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Insurance Accounting Newsletter
Steady, if slow progress

After another long week of joint meetings during the month of April, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have prepared the ground for a last attempt to resolve the major disagreements between them. Officially moving the date of the exposure draft (ED) publication to June was the price to pay for the divergence in opinions between the Boards. The Boards did manage to make some progress and many important decisions have been reached. However, in our opinion, the complexity of the remaining issues still makes the June deadline look optimistic.

At their previous meetings, the Boards had spent time developing the foundations for a composite margin model with the aim of allowing for a meaningful comparison against the two-margin approach, also considered previously (explicit risk adjustment and residual margin). The Boards will compare the merits of these two models at the May meetings. Although there is uncertainty on the final choice for how to address margins, agreement was reached in many areas that would affect the recognition and measurement of margins, regardless of whether a single composite margin or an explicit risk adjustment is chosen.

One important step forward in April has been the Boards' agreement on the subject of discounting, i.e. the second building block in the measurement model for insurance liability. The Boards have tentatively agreed that;

- the discount rate should not reflect the characteristics of the assets backing the liabilities;
- the discount rate should reflect the characteristics of the contracts, and be based on risk-free rate plus an illiquidity premium; and
- for participating contracts only, the dependence between the liability cash flows and the performance of assets should be taken into account in the measurement.

In addition, the IASB reached an agreement on the principles to define contract boundaries and accepted the initial recognition approach developed by FASB.

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Composite margin approach model taking shape

At their previous meetings, the two Boards had come to reach different views regarding the approach to margins. Despite both Boards agreeing that no day one profit should be recognised (and a day one loss to be recognised immediately through profit and loss), they disagreed on how the calibration exercise should be done on initial measurement (i.e. at inception) to obtain that zero profit.

The IASB supports using an explicit risk adjustment that represents "the amount an insurer would rationally pay to be relieved of the risk". Although the FASB agrees in principle with the objective of the risk adjustment, it prefers to adopt a composite margin which implicitly includes both the risk adjustment and the residual margin. In an effort to avoid artificial accounting losses on day one, the IASB voted in favour of a calibration exercise that uses a consideration (i.e. premium) net of acquisition costs. The FASB on the other hand does not want to recognise the acquisition costs as revenue on day one and therefore favours a calibration that uses a gross consideration.

These two key differences are being tabled one more time for resolution in May and the Staff was asked to further develop the composite margin model to enable a comparison between that and the explicit risk adjustment approach.

As for the residual margin in the IASB preferred model, the composite margin is calculated to eliminate any day-one gain and arises on initial recognition as a difference between the expected value of the estimated gross premiums (in IASB model net of incremental acquisition costs) and the discounted unbiased estimate of the insurance contract out flows.

In the interest of moving the project forward, Board members were asked in April to decide on the characteristics of the composite margin approach, ignoring the fact that another model is being considered (i.e. explicit risk adjustment). The decision making process started with a unanimous agreement that contracts which are onerous at inception should have the loss recognised immediately in the profit or loss, resulting in no composite or residual margin.

Having been presented with two alternatives for releasing the composite margin to income, the Boards considered subsequent measurements.

Both the IASB and FASB rejected the proposal of selecting a "rule based" driver for the release of the margin and were unanimous in supporting a principle-based approach that would release the margin over the coverage and claims handling period, unless a pattern exists that better reflects the insurer's release from risk. The Staff was asked to develop more detailed guidance on the subject.

Decisions applicable to both composite and residual margin

A number of Staff recommendations were equally applicable to the composite and residual margins. Having postponed the selection of the approach, the Boards considered the issues common to both alternatives.

A large majority of the Boards' members agreed with the Staff recommendation to recognise the margin as part of the overall insurance contract liability, rather than as a separate liability. Only two members were in favour of recognising the margin separately on the balance sheet because of its 'deferred income' nature and argued it does not arise from fulfilling the insurance obligation. However, the fact that the recognition and measurement of the residual/composite margin are intrinsically tied to the other elements of the insurance liability appeared to be a more persuasive argument.

This decision confirms the overall IASB and FASB view that the insurance liability should be presented on the balance sheet as a single number reflecting all cash flows under the contract on a net basis. The Boards voted unanimously to require disclosures about the residual/composite margin with the view that it would provide useful information.

The issue of whether interest should be accreted on the composite/residual margin was brought back for discussion. Because the margin is derived from discounted amounts, the Staff recommends that interest be accreted to allow for the unwinding of the resulting interest, hence the proposal to accrete interest on the margin. The majority of the IASB members agreed with this proposal (10 in favour, 4 against). IASB members against the proposal argued that the margin is mostly a day-one calibration effect and since there is common agreement not to re-measure the margin, it should not accrete interest either. The FASB voted unanimously against accruing interest on the margin for that same reason.

