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Insurance Accounting Newsletter
Insurance global GAAP in the making

Since mid December it has been a busy few weeks for both the International Accounting Standards Board (IASB) and the American Financial Accounting Standards Board (FASB). Two key joint meetings were held, one on each side of the Christmas holiday with some very important decisions. On 16 December 2009 and 5 January 2010 the Boards re-confirmed their commitment to convergence and worked through their measurement model differences identified at the previous October meeting agreeing on new accounting principles that remove most of the fundamental differences they had identified in the summer months. This newsletter presents our own understanding of the discussions held at those meetings and their outcomes.

First FASB and IASB Joint Meeting – 16 December 2009

Insurance contracts will be out of the scope of revenue recognition for customers' contracts

Prior to the joint October meeting the FASB argued that accounting for an insurance contract should be in line with the principles being developed for revenue recognition, i.e. there should be no difference between the accounting treatment of a company selling insurance contracts and one selling goods and services. This argument rejected an explicit and active measurement of the uncertainty surrounding the probability distribution used to calculate the expected value of future cash flows. In line with accounting for revenue from goods and services sales, FASB had argued to adopt for insurance contracts an approach based on the allocation of the customer consideration. Another important corollary of this view discussed in our last newsletter was the decision to expense upfront the acquisition costs without any contextual revenue recognition from the premium receivable.

Following the acknowledgement at the October meeting that the customer consideration allocation approach may not produce useful financial information for insurance contracts, Staff worked through the application of the revenue recognition model to insurance and presented some slides effectively demonstrating that this model does not fit well with the uncertain nature of the insurance contract's cash flows.

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The majority of the FASB members were persuaded that the building blocks measurement approach produces more relevant, transparent and understandable financial information. At the December 2009 meeting FASB decided to align the future US GAAP for insurance to the IFRS proposals derived from an active measurement of all the three building blocks.

The Staff demonstrated that the revenue recognition model is not suitable because the performance obligation is not remeasured unless the contract is onerous. In contrast, under the explicit building blocks approach the performance obligation is always remeasured to reflect the changes in circumstances. Hence when the circumstances change, the building blocks method produces a more relevant and understandable measure of the underlying economics.

The simple example used by the Staff illustrated that just a simple change in one assumption (e.g. one policyholder survives an extra year) results in revenue and profit fluctuations that are not in line with the underlying economics. The revenue recognition and profit pattern based on the allocation of the consideration received for each insured event used to allocate revenue was different from the total expected cash flows, even though over the four year period the overall net result was the same (excluding the effects of discounting).

These illustrations allowed the Board members to appreciate the shortcoming of the allocation method against the full active measurement of expected cash flows proposed by the IASB.

The Boards appeared to have also accepted that the substance of an insurance contract is in fact different from that of a service contract. It was suggested that an insurance contract could blend as many as four different elements: service (e.g. the asset management service provided to pension insurance policyholders), protection, investment and derivative. Each insurance contract combines these elements in different ways, making it difficult to analyse insurance as purely a service contract or purely a financial instrument.
The Staff suggested that, also in the handling of the multiple element nature of insurance, the building blocks measurement approach copes better with the complexity and interdependence of the insurance contract cash flows than an allocation approach.

If I give something to you will you give something to me?
The compromise on margin

Having reached a joint view that the revenue recognition model is unsuitable for insurance risk volatility, the Boards tentatively agreed on the following wording for the measurement objective of the new accounting standard:

"A reporting entity should measure an insurance contract equal to its current estimate of the cost to fulfil the present obligation created by the contract.
A reporting entity should estimate that cost using:

i. the unbiased, probability-weighted estimate of future cash flows expected to arise as the insurer fulfils the obligation;

ii. the time value of money;

iii. a risk adjustment reflecting the effects of uncertainty about the timing and amount of future cash flows; and

iv. the residual margin to eliminate any positive day one difference."[1]

The Boards also re-affirmed that when applying the present value techniques the entity should use observable market prices for market variables.

For non-market variables the insurer should use all available data, both internal and external, giving weight to those information sources that are more relevant in the circumstances.

The members vote presented a majority of 9 IASB and 3 FASB members. For the FASB this is a slender but sufficient majority.

Similar to the FASB decision to abandon a strict alignment with revenue recognition accounting, the IASB accepted dilution of its ambition to maintain strict consistency with the measurement principles developed in its project on general liabilities for which it has published an exposure draft on 5 January 2010 (revisions to IAS 37).

