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Insurance Accounting Newsletter
Current Exit Price off the table

At its meeting on 18 June, the International Accounting Standards Board (IASB) abandoned the use of a Current Exit Price (CEP) model for the development of an IFRS for insurance contracts which aligns the IASB position with the position reached by the American Financial Accounting Standards Board (FASB) last February.

The FASB held an educational session on 24 June on risk margins which included a presentation by representatives of the International Actuarial Association.

Key outcomes from the IASB June meeting

The removal of the CEP model from the list of options being considered was voted in conjunction with a tentative decision to no longer consider the Current Fulfilment Value (CFV) model known as "candidate 3". Candidate 3, a model under which insurance contracts would be accounted for using a three-building-blocks approach plus a residual margin, was one of the two CFV models remaining in the list of candidates. The IASB decided to abandon this model and to replace it with an alternative measurement model based on the recently updated IAS 37.

IAS 37 covers accounting for liabilities that are not covered under another specific IFRS.

Whilst the IASB Staff proposed a new timetable for the development of the insurance IFRS with an April 2010 publication date for the Exposure Draft (ED), this proposal was rejected and the IASB members asked the Staff to re-formulate its plans to ensure that the ED is published in December 2009.

Finally the IASB approved the Staff proposal to undertake targeted field testing prior to the publication of the ED.

Updated IAS 37 model as a candidate for measuring insurance contracts

IAS 37 has been subject to deliberations for improvement since the publication of an Exposure Draft in 2005. The IASB discussions on insurance contracts accounting had influenced the improvement work on IAS 37 by proposing that the two projects be more formally aligned. This alignment was made possible by the decision to use the three-building-blocks approach with entity specific attributes for the updated IAS 37 model. The IASB Staff explained it would adapt the IAS 37 model to insurance contracts by bringing in some of the CFV characteristics, such as the presence of a residual margin calculated from the calibration to the net transaction price.

For some time, commentators of the IASB work have noted a number of issues that "cut across" several different projects. These include several of the accounting problems the IASB has been dealing with in its insurance (phase II of IFRS 4) and liability (IAS 37) projects. Following decisions taken by the IASB in the last few months, the Staff sees a high degree of convergence between the revised IAS 37 model and the CFV models discussed for phase II of IFRS 4. Based on this assessment, the Staff proposed that a measurement approach for insurance contracts, clearly in line with the updated IAS 37 model, be added to the list of candidates for phase II of IFRS 4. Consequently, it suggested that the CFV measurement approach known as "candidate 3" (and that includes a margin for the cost of bearing risk and a residual margin) be removed from the list of candidates. The Board tentatively agreed with both proposals.

In the circumstance where recent IAS 37 developments would be used for the purpose of measuring insurance contracts, phase II of IFRS 4 would contain a principle stating that insurance contracts should be measured based on the amount that the "insurer would rationally pay to be relieved of the liability arising from the contract". As for the CFV model in the absence of an active market, the modified IAS 37 model clarifies that an insurer shall estimate that amount based on the burden to fulfil the obligation over time, or what it would rationally expect to pay to a third party to take over that liability. To reflect the presence of the insurance transaction price, Staff explained that it would keep the CFV calibration approach (approved in April), such that there is no day one gain but only revenue to the extent the transaction price provides recovery of the incremental acquisition costs incurred.

During its June insurance discussion, the IASB agreed that sufficient progress has been made on both the Insurance (IFRS 4) and Liabilities (IAS 37) projects for the two to use a common measurement approach. Nevertheless, the IASB asked the Staff to explain in more detail how the modified IAS 37 model could be applied to insurance liabilities, given the steer towards a slightly different conceptual basis; this is expected to happen at the next meeting in July.

For example, IASB Members would like to know what additional Application Guidance might be necessary to implement this principle. It was suggested that a session at the next IASB meeting with the Staff on both the insurance and IAS 37 projects could help finalise this discussion.

