

Insurance Accounting Newsletter

Progress continues, divergence remains



Introduction

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) resumed their joint deliberations after the April pause for reflection and the announcement that the work on the new accounting standard will continue beyond the end of June 2011.

Several joint meetings were held, as well as the Insurance Working Group (IWG) meeting on 16 May. Several crucial topics were discussed at the various meetings with a number of tentative decisions made, some which delivered disappointing disagreements between the two Boards. Amongst others, the topics covered included short-term duration contracts, accounting mismatch, unbundling, margins and purchased reinsurance accounting.

This Insurance Accounting Newsletter covers the joint IASB and FASB meetings held on 27 April, 4, 11-12, 17-18 and 31 May, as well as the Insurance Working Group (IWG) meeting that took place on 16 May.

The most critical development in this period is the unfortunate disagreement between the Boards on the accounting for the uncertainty of the cash flows expected from an insurance portfolio.

An extensive debate took place at the 17-18 May meeting, on whether the insurance contract liability should be measured on the basis of expected cash flows plus an explicit risk margin or a single composite margin with both elements of risk and deferred profits. The exposure draft (ED) proposed the former approach, i.e. an explicit risk adjustment. In contrast, the FASB's discussion paper had proposed a composite margin. Following extensive analysis of both approaches from the Staff the Boards were called to make an informed decision. Unfortunately, their respective views did not converge. The IASB asked the Staff to refine the wording in the ED to ensure the nature and objectives of the risk adjustment are better explained.

The rest of this newsletter offers our views on other key issues that emerged from the debates held at the various meetings without necessarily following the chronology of the individual meetings. We focus instead on the decisions and issues that in our opinion have a more significant impact on the development of the final IFRS and on its implementation within insurance business.

Deloitte continues to report on the outcome of each insurance session immediately after every IASB meeting; you can find those on our IFRS website IASPlus (www.iasplus.com).

Accounting for risk and profit – divergence on margins (17-18 May)

The joint Board's discussion on margins (risk adjustment and residual margin vs. the composite margin) spanned the two sessions on 17 and 18 May with an attempt to resolve the divergence the two Boards had on this key model characteristic since March last year.

The majority of the discussions on 17 May focused on two papers that attempted to summarise the months of preparatory work the two Boards had undertaken on this issue (paper 3A for the risk adjustment and paper 3F for the composite margin).

Risk adjustment

Board members noted that one of the primary differences between the risk adjustment and the composite models is the objective of the margins. In the risk adjustment model, the margin measures the variability of the cash flows. In the composite margin model, the entire margin represents deferred profit that should not be recognised until the service of standing ready to meet claims has been performed. Selecting the most important objective for the development of the accounting standard remained the key task at hand for the Boards.

Clearly polarised views emerged between the Boards and the assessment of the two objectives went on to colour much of the discussion over the two days. In addition, the Staff pointed out a distinct geographical split between the constituents as far as the support for each of the two approaches was concerned. This is based largely on current or emerging industry practice in each geographical region. Some Board members commented that the new standard should improve current practice, rather than aiming to maintain the status quo, and that the drivers of the final decision should be based on conceptual correctness and practical applicability rather than preservation of current practices or the assessment of the amount of education required in a particular jurisdiction.

Although some Board members objected to the level of subjectivity the risk adjustment approach might allow, other members pointed out that as long as the level of subjectivity was disclosed it would provide valuable information regarding the risk levels of the entity's liabilities. No specific disclosures were suggested, but references to the subjectivity and disclosures relating to level 3 fair values for financial instruments and IAS 37 disclosures were mentioned.

Finally, a Board member commented on the remeasurement differences between the two models, noting that the lack of remeasurement in the composite margin model was likely to conceal developments in risk, making it less transparent than a risk adjustment model.

Composite margins

Although Papers 3E, 3F and 3G were referred to, the majority of the Staff's presentation revolved around Paper 3F on the realisation of the composite margin. As before, the Staff introduced the paper describing the development of the composite margin model and presenting arguments for and against the use of this model.

Several of the issues raised during the discussion on the risk adjustment model were raised again. In particular, concerns about the transparency of the composite margin and whether the objective of liability measurement was truly being met, with the composite margin model being compared with a Revenue Recognition approach rather than focusing on liability measurement.