The new draft of IAS 37 proposes that an entity measures its obligations at the lowest amount the entity would rationally pay to extinguish it. This measure, as we discussed in the previous newsletter, included the notion of exit price, as the value a third party would demand to accept the transfer of the obligation and the commutation to the party towards whom the obligation is due.

[1] IASB and FASB Staff paper 7A, December 2009

The insurance measurement model agreed in December solely focuses on the entity specific estimates of future cash flows, as emphasised by the word 'its' in the measurement objective and represents the amount required to fulfil the obligation. All references to other IAS 37 values have been removed in response to FASB criticism.

While the IASB agreed to remove residual references to exit price, FASB agreed to accept the inclusion of a risk adjustment as an explicit element of the measurement model.

The model under both IFRS and US GAAP will include a margin split into two elements: the risk adjustment to reflect the uncertainty of the probability distribution of the estimated cash flows, which is remeasured at each reporting date, and the residual amount recognised when the comparison of the other actively measured blocks to the gross consideration receivable produces a positive difference. Both Boards had agreed in October that the new accounting model would prohibit the recognition of accounting profit at initial measurement. At their December meeting they agreed that the residual margin would be calculated as the residual difference with a value comprising three actively measured building blocks.

The alignment of the two models was complete as the IASB accepted to remove from the accounting standard their prior requirement of a separate service margin for future expected profits on all services sold by the insurer other than the obligation to stand ready to meet claims. This profit element would now be captured within the residual margin without a requirement for separate disclosure.

Risk adjustment – what should it capture?

One of the FASB objections to the separate measurement of the risk adjustment was that there is no such requirement when the full probability distribution is reflected in the first building block. The debate during the last few months has led the FASB to accept that a liability of CU100 certain of being paid is less onerous than a liability with an expected probability weighted average of a CU100 and an uncertain outcome. That difference could only be captured by an additional separate liability: the risk adjustment. The long term nature of many insurance contracts, the degree of uncertainty and the need for a current measure reflecting changes in cash flow expectations make a separate risk adjustment measure more important in the case of insurance contracts than any other obligations. Having abandoned the objective to fit insurance in the generic revenue accounting model, the FASB accepted that for the inherent uncertainty of insurance to be faithfully represented in the financial statements, it should be reflected in the separate risk adjustment, as proposed by the IASB.

The Staff originally recommended including the principle that the risk adjustment measures the price an insurer would pay to be relieved from the risk of the estimated uncertain cash flows. However at the end of the debate this proposal had changed to a principle that would require this adjustment to be defined in terms of its role to reflect the uncertainty in the distribution of insurance contract cash flows that is not captured in the value of discounted expected cash flows, and that it should reflect changes in such uncertainty over time. The vote in favour of this key principle was a majority of 9 IASB and 4 FASB members.

A key open issue on the measurement of the risk adjustment that has not yet been discussed in any detail is the definition of the relevant unit of account. The IASB discussion paper proposed to measure the risk margin on a portfolio basis where the portfolio was defined as a group of insurance contracts sharing broadly the same risk characteristics (homogeneity test) and that are managed together as one portfolio (management test). However that definition may now change and, with a renewed focus on entity specific estimates, the risk adjustment may be based at the level of the reporting entity itself.

Earning the residual margin – the new profit pattern has not been agreed yet

The residual margin is the amount that initial calibration creates when it needs to eliminate a possible accounting gain. When calibration produces a negative difference that amount is immediately recognised as a loss consistently with the treatment of any onerous contracts leaving only three building blocks in the resulting insurance liability. This day 1 loss does not include the impact of acquisition costs that will always be expensed, as these do not form part of the insurance contract's initial calibration.

The Boards have yet to agree on the IASB tentative model to release the residual margin. This will be discussed in one of the next meetings.

Second FASB and IASB Joint Meeting – 5 January 2010

As promised in their strategy meeting in November last year, the two Boards started the new year with additional meetings that should assist them with the ambitious convergence programme they have decided to undertake over the next 18 months.

Needless to say that insurance was on the table for the first of these additional meetings bringing back for discussion most of the papers that were not covered in the December 2009 joint meeting:

- embedded derivatives;
- unbundling; and
- presentation of insurance contracts in the income statement.

