Deloitte.

Insurance Accounting Newsletter
The road to convergence

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have started the year in full swing with two intense joint meetings having already taken place in January followed by an important FASB-only meeting that removed another major obstacle on the road to convergence for insurance accounting.

We reported on the first joint meeting in our January issue and this newsletter presents our understanding of the discussions held in the three hour long meeting of 19 January and their outcomes, and the subsequent FASB meeting on 27 January. Although a few issues remain unresolved, the long awaited exposure draft is finally taking shape and it can now be expected in May.

Refining the new accounting model

The Boards approved the principle that the new accounting standard should produce a single amount in the balance sheet, by combining the net cash flows into one carrying amount.

The principle in the new standard will express this in terms of current fulfilment value as a reference to the value of the fulfilment obligation rather than its cost.

That is an important conceptual distinction which the Boards were very keen to clear up, particularly to have the basis for the separate risk adjustment liability and also to explain the inclusion of future profits in the residual margin component of the insurance liability.

The Boards also reiterated their preference to define the risk adjustment as the liability which reflects the uncertainty of the underlying estimate and that the adjustment should be remeasured at each reporting period.

Net rights and obligations basis for measurement and presentation

The first recommendation the Staff put forward concerned whether the measurement basis of the insurance contract should be applied to the overall contact or separately to its gross rights and obligations. The issue is whether one should look at the contract as a bundle of rights and obligations and measure those as one unit of account or measure the obligation on one side, representing that as a liability, and account for the rights under the contract as an asset.

Issue 11 – February 2010

There was extensive debate around this idea and a minority of the IASB members, who had opposed the majority decision on policyholder's behaviour and cancellation options, took the opportunity to state their disagreement with the notion that the insurer has a right to premiums under the policy if the policyholder is able to cancel the contract at any time.

In a similar vein, some members from both Boards were concerned that using a net basis for the measurement could produce debit positions for contracts that are normally perceived as liabilities. Again, the majority of the IASB members explained they did not share the same concerns and, at the time of the joint meeting, the FASB members had yet to discuss at length this particular issue. However, we must remember that both Boards have recently agreed that insurers will have to calibrate the initial measurement of the insurance contract to the gross premium receivable. The FASB subsequent discussion (see below) on the accounting for cancellation options has now brought both Boards on to the same conceptual basis.

Our understanding of the practical application of this calibration regime is that on day one it will always generate a liability, even if significant additional premiums or other contractual inflows are expected, i.e. a credit balance. At the point of issue and when acquisition costs are bigger than the initial premium, we believe that the possibility of a debit balance is possible only when calibration is made against a premium net of acquisition costs. The use of a net consideration was the position that the IASB abandoned last October in favour of the gross consideration approach.

The vote on the Staff recommendation to measure the three building blocks on a net rights and obligations basis resulted in a clear majority of both Boards in favour (IASB – 13 in favour, 2 against; FASB – 3 in favour, 2 against).

The Boards then unanimously approved the Staff recommendation to have one single figure presented on the balance sheet of an insurance company.

Measurement objective – cost or value of the obligation to fulfil?

The Staff proposed that the definition of the measurement objective of the new accounting standard should refer to the notion of value, rather than the notion of cost of fulfilment. The recommendation is for the new standard to use the following words: the measurement of an insurance contract should reflect "an entity's current estimate of the present value of resources required to fulfil the net obligation created by the insurance contract".

The present value is calculated as the mean probability of the distribution of future cash flows. In addition, the risk adjustment component is added to the present value.

The Boards agreed with the Staff that the objective of measuring an insurance contract should reflect the value rather than the cost, although they would like to see the wording refined, before the exposure draft is published, to reflect more clearly the risk adjustment building block. Some Board members suggested reconsidering the word "resources", which is thought to be difficult to understand and for which providing a reliable and consistent application in practice would be problematic.

