

Insurance Accounting Newsletter

Divergence on new business revenue



FASB diverges from IASB on new business revenue

IASB decides on contract boundaries in line with industry proposals

The American Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) held meetings on 18 May and 21 May respectively, to discuss further and decide on the future of insurance accounting.

The FASB also held educational sessions on margins, acquisition costs, policyholders' behaviour and contract boundaries on 6 May and 27 May, although it is now running its decision making discussions behind the IASB. The 18 May FASB agenda covered Margins for Risk (MfR) and acquisition costs and at its meeting on 21 May, the IASB reached an important decision on policyholders' behaviour and contract boundaries.

New business revenue

A notable outcome of the May meetings is the divergence between the two Boards on a key component of the new accounting model. The FASB tentatively decided not to recognise new business revenue at inception of an insurance contract. This is a different approach to the IASB's; they decided in April to use the premium net of incremental acquisition costs when calibrating the margins of the initial liability.

Divergence between the two Boards

It is not the first (and unlikely to be the last) time that the two Boards have reached differing tentative decisions during the course of their joint projects. However, they ultimately aim to set convergent standards and there is a mechanism to try and reach a compromise; for example, a joint meeting is scheduled in London on 23-24 July 2009.

Having said that, if no compromise is reached on initial calibration and new business revenue, the FASB proposals would result in an accounting loss on day one whenever an insurer incurs acquisition costs and, as a consequence, a larger liability than that under the IASB proposals would be recognised.

Future premiums

The IASB has reached a very important decision about the accounting for cash flows from renewal and cancellation options. The IASB agreed to consider those cash flows as contractual and, when no standalone price is available to value them, to "look through" these options for measurement purposes. The "look through" would be extended to the point (the contract boundary) when the insurer acquires the unconditional right to re-underwrite/re-price or to cancel the individual contract.

As a consequence of this decision, the IASB is to abandon the proposals put forward in the 2007 Discussion Paper of separately accounting for renewal and cancellation options as a customer intangible asset, which found very little support from most commentators. It is worth noting that industry research on this topic was instrumental in facilitating the debate and the IASB's ultimate decision.

Having pushed back some of the scheduled agenda items such as discount rates to future meetings, the IASB has published a new draft timetable that indicates a delay in the publication of the exposure draft (now April 2010 – was December 2009) and the new IFRS (now July 2011 – was May 2011).

Finally, we note that the IASB and its stakeholders will also be meeting at the Insurance Working Group on 29 and 30 June in London to reflect on the decisions made and to discuss remaining topics. We will of course keep you informed by publishing a special issue of our Insurance Accounting Newsletter to comment on the outcomes of that meeting. Stay tuned!

FASB May Meeting

Margins for risk

The FASB was presented with the same questions and proposals on MfR that the IASB discussed in April. However, the FASB has not yet reached any clear decisions. The questions put to the FASB focused on:

- the need for an MfR in the measurement of an insurance liability;
- if there was a need, the choice of a measurement basis for the MfR; and
- whether or not the US GAAP proposals would require the remeasurement of the MfR at each reporting date.

Although the FASB agreed that the accounting model should reflect uncertainty, it questioned the nature of the MfR without completing further research. In particular, the debate highlighted that some FASB members would like to understand whether there is a difference between the concepts of risk and uncertainty.

The distinction between risk and uncertainty

One FASB member noted that a margin that reflects uncertainty would be compatible with a Current Fulfilment Value (CFV) approach. However measuring risk seems to introduce a market participant's perspective (e.g. the degree of its risk aversion) that would appear to be an attribute of the Current Exit Price (CEP) which the FASB has already abandoned.

Another FASB member elaborated on this distinction by asking for Staff to research the link between the probability-weighted estimation to determine block 1 and the proposal to use the MfR as an additional liability to capture uncertainty in that probability distribution. According to this FASB member, Staff should explain whether or not all of the estimation uncertainty may already be reflected in the calculation of block 1.