One Board member suggested that, at the same time, the IASB Staff could also finalise the work on the nature of the margin for risk. In particular, the decision on whether the margin represents the entity's cost of capital or the entity's compensation for bearing the insured risk. The Staff noted that its research may conclude the two approaches produce substantially the same accounting result.

Current exit price

The Board agreed to no longer consider the CEP model as one of the measurement candidates, subject to appropriate modification to IAS 37. All but two Board members voted to remove this candidate from the list of measurement models.

The IASB has now reached a clear majority in favour of an accounting model which would not enforce market consistency on transactions that do not have a secondary market where accounting estimates could be reliably validated. This decision aligns the IASB to the same position held at the FASB.

In summary, the two remaining measurement models that the IASB will be discussing at its next meeting with the FASB are:

1. a measurement model that uses the IAS 37 approach to account for insurance contracts based on the amount that the insurer would rationally pay to be relieved of the remaining contractual obligations, calibrated to the net transaction price with the policyholder; and

2. a current fulfilment value with two building blocks (the present value of an unbiased current and probability weighted estimate of future cash flows) and a composite margin produced by calibrating to the net transaction prices.

Insurance project timetable

The Staff presented a revised project timetable suggesting the publication of the ED in April 2010, with a four months comment period and the publication of a final standard in July 2011. IASB Members were concerned that without an ED issued this year, current IASB Members would not have time to complete deliberations prior to the substantial rotation of IASB due on 1 July 2011 (at which time seven board members are due to retire, including Sir David Tweedie, the IASB Chairman). The Board requested that the ED is published no later than December 2009. The discussion did not cover the extent of the comment period for a December 2009 publication date and we understand that there is a widespread desire among several constituents to have a comment period of at least six months in view of the workload required for December year end reporting season.

We believe the position taken at the meeting displays a degree of commitment to complete the project; that is encouraging and should be welcomed. The Staff paper however highlighted that there are still several important details to discuss at both IASB and FASB (see *Deloitte IAN – Issue 4, Appendix 2*). We are concerned that, without a more generous allocation of time at the future Boards meetings, the practical aspects of dealing with the remaining details may overwhelm the best of intentions.

Field tests

The Staff proposed to undertake 'targeted field tests' to be completed before the ED is issued. This would allow the IASB and FASB to assess whether the proposals will achieve their objective and understand further how they would change current practice. The Staff expects to engage approximately 15 insurers (preparers), with follow-up involvement from user groups. Although the Staff had hoped to complete their work in advance of the ED being issued, they noted that following the explicit direction of the IASB to publish the ED by December 2009, not all work might be completed before then.

Next steps

The Insurance Working Group of the IASB met for a two-day meeting in London on 29-30 June. A very full agenda was discussed and we will report our understanding of this meeting in a special issue of the Insurance Accounting Newsletter.

In July the IASB will hold another discussion during the week commencing 20 July which will be followed by the joint meeting of IASB and FASB on 23-24 July to be held in London. At the time of issuing this newsletter the FASB has not announced the dates of its future meetings that will be used to discuss insurance contracts accounting.

Appendix: Summary of tentative decisions to date

Converging views	IASB & FASB	
Measurement approach	Basic features of measurement approach: • 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 has now rejected CEP. Yet to decide between updated IAS 37 model 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	• 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: • 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.

Deloitte Insurance contacts

Global insurance network

Joe Guastella
Global Insurance Leader
U.S.
+1 212 618 4287
jguastella@deloitte.com

Francesco Nagari
Global IFRS Insurance Leader
U.K.
+44 20 7303 8375
fnagari@deloitte.co.uk

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

Neil Harrison
Canada
+1 416 601 6307
nharrison@deloitte.ca

John Johnston
Bermuda
+441 292 1500
jojohnston@deloitte.com

Designed and produced by The Creative Studio at Deloitte, London. 31549