Board members also argued back and forth about which model was "simpler" to implement, measure and apply, and whether that simplicity resulted in transparent and decision-useful information.

Ultimately, very few new arguments were raised compared to those we have previously reported on this subject. These discussions resulted in a general consensus amongst the Board members that the results (if not the presentation) of the two models was largely similar and that there were probably only a few areas or circumstances where significant differences would remain.

In an effort to achieve convergence, the Boards directed the Staffs to prepare a number of examples for discussion on the following day. These examples were presented to the Boards on 18 May as a new paper was produced overnight (paper 3K).

Model comparison

The IASB Staff noted that the FASB Staff disliked the model used as it did not appear to be in line with the latter's proposed objective for the composite margin, lending further weight to the argument that this issue will not be resolved unless the Boards can agree on the objective of the margins, either the IASB's approach to account for uncertainty via risk adjustments or the FASB's approach to defer and subsequently allocate profit based via a composite margin.

A significant amount of time was spent discussing and understanding the examples presented, and reconsidering the arguments raised during the previous days discussions.

At the end of this intense debate a fundamental disagreement between the two Boards appeared to remain on the purpose of the margins, with the IASB arguing that the risk adjustment represents a measure of the uncertainty in the cash flows of the liability, while the FASB argued that the uncertainty was already captured in the probability weighted average cash flows.

The IASB argued that a contract with a 50% chance of a £100 loss and a 50% chance of a £0 loss has a fundamentally different risk profile than a contract that had a 100% chance of a £50 loss, even though they both have a weighted average cash flow value of £50. The IASB was, however, unable to persuade the FASB of the relevance and reliability of an accounting model that recognises and discloses some measure of that variability.

Eventually, the Boards' Chairmen indicated that a decision (even if tentative) was required and called the vote. The IASB voted strongly for (only two opposed) retaining an explicit risk adjustment, while FASB voted equally strongly (five for) the composite margin. Board members expressed dissatisfaction with this result and indicated a preference for a single standard to be developed and suggested that the topic could be reconsidered after later meetings (e.g. finalisation of the proposed treatment for the residual margin) had provided additional clarity on the exact extent of divergence.

Deloitte observations

In our comment letter Deloitte expressed support for the risk adjustment model because we believe that financial statements that provide this information offer a more relevant and faithful representation of the economics of a portfolio of insurance contracts.

Our support for this approach was in the context of recommending an accounting model that requires the prospective recalibration of the residual margin against all variables utilised for the building blocks valuation. It is inherent in the economics of assembling and managing portfolios of insurance contracts that the embedded profits arising from the premiums receivable from the in-force policies is adjusted in response to the variability of those factors that affect the future benefit payouts. This embedded profit is represented by the residual margin of all contracts issued and it is earned via the recalibration against the other variables inclusive of a the systematic release of the residual margin computed on the basis of the passage of time, or another rational basis

Such an accounting approach could offer the basis for an agreement between the two Boards and we continue to recommend it as an approach that could produce accounting profits that are a faithful representation of insurers' fulfilment activities.

The Deloitte position also included recommendations to enhance the definition of a portfolio to include principles that could deal with the open nature of insurance portfolios and with the benefits of diversification that may have been achieved across different legal entities within the same insurance group. None of these important issues has yet been discussed by the Boards.

Disagreement on the measurement of short-term contracts (27 April)

The Boards discussed extensively a set of recommendations aimed at dealing with "short term insurance contracts"; although the discussions left a few areas where further clarification work will be necessary several decisions were reached. In this area the progress was also tainted by disagreement but, unlike the disagreement on margin, we are of the view that the practical implications of divergence in this area are less serious.

Eligibility requirements

The ED definition of short-duration contracts is based on two criteria: the first testing that the duration of the coverage period (i.e. the period during which an insurer stands ready to pay claims) is one year or less and the second checking that the contract does not embed features that make the cash flows vary significantly. The ED required that, during the pre-claims period, all short term insurance contracts be accounted for using a modified approach. Beyond the coverage period, the claim liability arising from short-term insurance contracts would be accounted for using the main building blocks model.