Having failed to formulate a tentative decision on the need for an MfR, the FASB felt unable to proceed further. However, on the question of whether the MfR should be remeasured at each reporting date, the FASB took the unanimous decision that the US GAAP proposals would require the insurance contract as a whole to be updated to reflect uncertainty, notwithstanding how that concept will eventually be defined and accounted for (e.g. with or without a MfR).

Acquisition expenses and new business revenue

The FASB's decision on the initial calibration of an insurance contract resulted in a divergence from the IASB's decision in April. As per the IASB, the FASB agreed that acquisition costs should always be expensed as incurred and that no Deferred Acquisition Costs ("DAC") be recognised. However, the FASB was not persuaded that the consideration a policyholder pays to the insurer includes amounts both to acquire the contract and to compensate the insurer for the recovery of the acquisition costs. The FASB tentatively decided that the consideration is paid to acquire the insurance contract only. Thus similar contracts will have different liabilities if they are sold via different distribution channels with the recovery of different distribution costs reflected in the premium charged.

Based on this decision, the FASB decided that the calibration of the initial measurement would need to be applied to the premium gross of acquisition costs. The consequential tentative decision was the prohibition to recognise any revenue or income at the point of sale on the grounds that the insurer has not performed any of its contractual obligations toward the policyholder.

The FASB further justified its decision indicating that in its opinion, this accounting treatment would align insurance contract accounting with all other industries that would use the revenue recognition standard proposed in the recent joint Discussion Paper on the subject.

Practical implications

The FASB tentative decision on new business revenue and initial calibration means that insurers recognise a day one loss equal to acquisition costs expensed, even if the premium received from the policyholder contains a component that is paid purely to allow the insurer to recover such costs.

The IASB tentative decision instead means that insurers are permitted to recognise day one revenue equivalent to incremental acquisition costs to the extent that the calibration of the three-building-blocks, against the premium net of acquisition costs results in a Residual Margin liability.

The difference does not only impact initial measurement. All other things being equal, the subsequent underwriting profit recognised under US GAAP would be higher than under IFRS because of the additional profit included in the US GAAP version of the Residual Margin liability.

IASB Meeting

Accounting for renewal and cancellation options

In many long-term insurance contracts, the policyholder has the right to continue the insurance cover as long as the premiums are paid. However, this payment is not compulsory and its termination unilaterally cancels the insurance contract i.e. in effect the insurer has written an option for the policyholder's benefit. This option compels the insurer to accept the policyholder's premiums (as determined by the insurance contract) and continue the insurance coverage without a corresponding right to enforce such payments.

The IASB considered three approaches to account for these renewal options:

- Ignore the option;
- Measure the option;
- Look through the option (i.e. treat that cash flow subject to the renewal and cancellation options as part of the existing contract).

The IASB tentatively decided "that the measurement [of the insurance contract] should include the expected (i.e. probability-weighted) cash flows (future premiums and other cash flows resulting from those premiums, e.g. benefits and claims) resulting from those contracts, including those cash flows whose amount or timing depends on whether policyholders exercise options in the contracts."

It is particularly important to note that these options were also presented to the IASB Revenue Recognition discussion. Consistent with the decision for insurance accounting, the IASB reached a tentative decision to account for these options in other types of contracts "as a performance obligation if the stand-alone selling price of that option can be determined without undue cost". The approach to apply the "look through" measurement to revenue accounting when the option price is not available without undue cost will be explored in a future meeting.

Although the IASB tentatively agreed to measure renewal and cancellation options embedded in insurance contracts on a "look through" basis when no standalone price is available to value them, a minority of IASB members did not agree with this analysis. As a result, there was a request for a completion debate in the near future at which the IASB Staff will present a fully developed proposal of the text that would be included in the Exposure Draft.

Contract boundaries

The decision on including the renewal and cancellation options in the contract's measurement assisted the IASB in reaching a second tentative decision to use, as the contract boundary, the date when the insurer acquires an unconditional right to individually cancel or re-underwrite/re-price the policy. The IASB recognised that previous attempts to define contract boundaries using the "guaranteed insurability" rule were not superior to the proposal presented at the meeting.

These two IASB tentative decisions are substantially aligned to the proposals put forward by the insurance industry during the last few months. The project implications of these decisions are particularly positive since this has been one of the most difficult areas for the IASB and the industry to find common ground.

