaning to the overall revenue amount—it is the present value of the premiums received (and receivable, if any) attributable to the insurance component at the time the coverage is provided.
- b. Considering the interest expense from unwinding the discount on the margin together with the interest expense on unwinding the discount on the future net cash flows better reflects the time value of money between the receipt of premium and satisfaction of the corresponding performance obligation.
- c. Notwithstanding the comment letter responses to the FASB Discussion Paper that generally expressed opposition to accretion of interest on the margin, subsequent discussions with preparers showed they supported accretion if interest is accreted on the remainder of the revenue.

Question 6 – Whether to Accrete Interest on the Margin

Does the Board agree that an insurer should accrete interest to unwind the discount on the margin?

What Rate Should Be Used to Calculate Interest

53. Some comment letter respondents questioned the rate used to determine the amount of interest accretion, including what point of the yield curve should be used and whether a current rate or the rate determined at contract inception should be used.

54. The overall principle for the discount rate is that it should reflect the characteristics of the liability. Because the margin is determined at inception based on the expected cash flows of an insurance contract, the margin arguably shares the characteristics of the insurance contracts' cash flows. Use of the same yield curves used to discount the cash flows of a portfolio of insurance contracts also avoids any complexity with trying to establish a separate yield curve for the cash flows and margin.

Point-in-Yield Curve

55. The Board has tentatively decided that the margin should be released as the insurer is released from risk as represented by a decrease in the variability of cash flows (and thus when the profit is more certain). Accordingly, the staff notes that discount rates that correspond to the expected timing of the margin release would be consistent with the principles proposed for discounting the expected future cash flows component of the insurance contracts liability.

Rate Established at Inception or Updated Each Period

56. Considering that the margin does not reflect a fully current measurement (that is, unlike the remainder of the insurance contracts liability, it is only adjusted for systematic releases of the initially determined margin based on release from risk rather than fully remeasured), the relevance of updating the discount rates is diminished. The staff thinks that continuing to discount the margin and accreting interest using the yield curve identified at inception is a better reflection of both the underlying pricing assumptions of the insurer and implicit economic choices that the policy holder makes when choosing to pay over time or in advance. In addition, accreting at the rates at inception will result in similar amounts recognized as premiums in profit or loss regardless of whether the premiums are paid in advance or over time.

57. The staff also observed that rates determined at contract inception would be consistent with the tentative decisions for the premium allocation approach's liability for remaining coverage (which includes the implicit margin) and the revenue recognition project in which the rates used are locked at contract inception. Additionally, locking in the initial yield curves also is consistent with U.S. GAAP guidance regarding discounting receivables arising from transactions with customers in the normal course of business (Subtopic 835-30, Interest—Imputation of Interest.

58. Arguments in favor of updating the yield curve include improved consistency with the rates used to measure the cash flows component of the insurance contracts liability and that, because part of the objective of accreting interest on the margin is to reflect the fact that the entity would rationally have charged a different cash amount if

the contract had stipulated earlier or later payment by the customer, use of a current rate might be more appropriate.

Staff Recommendation

59. The staff recommends that:

- a. Insurers use the same yield curves used for purposes of discounting the cash flows of an insurance contracts portfolio for accreting interest on the margin.
- b. The point on the yield curves that should be used for discounting the margin should correspond to the expected timing of the margin release.
- c. The yield curves used to accrete interest on the margin should be locked in at inception of the contract and not adjusted subsequently.

Question 7 – Rate to Be Used to Accrete Interest
Does the Board agree with the above recommendation?