Embedded derivatives

The Staff argued that the new accounting standard should not require a separate recognition of embedded derivatives at fair value, applying instead the same measurement approach to the embedded derivative cash flows as to the rest of the insurance contract, i.e. the building blocks approach.

The view is that there is little benefit in bifurcating embedded derivatives and measuring them at fair value because the measurement model already reflects a current measure of all observable financial variables.

The differences with the current fair value model would be: use of entity specific measures for non-market variables, exclusion of the entity's own credit risk and the impact of using residual margin to prevent the recognition of a day-1 accounting gain. These differences were not considered by the Staff to be significant enough to justify bifurcation, compared to the cost and effort involved.

However the debate that unfolded at the joint meeting did not lead to a confirmation of the Staff recommendation and the Boards decided to address this topic at a future meeting.

Unbundling

The Staff presented this matter highlighting that the proposals deliberately excluded the treatment of pre-claims insurance liabilities as a separate part of the total liability, as well as the treatment of funds under management for unit linked and other similar contracts. These will be considered in a separate discussion.

The Staff proposal to require unbundling for components of an insurance contract that are not interdependent and to prohibit unbundling for recognition and measurement if the components are interdependent, was approved by the Boards.

Consideration of whether unbundling should be prohibited for presentation if not required for recognition and measurement was deferred until the Boards have discussed further the proposals on presentation of insurance contracts.

However, the official record of the two Boards uses different emphasis to report the outcome of the decision with the IASB endorsing the Staff proposal that the insurer should:

- "unbundle a component of an insurance contract if it is not interdependent with other components of that contract; and
- not unbundle a component that is interdependent."[2]

The IASB has also helpfully agreed with its Staff that it would expect this requirement to have an infrequent application.

The FASB set a series of conditions to its approval of these principles and asked the FASB staff to present a new paper that explains how "unbundling for recognition and measurement relates to (a) the definition of an insurance contract and the scope of the proposed standard, (b) the presentation models for the performance statement, and (c) bifurcation of embedded derivatives."[3]

Presentation

The discussion on how to present premiums and claims in the income statement is a delicate matter that has, to date, engaged the Boards in a number of discussions. At this meeting they considered the basis on which revenue should be reported.

Staff developed two principles:

- to recognise revenue on an earned basis instead of a written basis;
- to report as revenue only the part of the premium that relates closely to the insurance coverage and other services provided under the contract (i.e. not to recognise as revenue those premiums that are expected to be repaid to the same policyholder).

Although the recognition on earned basis would be a change to the current accounting practice for life insurance contracts, it would result in all insurance contracts being accounted for consistently. The second principle is aimed at accounting for investment elements of an insurance contract.

[2] IASB Update, January 2010
[3] FASB summary of decisions, January 5th 2010

The earned basis was approved by a nearly unanimous majority (only one IASB member voted against it).

The debate continued without reaching new decisions and analysed the merits of three revenue presentation methods that apply the earned basis:

- Earned premium method as currently applied by several non-life insurers may be appropriate if the deposit component of an insurance contract is relatively small.

- An unbundled (fee-based) approach that would be applicable if the insurance contract has elements that require unbundling.

- A 'margin model' or 'expanded margin model' that would recognise as revenue the release of residual margin and apply to all types of insurance contracts. This approach depends on the accounting for residual margin that has not yet been finalised. Additionally the revenue under this method would not equal gross consideration received, departing from current IASB and FASB revenue recognition requirements if the Boards decided to continue their attempts to align the insurance accounting standard with that applicable to the sale of goods and services.

IASB meeting – 15 December 2009

Assets backing insurance liabilities and OCI presentation for changes in insurance liabilities

Prior to the December joint meeting the IASB alone met to agree nearly unanimously (one member abstained) that the new insurance standard should not prescribe accounting for assets held to back insurance liabilities.

Some respondents to the IASB discussion paper suggested that insurers should be required or permitted to report some or all changes in the insurance liability in OCI to avoid accounting mismatches and reporting of short term volatility. The accounting mismatches arise because some assets backing insurance liabilities are remeasured through the OCI reserve (e.g. available-for-sale assets).

However, under the new IFRS 9 only equity investments can be remeasured in OCI with no recycling to profit and loss on disposal and with separate recognition of dividends in the profit and loss. Therefore some accounting mismatch will remain when this new pronouncement is effective in 2013.