The Staff noted that a number of comment letters were particularly critical of the first eligibility criterion which appeared to introduce a bright line instead of being principle-based. To address this comment, the Staff recommended the eligibility criteria to be the following:

- the contract does not include a significant financing element, i.e.:
 - the time between the receipt of premium and the provision of coverage is insignificant; and
 - the amount of premium charged is not substantially different if the policyholder paid at the beginning of the coverage period.
- the contract does not contain embedded options or other derivatives that significantly affect the variability of the cash flows, after unbundling any embedded derivatives (this criterion being substantially the same as what was proposed in the ED).

Using a recent decision from the Revenue Recognition project, the Staff also recommended including a statement whereby a contract is not considered to have a significant financing element if the coverage period is one year or less substantially keeping the original first criterion from the ED as pure guidance for the application of a principle based criterion.

Most IASB members were uncomfortable with the "significant financing" criterion because it seemed to open the modified approach to a wider subset of contracts than anticipated. The joint discussion did not appear to generate a tentative decision on the recommendation other than a statement that the Boards intend to have a modified approach based on the unearned premium method. Instead it appeared to have highlighted a number of differences that the Boards will have to deal with as they finalise this issue.

"One" or "two" models?

Most of the debate revolved around the conceptual justification for a modified approach for pre-claims liability of short-term insurance contracts. The Boards disagreed as to whether the modified approach would be a proxy for the single existing model or whether it represents a new separate model.

It transpired from the debate that the FASB would prefer to consider the modified approach as a separate model from the building block approach rather than its proxy. Although this departs from the position put forward by the ED, it seems to have little practical impact for the discussion on the pre-claim measurement of short-duration contracts.

The IASB position remains to have a single measurement model, with a modified approach that delivers substantially the same information when certain criteria are in place.

The Boards asked the Staff to focus on identifying these criteria going forward.

Discounting of the pre-claims obligation

The debate continued on the Staff recommendation to leave the unearned premium liability undiscounted if the eligibility criteria are met. The debate noted that the absence of a clear consensus on the eligibility criteria had made the discussion on this point more difficult to progress at this meeting.

Some of the IASB members noted that the new standard will apply to markets where high inflation exists and thus the allowance of an undiscounted approach over a twelve month periods would need to be assessed carefully. They also noted that reassessing the merit of the "significant financing" criterion in light of this comment could offer the way forward on this issue.

Treatment of acquisition costs

In the Revenue Recognition project, the Boards recently decided to account for incremental costs as assets when they are incurred on a contract likely to generate sufficient revenue to recover them. This approach had previously been rejected by the Boards for the insurance contracts project in favour of the ED proposal to include the incremental acquisition costs in the measurement of the insurance liability. As a result of the revenue recognition decision, the staff reintroduced the deferred acquisition cost assets option in the options presented to the Boards.

The IASB members were in favour (9 out of the 10 board members in attendance) of retaining the ED principle in line with the building blocks approach and to use a single definition of contract acquisition costs based on costs that directly relate to the contract acquisition activity – on a portfolio basis.

The FASB members instead challenged the proposals of the Staff and noted that there was an opportunity for the new insurance standard to be aligned with the Revenue Recognition project, particularly as they reiterated that they would look at this approach as a separate model that should clearly be closer to the revenue accounting model.

FASB argued that the presentation of the acquisition costs as an asset would enhance the comparability with the other industries where the new requirement from the Revenue Recognition project would apply.

The chairs of the two Boards asked the Staff to bring this issue back for discussion in the near future to seek a convergent outcome.

Premium allocation patterns and onerous contract test

The Staff reconfirmed the ED proposal to release the unearned premium to income either on the basis of time, or on the basis of the timing of cash flows if significantly different from the time basis. Both Boards agreed with the recommendation. The final standard will require the liability to be released to income based on the passage of time over the coverage period, subject to a test that another basis that utilises the expected timing of incurred benefits and claims is not significantly different.

The final session on this topic aimed at setting out the criteria for the testing whether a portfolio of unexpired short term insurance contracts has become onerous.

The fundamental issue of the role of the risk adjustment returned with the Staff recommending an onerous contract test based on the first two building blocks only (expected cash flows and discount rate). A number of IASB members contended that, contrary to the Boards intention, this approach would result in the modified approach being similar in complexity to the main model. They argued that if the simplified approach represents a proxy, the liability test should be done against a full building block calculation, not one that is curtailed of the component that captures the uncertainty which often causes the onerous contract situation. An additional concern was expressed as the unearned premium liability is undiscounted whereas the onerous contract test uses a discounted amount.