Discounting

The Staff asked the Boards to express their preference between two approaches for the discount rate, which were to either:

a) adjust future cash flows for the time value of money in a way that captures the characteristics of the rights and obligations from the insurance contract, without capturing the characteristics of the assets actually held to back those insurance liability, unless the liability does share those characteristics; or

b) require the use of a high-grade corporate debt rate.

The Boards articulated quite clearly that there was no appetite to require the use of a high-grade corporate bond rate. Their view is that it would be too prescriptive, it would overlay a proxy for own credit risk that may not reflect economic reality and that certain jurisdictions may not have deep and liquid markets with high-grade corporate bonds that could be used for accounting purposes.

A number of IASB and FASB members expressed a preference for the discount rate to include an own credit risk spread, although this did not achieve majority. The Boards unanimously agreed that the discount rate objective should be as proposed by the Staff, and that the discount rate should reflect the duration, currency and the degree of illiquidity from the liability cash flows. The Exposure Draft will however ask specific questions to commentators on the subject of credit risk.

As for the inclusion of an illiquidity premium in the discount rate, some members expressed concern that there currently is no agreed methodology for determining this adjustment and that it may lead to inconsistency and lack of comparability between market participants. These concerns did not prevent them however supporting the Staff proposal. Required disclosures are expected to help users of accounts to understand the effect of the illiquidity premium and the sensitivity of the liability to this assumption.

When discussing the Staff's proposals around participating contracts and how these should be affected by the asset performance, the FASB questioned the relevance of that issue in the context of the "discount rate" discussion. Some Board members considered this question should be discussed in the context of determining the cash flows rather than the discount rate.

The benefit cash flows will be affected by the asset performance rather than the discount rate itself however, the Staff was seeking confirmation from the Boards that the liability for this type of business would have to bear some relation to the asset performance and the Boards agreed with this in majority. Replicating portfolio techniques were also discussed and the Staff explained that, if a portfolio of assets that exactly matches the liability cash flows could be identified, then it could be used to value the liability instead of the building block approach. The Staff pointed out that the non-market risks contained in the insurance liability makes rare the situation where it can be replicated by an asset portfolio.

Board members all agreed to include the full relevant guidance to determining the discount rate in the body of the ED as opposed to cross-referencing to the existing guidance from other standards, such as the fair value one.

Contract boundaries (IASB only meeting)

The topic of contract boundaries was addressed and the IASB unanimously approved the principle put forward by the insurance industry groups and regulators although they asked the Staff to re-word the proposal presented in the paper. The Boards thought the wording proposed was too wide and that the "unrestricted ability to re-underwrite" would mean that limited restriction on the re-underwriting would be sufficient to recognise renewals within the contract boundary. The Boards therefore asked the Staff to tighten the wording to better capture the underlying principle that emerged from the debate and agreed that the outline of contract boundaries should be based on the following principles:

- the ability of the insurer to unilaterally cancel the contract; and

- the ability of the insurer to re-price the contract to reflect the current assessment of insurance risks applicable to a specific policyholder.

Having agreed on the above principles for contract boundaries, the discussion moved on the development of the application guidance for those instances where the insurance contracts offer 'no claims' bonuses or include formulae driven adjustments to premiums. These types of adjustments assess the risk for various groups of policyholders and then, based on the individual experience, place the policyholder into a particular group potentially triggering a change in premiums. The Staff will investigate this issue further.

Recognition (IASB only meeting)

The IASB unanimously agreed with the principle as previously proposed and approved by the FASB, although it asked the Staff to change some of the wording for initial recognition.

The proposed wording was that "the insurer should recognise the rights and obligations arising from an insurance contract when the insurer becomes a party to the contract, which is the earlier of:

- the insurer being 'on risk' to provide coverage to the policyholder for insured events; and
- the signing of the insurance contract."

The IASB members asked to change the wording to reflect the fact that the signing of the contract may not expose insurer to risk if it can re-assess the risk and either cancel the contract or change the terms of the offer. Equally, the promise to provide coverage without ability to change prices may be binding without the signing of the contract.

The revised proposal for the ED is that an insurer would recognise an insurance contract at the earlier date of contract signing or being 'on risk' as a result of providing coverage, or a promise to provide coverage without the ability to change prices to take into account a re-assessment of the insurance risk accepted.

Outstanding issues and timetable

There is still a fairly full agenda to be covered before the ED can be finalised. A number of important issues have not yet been resolved and may lead to previous decisions being re-considered. The deadline for the ED has been moved to June but the risk of an unresolved divergence at the May Boards meetings could result in an unrecoverable delay.