Staff pointed out that IFRS 9 gives the reporting entity the option to designate such assets at fair value through profit and loss avoiding the mismatch, and the option to re-designate is available on transition. Using the fair value option was argued to be less complex than trying to identify which assets back which liabilities, tracking them and then deciding when to release the OCI amounts to profit and loss.

Another suggestion from the comment letters to the IASB discussion paper was to report through OCI changes of insurance liabilities due to short term fluctuations in a similar approach to that currently used for pension accounting.

The Board agreed with its Staff that the new IFRS would not include either recommendation from the comment letters.

Timetable

At the joint meeting on Tuesday 19 January 2010, a new timetable will be discussed. The Staff has proposed a delay of the Exposure Draft publication date from April to May 2010 with a comment period ending in September of the same year.

Together with this paper the upcoming joint meeting will cover the issues of subsequent measurement of the risk adjustment and the residual margin and the implications of policyholder behaviours on the accounting for cancellation and renewal options.

Appendix: Summary of tentative decisions to date

Converging tentative views	IASB & FASB
Measurement objective and approach	Current assessment of the insurer's obligation using four building blocks: • the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation; • incorporation of time value of money; • a 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.
Service margin	An explicit remeasured service margin is not included in the measurement approach.
Use of inputs for measurement	Consider all available information relevant to contract fulfilment and use current estimates of financial market variables as consistent as possible with observable market prices.
Non performance risk	Measurement should not be updated for changes in the risk of non-performance by the insurer.
Accounting profit	Prohibition from recognising accounting profit at initial contract recognition.
Acquisition costs accounting	Expense as incurred through income.
Revenue Recognition on Day 1	No revenue recognised at initial measurement since the liability is calibrated to the gross premium receivable from the policyholder.
Policyholder accounting	The Boards will reconsider the earlier decision to exclude policyholder accounting from the forthcoming ED, after the submission of a new paper on this topic.
Presentation	Rejection of a model that recognises revenue on the basis of written premiums (rather than recognising revenue as the insurer performs under the contract).

Divergent tentative views	IASB	FASB
Insurance contracts with participation features	Participation features should not be measured separately from the host insurance contract.	Participatory features should only be classed as liabilities when they meet the definition of a liability, particularly in relation to whether there is a legal or constructive obligation to pay.
Recognition	The IASB declined to make a final decision on recognising insurance contracts, instead asking the staff to perform additional analysis and provide fact patterns at a later meeting.	An insurance obligation should be recognised at the earlier of (1) the entity being on risk and (2) the signing of the insurance contract.
Derecognition	Derecognition of insurance liabilities should follow the IAS 39 criteria.	An insurance liability should be derecognized when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.
Unbundling	For recognition and measurement, an insurer should: • unbundle a component of an insurance contract if it is not interdependent with other components of that contract; • not unbundle a component that is interdependent.	If unbundling is not required for recognition and measurement, it should not be a permitted option. The FASB asked staff to clarify further how unbundling for recognition and measurement relates to: (a) the definition of an insurance contract and the scope of the proposed standard; (b) the presentation models for the performance statement; and (c) bifurcation of embedded derivatives.

Recent changes

IASB tentative decisions not yet discussed by FASB	
Discount rates	Principles based approach, based on liability characteristics (currency, duration and liquidity).
Unearned Premium Method	Requirement to use the unearned premium method to account for the pre-claim liability for all contracts which meet all of the following conditions: • cover 12 months or less; • no embedded options or guarantees; and • the insurer is unlikely to become aware of events which could result in significant decreases in the expected cash outflows.
Policyholder behaviour (to be discussed on 19 January 2010)	• 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 (to be discussed on 19 January 2010)	An existing contract terminates when the insurer has an unconditional right to re-underwrite/re-price that individual contract.
Deposit Floor (to be discussed on 19 January 2010)	Include in the first building block all the cash flows arising from the cancellation or the renewal options, i.e. no deposit floor.
Negative day one differences (to be discussed on 19 January 2010)	Recognise negative day one difference immediately as a day one loss.
Subsequent treatment of margins (to be discussed on 19 January 2010)	The residual margin will be earned over the coverage period, in a systematic way that best depicts the insurer's performance under the contract. Its release to profit will be independent of changes in the three-building-blocks.

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