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Insurance Accounting Newsletter
Last minute convergence

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) held three special meetings as well as the normal Board monthly meeting in June. A total of eighteen hours were spent discussing insurance accounting during the special meetings (1, 10 and 23 June) and the regular meetings (15 to the 17 June); a clear sign of the two Boards' commitment to finalise the Exposure Draft (ED) of IFRS 4 Phase II. The results of these meetings have been significant as the Boards resolved a number of major long standing disagreements. As we go to print, we are not expecting further public Board meetings to take place before the Boards vote on the ED.

Of special significance are the agreements that were reached on important issues such as acquisition costs and participating contracts. The only main difference of opinion remaining between the FASB and the IASB is on whether the measurement model should use a risk margin approach to reflect the underlying uncertainty. The FASB has, however, indicated that it is consulting with analysts and insurers and may choose to issue the text included in the draft IFRS as a separate discussion paper rather than a draft US accounting standard.

Below is a summary of what the Boards have agreed at the various June meetings:

Acquisition costs
The FASB has aligned its position to that of the IASB. The residual or composite margin will be reduced by the incremental acquisition costs at inception. This will be achieved either by including the cash flows from the acquisition costs in the measurement of the liability, or by excluding them from the initial measurement of the margin.

Unbundling
The Boards agreed that under the new accounting standard an insurer will be required to "unbundle a contract if the policyholder can redeem or withdraw his investment without losing guaranteed insurability and without the insured event occurring, OR if the benefit amount varies primarily based on changes in a financial factor."

Presentation
The Boards have tentatively agreed to include the summarised margin approach with supplemental disclosures as the preferred income statement presentation in the ED. This approach will be field tested during the consultation period and the results of this testing, together with the comments received from respondents, will determine the final approach selected for the new insurance standard.

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Participating contracts

- The Boards have agreed that participating features are integral to the relevant insurance contracts and they will be considered in the cash flow estimation.

- However, the IASB remains the only Board to favour the inclusion of investment contracts with discretionary participation features and sharing in the same pool of assets as participating insurance contracts within the scope of the insurance standard.

- The contract boundary for these financial instruments is defined as the point at which the policyholder has no further right to the participation benefits.

Risk adjustment techniques

- The Boards have agreed the wording of the risk adjustment objective as "the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed those expected."

- The Boards requested that the Staff develop application guidance on three proposed permitted techniques: confidence intervals, conditional tail expectations and cost of capital.

Cash flows

- The Boards have agreed on a new wording for the definition of the cash flows estimated under the first building block as "all future cash flows that are integral to the fulfilment of insurance contracts."

- The carrying amount of insurance contracts, including those measured using the unearned premium method, will be classified as monetary items for the purpose of foreign currency translation. This decision will resolve an accounting mismatch that currently exists under IFRS 4.

Purchased reinsurance

- The valuation principles for assets from purchased reinsurance contracts have been changed to require the accounting for reinsurance gains only; negative margins are prohibited.

- A minor difference remains due to the IASB's preference for a net cash flow approach to reinsurance ceding commissions. Under the preferred IASB model reinsurance ceding commissions would be treated as a reduction in premium paid. The FASB prefers a gross cash flow approach with ceding commissions treated as revenue to the extent that they offset acquisition costs and only the remainder classified as a reduction in premium paid. The following sections expand on each of these items in turn.

Acquisition costs

The FASB has accepted the logic of the IASB's view and agreed that the initial measurement of the insurance contract should calibrate the residual/composite margin such that it is reduced (but not below zero) by the amount of incremental acquisition costs (determined at the contract rather than portfolio level).

In the event that all of the acquisition costs incurred are directly attributable to the insurance contract and incremental, the insurer would recognise revenue equal to the expenses incurred resulting in no day one profit or loss. In all other cases the calibration would produce revenue that will only partially cover the full acquisition costs incurred leaving the insurer to report an accounting loss at the point of sale of a policy for the portion of acquisition expenses that are not incremental and directly attributable to that sale (e.g. marketing overheads).

The Boards also agreed that if any of the acquisition costs is recoverable from another party, the insurer would recognise such recovery right as an asset.