Risk adjustment definition

The Staff's recommendation defined the risk adjustment as "the amount the insurer requires for bearing the uncertainty about the resources it will require to fulfil the (remaining) net obligation from insurance contracts".

Some of the FASB members noted that this proposal could offer too much freedom of choice for the valuation technique that insurance companies would use to measure this adjustment. They would prefer the final text in the exposure draft to contain a tighter definition that could deliver substantial consistency of valuation among companies.

Some Board members expressed their preference for using option pricing models to value the risk adjustment for insurance contracts. This was not a position supported by the majority of both Boards, and it was explained that with the use of an option model to measure the risk adjustment, there is a high risk that the result may not be as reliable as using the three building blocks. Moreover the additional cost of implementing a proper option model would not be justified by its perceived limited additional reliability. The Staff noted that the principles of current measurement and use of current market prices contained within the three building blocks model are aligned with option pricing models.

The FASB discussed further the use of option pricing models as a component of the insurance contract measurement approach for cancellation options at its meeting on 27 January and asked the Staff to prepare additional analysis as to whether an option pricing model could be used to measure insurance contracts. The FASB will consider this point further in its discussion about risk margins as well.

The two Boards were generally supportive of the notion of risk adjustment as presented by the Staff and they approved the recommendation with a small majority (IASB: 8 in favour, 7 against – FASB: 3 in favour, 2 against).

The Boards also took the opportunity to state that this notion should be applied irrespective of whether the insurer intends to retain or transfer the contracts. This reconfirms quite clearly that the Boards have now definitely moved away from any attempt to re-introduce an exit price notion in the insurance accounting standard and instead, are steadily converging towards an entity specific fulfilment value model.

Remeasurement of the risk adjustment

Both Boards ratified the decision that the risk adjustment is a component of the liability that cannot be locked-in and has to be remeasured at each reporting date.

Policyholder behaviour, options to cancel/renew the contract and deposit floor

The IASB reconfirmed for the third time its preference for a look through approach on the renewal and cancellation options, with no deposit floor. The FASB did not reach an agreement with the IASB on these points at the joint meeting however, at its meeting on 27 January, the FASB tentatively agreed with the IASB on these points subject to further consideration of the IASB definition for the boundary of an insurance contract.

How to account for policyholder options?

The Staff's recommendation was to measure the options on a look through basis using the expected value of future cash flows related to the option, with the consequence that no deposit floor would apply. This essentially maintains the same valuation basis that has already been agreed for all non-optional cash flows. The IASB had already confirmed at its May and October 2009 meetings its decision to support this particular approach.

At the joint meeting, the implication on the deposit floor had not been appreciated fully and the FASB appeared once again on the path to divergence.

However at its meeting on 27 January the FASB reached agreement with the IASB on these points, subject to further consideration of the boundary of an insurance contract.

The previous week, one IASB member concerned with the "no deposit floor" decision asked for another vote to be taken which re-confirmed that that the majority of the IASB members are in favour of the "no deposit floor" approach.

Other options, forwards and guarantees included in an insurance contract

The Staff recommended the principle that only the options that are related to the existing contractual coverage of the existing insurance contract should be considered in the look through basis and included in the measurement of the existing insurance contract. All other options, guarantees and forwards, not related to the existing coverage, cannot be taken into account in the three building blocks for the existing contract. These other options will form part of a separate contract that will be accounted for according to the terms of that separate contract.

There was a clear majority in favour of the Staff's recommendation from both Boards.

Residual margins – a steady stream of profits

The Boards asked the Staff to develop a specific release pattern which would be imposed on all contracts, resulting in a much more narrow accounting policy choice for insurers in relation to the profit signature that would emerge from the release of residual margins.

However, the Boards agreed with the Staff that changes in the three building blocks will always be recognised in the profit and loss, with the release of residual margin to profit or loss not affected by the changes, whether positive or negative, in the three building blocks.