Practical implications

The varied nature of terms and conditions included in insurance contracts will require extensive contract analysis to identify those situations where system changes will be required in order to apply the new contract boundary principle to the calculation of the contract's discounted expected value (blocks 1 and 2).

Insurers may also consider revising terms and conditions of new contract designs to ensure that their legal form is aligned with the economic substance of the new accounting principle. Aligning form to economic substance would simplify the accounting processes.

Nearing half way?

The IASB will discuss a newly posted timetable at its meeting in June. We include the new schedule of meetings with the associated topics in the second appendix to this newsletter.

Whilst the project has been delayed, the new timetable does not change the plan for a 2011 completion date. In our opinion, the IASB has reached important decisions on some of the most difficult issues (e.g. the treatment of acquisition costs and the definition of the contract boundary) and this should facilitate the decision making process over the coming months.

Appendix 1: Summary of tentative decisions to date

Converging views	IASB & FASB	
Measurement approach	Basic features of measurement approach: <ul style="list-style-type: none"> • Use estimates of financial market variables consistent with market prices. • Use explicit current estimates of the expected cash flows. • Reflect the time value of money (still to be confirmed by FASB). • Include an explicit margin for uncertainty – FASB still to agree on uncertainty definition. 	
Measurement objective	FASB in favour of CFV	IASB yet to decide on CEP or CFV
Accounting profit	Prohibition from recognising accounting profit at initial contract recognition.	
Negative day one difference	Recognise negative day one difference immediately as a day one loss.	
Acquisition costs accounting	Expense as incurred through income.	

Divergent views	IASB	FASB
Acquisition costs definition	All costs through income as incurred. However incremental costs directly attributable to secure the contract shall be used in the calibration of the initial measurement of the insurance contract.	Not considered as all acquisition costs expensed.
New business revenue recognition on day one	Recognise to the extent of incremental acquisition costs and the presence of a Residual Margin liability.	Not recognised, initial measurement is calibrated to the gross premium received from the policyholder.

IASB decisions not yet discussed by FASB	
Policyholder behaviour	<ul style="list-style-type: none"> • Cash flows from renewal and cancellation options are part of the contractual cash flows rather than part of a separate customer intangible asset. • Measurement of these options shall be based on a "look through" approach when reference to standalone price is not available.
Contract boundary	An existing contract terminates when the insurer has an unconditional right to re-underwrite/re-price that individual contract.

"Known unknowns"	
FASB	To formally confirm: <ul style="list-style-type: none"> • the four features of CFV already approved by the IASB; • the rejection of a method with no margins and no discounting for non-life claims liabilities; and • the definition of uncertainty/risk and whether certain risk features should not be included in contract liability measurement.
IASB	To confirm preference to use a CFV approach.

Appendix 2: IASB Timetable for Board discussions and Working Group Meetings* as per Agenda reference 10F for June 2009 meeting