The lengthy discussion the two Boards held produced the all important agreement on the initial calibration. However it also raised some issues (e.g. how to account for successful/unsuccessful sales costs) for which a definitive conclusion will be left to the Staff to resolve through the pre-ballot phase of the drafting process.

Unbundling

In order to attempt to reach agreement on unbundling, the Staff was asked in May to develop further the principle of separating the components of an insurance contract. The new Staff paper did not find a particularly warm welcome from the Boards who felt it was not addressing the concerns of FASB. However the ensuing debate allowed the Board members to formulate an unbundling principle as follows:

"Unbundle the components of an insurance contract if the policyholder can redeem or withdraw his investment without losing the guaranteed insurability and without the insured event occurring, OR if the benefit amount varies primarily based on changes in a financial factor."

The Boards agreed that they would like to review a text in the pre-ballot ED developed from this tentative principle. However, if this attempt does not result in the expected convergence of views, the Boards agreed to revert to the Staff's original proposal to require unbundling of all components that are not interdependent with each other and use field testing during the consultation period to finalise the accounting approach.

Presentation

The Staff kept open for the Boards' to decide whether to require a presentation based on a margin approach or based on an approach that treats written premiums as revenue.

The discussions this month clarified that a majority of both Boards would prefer a presentation that is consistent with the measurement model, and they voted in favour of a summarised margin approach with additional disclosure showing cash flow information.

Interest accretion on residual/ composite margin

Although the Boards previously disagreed on whether to accrete interest on the residual/composite margin, some FASB members said they would change their vote and agree to the IASB accretion model for the sake of convergence on the final text of the ED. In the event the Boards agreed to accrete interest on the residual/composite margin, they still need to decide the basis for the accretion interest rate. In particular, the issue would be to select between a model where the interest rate is locked-in at inception to align the accretion logic to the systematic and rational release of the margin to income, or whether the rate should be market consistent and in line with the second building block of the core accounting model. Our observation of this month's discussion suggests that most Board members were indifferent between the two approaches. The Chairmen agreed that the question would be posed in the ED and the Boards would follow the respondents' preference in the finalisation of the new accounting standard.

Participating contracts

Unusually, in the meeting of 10 June, the Staff presented different recommendations to the two Boards – for the IASB to include participating investment contracts in the insurance standard, and for the FASB to include participating investment contracts in the financial instruments standard. The FASB agreed with the Staff recommendation, and the IASB was able to reach agreement on this topic only thanks to Sir David Tweedie's exercise of his casting vote to support the Staff recommendation.

This tentative decision was conditional on inclusion of both positions in the ED such that respondents could openly comment on the direction taken.

The IASB then considered the extent to which participating investment contracts would be scoped into the insurance standard.

The IASB tentatively agreed with the Staff's recommendation that only investment contracts which participate in the same pool of assets as participating insurance contracts should be included within the insurance standard, thus restricting the scope inclusion to insurers issuing participating investment contracts. The IASB also agreed that the contract boundary for such contracts would be defined as the point at which the policyholder has no further right to receive benefits arising from the participating feature. Deloitte believes that this contract boundary is applied only to participating investment contracts and that participating insurance contracts would be accounted for with reference to the contract boundary defined for insurance contracts, which does not make any reference to participating rights within the contract.

Risk adjustment techniques

During the meeting on 10 June, the Staff proposed draft application guidance which was intended to limit the permitted techniques that could be used to estimate the risk adjustment. These proposals apply only to the model with an explicit risk adjustment as supported by the IASB. The Boards did not reach a conclusion at this stage and asked for a new version of the Staff paper to be presented. They noted however that the proposed measurement techniques would need to meet the defined measurement objective, and that any capital measurement (e.g. for the cost of capital technique) should be based on an economic basis rather than regulatory requirements.

On 16 June, the Boards reviewed the revised Staff draft guidance and, after a significant discussion, they concluded that the measurement objective for the risk adjustment should be modified to "the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed those expected."

Some Board members commented that the new objective is extremely close to an exit-price notion. The majority of them dismissed this by arguing that the exit-price notion was dependent on an external market to provide price calibrations, and other factors such as service margins and own-credit risk and in their view, the proposed objective did not require any of these.