Negative day-one differences

The residual margin is that portion of the liability that is created at initial measurement when the three building blocks are calibrated against the premium receivable and the calibration produces a positive difference.

The Staff was keen to confirm with the Boards what the accounting treatment should be when such a difference is negative. Although the Boards had already agreed in December on the recognition of a loss in that situation, it was a necessary step from a procedural perspective, to have this confirmed.

There was a unanimous decision in favour of the Staff recommendation from both Boards. However, the Staff was asked to clarify how to establish the existence of such a day-one loss and in particular, the unit of measurement for the day-one calibration. The Staff confirmed that this aspect would be dealt with in a future paper that will debate unit of measurement general principles for application of the unit of account within the new accounting standard for insurance. It is noted on the agenda for one of the joint meetings scheduled for March.

Subsequent release to income statement

The Staff 's recommendation, already supported by the IASB at a previous meeting, is that insurers should select an accounting policy for recognition of the residual margin in the income statement that reflects the characteristics of the margin and the performance obligations relevant to the nature of its insurance contracts.

The Staff was asked how this principle would apply in practice and what the impact of this principle would be on an insurance contract that contains a substantial savings component, such as a whole life policy. The Staff suggested that an insurer may be likely to develop a residual margin release policy that would be based on the assets under management, rather than release from risk that is already taken into account by the risk adjustment. Furthermore, within existing current accounting practices, the Australian Margin on Services would be an example of a possible application of this principle.

The majority of Board members expressed strong concerns and recommended that the Staff revisit the recommendation which appeared over complicated by allowing different practices to emerge. They also felt that the new insurance accounting standard would need to contain a more prescriptive principle that is consistently applicable across different insurers. During the debate, one of the Board members even expressed a preference for using a very simple straight line basis for releasing the residual margin. The Boards therefore voted against the Staff's recommendation and asked the Staff to prepare a new paper that sets out a more prescriptive principle for the release of the residual margin.

Because of the above decision, the Staff's recommendation relating to the period of release of the residual margin was not voted on. The recommendation was for the residual margin to be released to income over a period that follows from the driver selected by the entity for releasing that margin. The Boards will decide on this matter after the new paper is produced on the release pattern of the residual margin. It is worth noting that the IASB has already approved at a previous meeting, when discussed on a standalone basis, that the residual margin should be released over the coverage period of the contract.

Changes in expected present value of cash flows

The Staff paper proposed three approaches to address subsequent changes in the residual margin when the expected present value of cash flows also changes:

- Approach A: keep the release pattern of the residual margin unchanged.

- Approach B: the residual margin is adjusted to absorb positive/negative changes in cash flows that do not arise from changes in financial market variables (a shock absorber).

- Approach C: the residual margin is adjusted as a fixed proportion of the amount representing the expected cash flows.

The Staff rejected approach C as one that does not produce relevant information. Both Boards agreed with the Staff conclusion and focussed their debate on the choice between approaches A or B.

The staff paper noted that approach A has the benefit of reflecting changes in estimates in the underlying cash flows immediately in P&L thus providing information to users about those changes. However, it may result in an insurer continuing to recognise residual margin that is no longer expected to emerge from insurance contracts where there have previously been adverse changes in the expected cash flows.

Most comments were in favour of approach A i.e. to keep the release pattern of residual margin unchanged where there are changes in the expected cash flows. The IASB had tentatively voted in favour of approach A at its September meeting and re-confirmed that decision as both Boards voted with a clear majority in favour of approach A (IASB: 9 in favour, 6 against – FASB: 4 in favour, 1 against).

Timetable

The Staff has proposed to delay the publication date of the Exposure Draft from April to May 2010, with the comment period remaining in September of the same year.

There are two joint meetings scheduled for February. The Staff paper notes that, reinsurance, policyholder accounting, unbundling, embedded derivatives, presentation, policyholder participation and specific examples of participating contracts are due to be discussed in February and further issues are scheduled for March.