Both the IASB and the FASB have scheduled extra meetings to discuss the issues jointly and on a stand-alone basis to accelerate the publication of the ED and ensure that the final standard is out before the majority of Board members change at the end of June next year.

The following significant issues remain outstanding:

- Divergence on the risk adjustment margin and on the treatment of incremental costs in the initial calibration.
- Unbundling of embedded derivatives (to be brought back for consideration at FASB request), including the impact from the margin model chosen.
- The level of aggregation or unit of accounting and how the diversification benefits of a portfolio of insurance contracts may be reflected in the measurement of an insurance liability.
- Transition to the new standard – when and how it will take place and how it would fit with the other projects considered by the two Boards, especially the financial instruments accounting standard.
- Presentation – detailed wording and application guidance.
- Contract boundaries – detailed guidance and final wording.
- Follow-up issues on recognition and derecognition.

The following issues were scheduled for the May meeting:

- Unearned premiums approach (using IASB only tentative decision as a starting point).
- Scope consideration for investment contracts with discretionary participating features.
- Scope decisions for financial guarantees, fixed fee and health insurance contracts.
- Treatment of receivables related to acquisition costs.
- Treatment of reinsurance ceding commissions, in particular for non-proportionate contracts.
- General principal for disclosures.
- Accounting for business combinations and whether current practice of recognising the difference between fair value and carrying value of insurance liability as an asset can be carried forward.

Appendix. Summary of tentative decisions to date

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; and • contingent consideration payable or receivable in a business combination.
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. There is, however, a disagreement between the IASB and the FASB on the "loss test". See below.
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. The Staff are to propose further refinement of the measurement objective wording.
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.
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.
Discount rates	The Boards have tentatively agreed that: • the discount rate should reflect the characteristics of the contracts (currency, duration and liquidity); • the discount rate should not reflect the characteristics of the assets backing the liabilities; and • where the amount, timing or uncertainty of the contracts' cash flows depend on the performance of specific assets, the measurement of these contracts should consider that fact.
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.
Presentation	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 • results from investments (interest income and unwind of discount on the insurance liability). A traditional premium allocation approach may only be used for insurance contracts required to be measured under the unearned premium approach. The Staff should develop further an expanded margin approach.
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.

Recent changes

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. The Boards will consider further the accounting by cedants for residual margins and impairment of reinsurance contracts 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 cedant and reinsurer should account for ceding commissions on proportional reinsurance in same manner as the cedant's related acquisition costs. The Boards will consider further the anchoring of ceding commission to acquisition costs and accounting for ceding commission on non-proportional reinsurance contracts.
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.
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. However, the Boards have not agreed on a definition of interdependence and have requested that the Staff prepare unbundling application guidance to include a revised definition of interdependence (including its specific application to universal life and other account driven contracts) and illustrative examples for determining interdependence. If unbundling is not required for recognition and measurement, it should not be a permitted option. Embedded derivatives within an insurance contract should be subject to the same unbundling requirements as other components of the insurance contract.
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.
Contract boundary	The boundary of an insurance contract is the point at which the insurer either: • is no longer required to provide coverage; or • has the right to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.
Recognition	An insurer should recognise an insurance obligation at the earlier of: • the entity being on risk to provide coverage to the policyholder for insured events; and • the signing of the insurance contract.
Other comprehensive income	The Boards have tentatively decided: • not to change the current accounting for an insurer's assets; and • not to permit or require the use of other comprehensive income for insurance contracts.

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.

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Divergent tentative views	IASB	FASB
Acquisition costs accounting 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 Expense non incremental acquisition costs as incurred. Incremental acquisition costs should be included in the contract cash flows to determine the residual margin at the inception of the contract.	Expense acquisition costs as incurred through profit or loss, with no release of revenue on day 1. The initial contract liability is therefore calibrated to gross consideration receivable.
Definition of significant insurance risk	The IASB favours a definition based on the variability of cash flows as currently included in IFRS 4, where the test should be on the range of possible outcomes and the significance of reasonably possible outcomes relative to the mean, i.e. the variability of outcomes should be significant.	The FASB, while agreeing on the variability of cash flows, believes that there should also be a test to identify a possible outcome, in which the present value of the net cash flows (premiums less claims/benefits) is negative, i.e. a contract loss test.
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.	Participation 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. The remainder should be classified as equity.
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.

	IASB tentative decisions not yet discussed by FASB or to be discussed further by FASB
Exclusion of discounting and margins for some business	IASB considered this approach for certain non-life business and tentatively rejected it from the measurement candidates.
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.

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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

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