Although the issue of negative margins was a concern for the Boards, the Staff noted this was likely to be very rare and the Boards agreed to the proposed measurement objective.

The majority of Board members was in favour of including additional discipline in the new objective to promote comparability.

To achieve this objective they approved the three proposed methods of calculation (confidence intervals, conditional tail expectations and cost of capital) and agreed that the Staff will draft additional information, as well as application guidance on these three methods, particularly on determining the appropriate circumstances in which to use them. Although a Board member raised a concern that the three methods only considered the quantity of risk, rather than both price and quantity, the Boards confirmed their decision.

Cash flows

The Staff presented draft application guidance on cash flows for the Boards' consideration at the meeting on 15 June. The guidance primarily indicated that:

- future cash flows from the fulfilment of an insurance contract should be included in the measurement of the contract;
- cash flows should reflect the insurer's estimate of its cost (both direct and indirect) to fulfil its insurance contracts, with no consideration of potential future contracts;
- where a replicating portfolio exists, such a portfolio should be used in the measurement of the insurance liabilities; and
- expectations at the reporting date should be taken into account for liability measurement as at that date, without considering experience or events after that date or cash flows under contracts after that date. The general principles on subsequent balance sheet events set out in IAS 10 would apply.

Overall, the Boards felt the guidance was well drafted although members asked the Staff to modify and clarify certain aspects to ensure no liability for future events arising from future contracts is recognised. Furthermore, the wording of the guidance describing the main principle of current fulfilment value should be fully aligned with that principle to minimise subsequent interpretation issues.

Of particular interest were the concerns that some of the FASB members raised regarding their view that some of the proposed costs included in the cash flows listed by the Staff did not tie in well with the fulfilment notion. The debate on these concerns highlighted the Boards' different interpretations of 'fulfilment'; the FASB adopts a literal interpretation while the IASB had been operating on a 'contract-specific cash flows' basis of fulfilment. Having established this, the Boards asked the Staff to review the existing fulfilment notion and develop a definition upon which they could agree.

The new proposed wording was presented to the Boards on 23 June and stated that all future cash inflows and outflows arising from the fulfilment of the contract should be included in the expected present value of the future cash flows. The Boards did not accept the Staff proposal and after debating, determined that the definition of fulfilment that the two Boards could agree should include the reference to the "incremental future cash flows that will arise directly from insurance contracts". The Boards also noted that there is no intention for this to result in a transfer notion as they are still firmly focused on the use of a fulfilment notion for the insurance standard.

Based upon this revision, the FASB indicated that it would change its opinion on certain matters.
In particular, the FASB tentatively decided to join the IASB in its approach of considering participating features as an integral component within the first building block.

The only remaining difference on participating contracts' accounting is the scope decision to include financial instruments with a participating feature in the scope of the ED. The IASB decided to include them if and only if they are issued from a participating fund that backs participating insurance contracts. The FASB has instead preferred to have participating financial instruments to be accounted for within the financial instrument standard.

Another decision on cash flows was reached at the 15 June meeting regarding the classification of amounts from insurance contracts denominated in a foreign currency and their translation. The Staff proposed that insurance contracts, and each of the components of an insurance contract, should be classified as monetary items. This classification requires the insurer to remeasure the reported amount at each balance sheet date in line with the foreign exchange rate at that date. The Boards unanimously agreed with the Staff proposal. This decision will eliminate an accounting mismatch present under current IFRS 4 where certain amounts arising from insurance contracts are treated as non monetary items and cannot be remeasured using the balance sheet foreign exchange rate.

Reinsurance

Following the February meeting, two matters remained to be discussed between the Boards on the subject of purchased reinsurance accounting.

The first issue was the treatment of negative margins in reinsurance assets. The Staff proposed that the valuation principle for reinsurance contract assets should require the accounting for reinsurance gains and that negative margins should be included directly in profit and loss, where the negative margin does not arise from a measurement inaccuracy. The Boards supported the Staff recommendation.

The second issue on the treatment of reinsurance ceding commissions resulted in a split position, with the IASB tentatively deciding that it would treat ceding commissions as a reduction in premium paid, and the FASB instead voting for the classification of ceding commissions as revenue to the extent that they offset acquisition costs with only the remainder treated as a reduction in premium paid.