The Staff paper was not discussed at the meeting but Sir David Tweedie noted that the timetable is tight and asked the Staff to schedule an appropriate number of meetings to meet the timetable. Although there are still many issues to debate the Boards are committed to delivering an insurance accounting standard no later than June 2011.

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.
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. The Staff is to propose further refinement of the measurement objective wording.
Risk adjustment	The risk adjustment is defined as the amount the insurer requires for bearing the uncertainty about the resources it will require to fulfil the remaining net obligation from insurance contracts. The risk adjustment will be remeasured at each reporting date.
Service margin	No explicit service margin is included in the measurement approach.
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.
Non performance risk	Prohibition from taking changes in the insurer's non-performance risk (including own credit risk) into account in subsequent measurement of the insurance contract.
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. Further discussion planned to establish the appropriate unit of measurement.
Acquisition costs accounting	Expense as incurred through the income statement.
Revenue Recognition on Day 1	No revenue recognised at initial measurement since the liability is calibrated to the gross premium received from the policyholder.
Policyholder accounting	The Boards will reconsider the earlier decision to exclude policyholder accounting form 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. 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.
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.
Subsequent treatment of margins	The Staff is to determine and recommend a simple mandatory basis for the release of residual margins. The Boards rejected the recommendation previously tentatively agreed by the IASB that the residual margin be released over the coverage period, on a systematic basis, as determined by the insurer, that best depicts the insurer's performance under the contracts. The release of residual margin to profit will be independent of changes in the value of estimates within the three-building-blocks.

Recent changes

Divergent tentative views	IASB	FASB
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.	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. The staff are to provide additional analysis 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.

	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.
Contract boundary	An existing contract terminates when the insurer has an unconditional right to re-underwrite/re-price that individual contract.
Risk margins	Although the IASB has decided not to use option pricing models to measure insurance contract liabilities, the FASB wish to consider it further.

Recent changes

Deloitte Insurance IFRS Contacts

Global IFRS Insurance Leader
Francesco Nagari
fnagari@deloitte.co.uk

Tax Services
Cathy Lynch
clynch@deloitte.co.uk

Life Accounting
Alex Arterton
aarterton@deloitte.co.uk
Desire Lan
dlan@deloitte.co.uk

Non-Life Accounting
Andrew Downes
adownes@deloitte.co.uk
Roy Shayahama
rshayahama@deloitte.co.uk

Life Actuarial Services
Derek Wright
derwright@deloitte.co.uk
Marylène Lanari-Boisclair
mlboisclair@deloitte.co.uk

Non-Life Actuarial Services
David Hindley
dhindley@deloitte.co.uk
Shreyas Shah
sshah@deloitte.co.uk

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

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in 140 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's 150,000 professionals are committed to becoming the standard of excellence.

Deloitte's professionals are unified by a collaborative culture that fosters integrity, outstanding value to markets and clients, commitment to each other, and strength from cultural diversity. They enjoy an environment of continuous learning, challenging experiences, and enriching career opportunities. Deloitte's professionals are dedicated to strengthening corporate responsibility, building public trust, and making a positive impact in their communities.

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms.

This publication contains general information only and is not intended to be comprehensive nor to provide specific accounting, business, financial, investment, legal, tax or other professional advice or services. This publication is not a substitute for such professional advice or services, and it should not be acted on or relied upon or used as a basis for any decision or action that may affect you or your business. Before making any decision or taking any action that may affect you or your business, you should consult a qualified professional advisor.

Whilst every effort has been made to ensure the accuracy of the information contained in this publication, this cannot be guaranteed, and neither Deloitte Touche Tohmatsu nor any related entity shall have any liability to any person or entity that relies on the information contained in this publication. Any such reliance is solely at the user's risk.

© Deloitte Touche Tohmatsu 2010. All rights reserved.

Designed and produced by The Creative Studio at Deloitte, London. 2336A