Meeting of Insurance Working Group	June 2009
Measurement approach We will ask the boards to discuss and reach a conclusion on the measurement approach (follow-up on February/June 2009 Board meetings on the measurement approach).	July 2009
Use of the unearned premium for short-duration contracts	July 2009
Other issues on the measurement approach <ul style="list-style-type: none"> • Should other comprehensive income be used for some changes in insurance liabilities? • Non-performance risk. Other relevant projects: revenue recognition, fair value measurements, employee benefits, credit risk in the measurement of liabilities.	September 2009
Discount rates <ul style="list-style-type: none"> • guidance on discount rates. Other relevant projects: revenue recognition, fair value measurements, non-financial liabilities (IAS 37), employee benefits.	September 2009
Policyholder participation – classification <ul style="list-style-type: none"> • When should participation features be classified as equity and when should they be classified as liabilities? How should participation features be reported in the statements of financial position, financial performance and cash flows? • Are there any specific issues for mutuals? Other relevant projects: concepts (elements, recognition), financial instruments with characteristics of equity.	October 2009
Participating, unit-linked and index-linked insurance contracts and investment contracts and universal life contracts <ul style="list-style-type: none"> • Should accounting mismatches be eliminated? If so, how? • If assets are held in separate funds, are they part of the reporting entity? • If policyholders bear part or all of the investment risk, how should this affect presentation and disclosure? Other relevant projects: concepts (unit of account), financial instruments, consolidation, concepts (reporting entity)	October 2009
Presentation <ul style="list-style-type: none"> • Presentation of the balance sheet and the performance statement (Staff intends to discuss some presentation issues when discussing particular topics. The purpose of session is to discuss topics not discussed in earlier meetings). Other relevant projects: presentation of financial statements.	November 2009
Disclosure <ul style="list-style-type: none"> • What disclosures should be required? Other relevant projects: presentation of financial statements.	November 2009
Other issues on the building blocks <ul style="list-style-type: none"> • Guarantee fund assessments. • Tax issues. • Salvage and subrogation. Other relevant projects: non-financial liabilities (IAS 37), income taxes, fair value measurements.	November 2009
Policyholder accounting – initial review <ul style="list-style-type: none"> • Initial review of whether the same measurement attribute is appropriate for policyholders as insurers. • If the same measurement attribute is appropriate, consider whether practical shortcuts are needed. Other relevant projects: concepts (measurement, unit of account), fair value measurements, non-financial liabilities (IAS 37).	December 2009
Policyholder participation – measurement <ul style="list-style-type: none"> • Consider specific measurement issues for participation features. • Do we need to amend the IFRS 4 definition of a discretionary participation feature (DPF)? • Should investment contracts with a DPF be in the scope of the insurance standard or financial instruments standards? • Are there any specific issues for mutuals? Other relevant projects: concepts (measurement), fair value measurements, financial instruments, financial instruments with characteristics of equity.	December 2009
Minor issues <ul style="list-style-type: none"> • Insurance contracts acquired in business combinations and portfolio transfers. • Should some income taxes be reported as taxes on policyholders, rather than as taxes on the insurer? • Interim reporting. • Transition, including transition for assets backing insurance contracts. • Consequential amendments. Other relevant projects: presentation of financial statements.	January 2009

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Policyholder accounting – follow up <ul style="list-style-type: none"> • Review initial conclusions on policyholder accounting. Other relevant projects: non-financial liabilities (IAS 37).	January 2009
Pre balloting	January 2010/February 2010
Sweep issues	March 2010
Publication of Exposure Draft	April 2010
Comments due	August 2010
Summary of comments	October 2010
Discussion of Issues from comment letters <ul style="list-style-type: none"> • The issues, both the content and the total number, cannot be estimated at this stage. • But we probably need to bring something to the Board every 1-2 months. 	November 2010 – April 2011
Pre balloting	April/May 2011
Sweep	June 2011
Publication of final standard	July 2011

Deloitte Insurance contacts

Global insurance network

Joe Guastella

Global Insurance Leader

U.S.

+1 212 618 4287

jguastella@deloitte.com

Asia Pacific

Hitoshi Akimoto

Japan

+81 3 4218 4858

hakimoto@deloitte.com

Simon Walpole

Hong Kong

+852 2238 7229

siwalpole@deloitte.com.hk

EMEA

Fabien Sauvage

France

+33 1 55 61 41 63

fsauvage@deloitte.com

Mark FitzPatrick

U.K.

+44 20 7303 5167

mfitzpatrick@deloitte.co.uk

Mark Ward

Switzerland

+41 44 421 62 72

maward@deloitte.ch

Peter Wright

Czech Republic

+420 246 042 888

pewright@deloitte.com

Latin America

Gustavo Bohórquez

Mexico

+52 55 50806201

gbohorquez@deloittemex.com

Carlos Srulevich

Argentina

+54 11 43202734

csrulevich@deloitte.com

North America

Rebecca Amoroso

U.S.

+1 973 602 5385

ramoroso@deloitte.com

Todd Roberts

Canada

+1 416 601 5709

toroberts@deloitte.ca

John Johnston

Bermuda

+441 292 1500

jojohnston@deloitte.com

For more information on Deloitte Touche Tohmatsu, please access our website at www.deloitte.com

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