These decisions would need to be reassessed in light of the new agreement on acquisition cost and it is conceivable that the Boards could agree on a common approach as they finalise the ballot draft of the ED.

The IASB position on ceding commissions would appear to be closer to the spirit of the recently formed convergence on acquisition expenses.

Now what?

No public meetings discussing insurance are currently scheduled between now and the publication of the ED. We expect the Staff to be currently finalising the drafting and balloting should take place in the next few weeks. Hopefully, the ED will be published before the end of July, with four months to comment. Field testing will be carried out on a few aspects of the proposals such as risk adjustments, cash flows and presentation.

Our next webcast and articles will keep you fully informed on what the Boards are proposing, the implications on the industry and next steps. Make sure you stay tuned!

Appendix – Summary of tentative decisions to date (recent changes highlighted)

Converging tentative views	IASB & FASB
Scope of the insurance standard	The following are excluded from the scope of the insurance standard: • warranties issued directly by a manufacturer, dealer or retailer; • residual value guarantees embedded in a lease; • residual value guarantees issued directly by a manufacturer, dealer or retailer; • employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans; • contingent consideration payable or receivable in a business combination; and • fixed fee service contracts.
Definition of insurance and evaluation of significant insurance risk	The IFRS 4 terminology "compensation" will be used in the standard rather than the US GAAP terminology "indemnification". Significant insurance risk will be evaluated using present values rather than absolute amounts and the role of timing risk in identifying insurance risk should be disqualifying rather than a primary condition for determining significant insurance risk in a contract.
Measurement objective and approach	Although both Boards agree on using a building block approach, which blocks should be included in the approach has become a point of disagreement for the Boards. The disagreement revolves around whether to use a separate risk adjustment or a composite margin. Details of the disagreement have been included below.
Measurement approach	The measurement approach will be applied to the overall insurance contract to produce one carrying amount inclusive of all rights and obligations rather than separate asset and liability components.
Measurement objective	The measurement objective will refer to the value rather than the cost of fulfilling the obligations under the insurance contract.
Contract boundary	An existing contract terminates when the insurer has an unconditional right to cancel or to re-underwrite/re-price that individual contract.

Converging tentative views	IASB & FASB
Service margin	No explicit service margin is included in the measurement approach.
Subsequent treatment of margins	The release of residual margin to profit or loss will be independent of changes in the value of estimates within the three-building-blocks. The margin will be released on a straight line basis over the coverage period unless the expected claims/benefits pattern provides a better systematic and rational basis.
Use of inputs for measurement	All available information relevant to the contract should be used. Current estimates of financial market variables must be consistent with observable market prices.
Cash flows	The definition of the cash flows estimated under the first building block should be worded as all the "future cash flows that are integral to the fulfilment of insurance contracts." The carrying amount of insurance contracts, including those measured using the unearned premium method, will be classified as monetary items for the purpose of foreign currency translation.
Discount rates	Principles based approach, based on liability characteristics (currency, duration and liquidity).
Accounting profit	Prohibition from recognising accounting profit at initial contract recognition.
Negative day one differences	Recognise negative day one difference immediately as a day one loss.
Acquisition costs and revenue recognition	Expense all acquisition costs as incurred through profit or loss, offset by a release of revenue on day 1 equal to incremental acquisition costs. Direct measurement of the contract liability should be calibrated to the consideration receivable net of incremental acquisition costs; OR Incremental acquisition costs should be included in the contract cash flows to determine the residual margin at the inception of the contract.
Policyholder accounting	Policyholder accounting (other than by cedants) will not be included in the Exposure Draft but will be included in the insurance accounting standard.
Presentation	Rejection of a model that recognises revenue on the basis of written premiums. Revenue will be recognised as the insurer performs under the contract). The insurance contract will be presented as a net amount inclusive of all rights and obligations rather than separate asset and liability components. Performance statement presentation should include at least the following information: • release of expected margin during the period; • difference between actual and expected cash flows; • changes in estimates; and • investments margin (interest income less unwind of discount on the insurance liability). Performance statement presentation should follow the summarised margin approach with supplemental disclosures.
Policyholder behaviour	Expected cash flows from options, forwards and guarantees relating to the insurance coverage (e.g. renewal and cancellation options) are part of the contractual cash flows rather than a separate contract or part of a separate customer intangible asset. Measurement of these options will be based on a "look through" approach when reference to standalone price is not available. All other options guarantees and forwards not relating to the existing insurance coverage will form part of a separate contract that will be accounted for according to the terms of that separate contract.
Deposit floor	The first building block will include all the cash flows arising from the cancellation or the renewal options, i.e. no deposit floor.
Reinsurance	Reinsurers to use same measurement principles as for insurers. Cedants should measure reinsurance assets using the same principles used to measure the reinsured liability. Reinsurance assets should not be offset against insurance liabilities unless the legal requirements are met. Reinsurance should not result in derecognition of insurance liabilities unless the obligation has been discharged, cancelled or expired. The valuation principles for assets from purchased reinsurance contracts have been changed to require the accounting for reinsurance gains only; negative margins are prohibited.

Recent changes

Converging tentative views	IASB & FASB
Disclosures	Three high level principles, supported by detailed requirements and guidance that will draw from existing guidance in IFRS 4 and US GAAP, will require an entity to disclose information that: • explains the characteristics of its insurance contracts; • identifies and explains the amounts in its financial statements arising from insurance contracts; and • helps users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts. Although the staff recommended a number of disclosure requirements, the Boards were unable to agree to them and requested that the staff reconsider the proposals in view of the comments made by the Board members.
Unbundling	The Boards agreed that the new accounting standard will use an approach whereby an insurer will be required to "unbundle a contract if the policyholder can redeem or withdraw his investment without losing guaranteed insurability and without the insured event occurring, OR if the benefit amount varies primarily based on changes in a financial factor."
	If unbundling is not required for recognition and measurement, it should not be a permitted option. For account-driven contracts, account balances that are explicit should be unbundled. The ED will ask the question as to whether all account balances, including those that are not explicit, should be unbundled.
Variable and unit linked contracts	The associated assets and liabilities should be reported as assets and liabilities of the insurer in the statement of financial position. Consolidation of investment funds will be addressed in the consolidation project.
Insurance contracts with participation features	Cash flows from participation features should not be measured separately from the host insurance contract and they should be part of the overall expected cash flows of that contract. The contract boundary for these contracts is defined as the point at which the policyholder has no further right to the participation benefits.
Risk Adjustment	If the measurement of an insurance contract is to include an explicit risk adjustment, it should be implemented by limiting the range of permitted techniques to measure such an adjustment.
	The wording of the risk adjustment objective has been agreed to be: "the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed those expected."
	Application guidance on three proposed permitted techniques will be developed (confidence intervals, conditional tail expectations and cost of capital). The ED will set out criteria to assess which techniques may be used.

Divergent tentative views	IASB	FASB
Measurement objective and approach, and risk adjustment	The building blocks are: • the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation; • the incorporation of the time value of money; • an explicit, re-measured risk adjustment for the insurer's view of the effects of uncertainty about the amount and timing of future cash flows; and • an amount that eliminates any gain at inception of the contract calibrated to the consideration receivable net of incremental acquisition costs. Consistent with IAS 37, the risk adjustment, re-measured at each reporting date, is defined as the amount the insurer would rationally pay to be relieved of the risk.	The FASB does not support the recognition of a separate risk adjustment, and has returned to its pre-December 2009 position. The FASB agrees with the IASB on the first two building blocks, but favours a composite margin rather than the risk adjustment and residual margin preferred by the IASB. The composite margin contains both the IASB's risk adjustment for the insurer's view of the effects of uncertainty about the amount and timing of future cash flows and an amount that eliminates any gain at inception of the contract calibrated to the gross consideration receivable.

Divergent tentative views	IASB	FASB
Reinsurance	Reinsurance ceding commissions to be treated as a reduction in premium paid to reinsurer.	Reinsurance ceding commissions to be treated as revenue to the extent that they offset acquisition costs, and the remainder classified as a reduction in premium paid.
Insurance contracts with participation features	Investment contracts with discretionary participation features sharing in the same pool of assets as participating insurance contracts will be included in the scope of the insurance standard.	Investment contracts with participation features will be in scope of the financial intruments standard.

Recent changes

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