Eventually the Boards found some common ground by agreeing that the onerous contract test (to be defined at a future meeting) should be undertaken when the insurer judges that there are certain indicators suggesting the insurance liability for the unexpired short-term contracts is not sufficient. These indicators were presented as "qualitative factors" and included deteriorations in the loss ratio or the increase in the severity and/or frequency of the insured events.

Pending further work on the definition of the portfolio, the Staff had not recommended the level at which the onerous contract test should be performed and this issue will be addressed at a future meeting.

Finally the decision as to whether to make the modified approach a requirement or an accounting policy choice was deferred to a future meeting.

Reactions from the IWG on 16 May 2011

In support of the dual model approach we noted that one of the IWG members expressed a firm view that the logical development of the separate model for short duration contracts is to introduce undiscounted claims liabilities without a risk margin. He also noted that a common response from outreach activities regarding the discounting of claims liabilities arising from short term contracts was that it would complicate financial reporting for investors in that sector due to the difficulty in assessing short term insurers' ability to set sufficient claims liabilities and measure them consistently from period to period.

Other IWG members agreed that non-life insurance is often managed and priced using underwriting metrics rather than metrics that reflect future investment margins although taking into account discounting in short term insurance pricing is more common in high interest rate environments.

The observer from the International Association of Insurance Supervisors noted that irrespective of whether the one or two model approach was used, the consideration of time value of money for claims liabilities must be retained in the final accounting model because in some countries current economic conditions and the associated higher level of interest rates makes it a material factor for financial reporting.

Deloitte observations

Deloitte recommended that a modified accounting approach for short duration contracts' pre-claims liabilities is permitted rather than required, as a practical approximation of the building blocks measurement. It would allow the presentation of these contracts along the lines of the statement of comprehensive income presentation widely accepted by investors in insurers that sell these types of contracts.

In our comment letter we recommended that the Board adopts an accounting approach for short duration contracts similar to the unearned premium approach currently used under US GAAP. A provision for onerous contracts based on the building blocks model would be recognised if the measure of the portfolio using the building blocks approach exceeds the unearned premium liability at each reporting date.

Our proposed short duration contract accounting model would also include the following elements:

- As premiums are earned over the period of coverage, a liability would be recognised for losses incurred in the period of coverage including reported losses, incurred but not reported losses and claims handling and settlement costs. The liability would be recognised using the principles of the building blocks approach including the present value of the probability weighted cash flows and a specific risk adjustment to address the uncertainties in the ultimate amount and timing of the cash flows.
- A residual margin liability would be determined and established as the premiums are earned and as the claims liability is recognised for the losses and claims expenses incurred.
- A portion of the residual margin would be attributed to the period of coverage and such portion would be part of the premiums earned. The remaining portion of the residual margin would be accounted for consistent with the recalibration model we described in our response to Question 6 above. As discussed in that response, we believe the residual margin release should include the claim settlement period. To recognise the entire residual margin only over the period of coverage seems inconsistent with the continuation of the exposure for the uncertainty in the cash flows after the period of coverage ends.

Divergence on how to deal with the accounting mismatch for participating contracts (11 May)

The ED proposed to reduce the accounting mismatch which exists for participating contracts under current IFRS and US GAAP by implementing exceptions in the rules for measuring assets. The ED allowed the assets to follow the measurement approach applied to the associated insurance liability. The new proposal for dealing with the accounting mismatch put forward by the staff links the measurement of the liability to that applied to the associated assets. The staff argued that this proposal more effectively reduces accounting mismatches and was more in line with the Boards' first axiom.

The Staff also clarified that the two asset solutions in the ED would remain in place allowing the recognition of an asset measured at fair value through profit or loss whenever an insurer holds its own shares or an owner occupied property within a fund that is linked to a unit-linked insurance contract.

In more detail the recommendations to the Boards were:

- the cash flows expected to result from the policyholder participation should be included in the insurance liability on the same basis as the measurement of the underlying items in which the policyholder participates;
- the measurement of the participating contract should reflect the asymmetric risk sharing between the insurer and the policyholder resulting from the minimum guarantee;
- the changes in the insurance contract liability shown in the statement of comprehensive income should be consistent with the presentation of the changes in the items from which the participating liability is dependent; and
- the same measurement approach should apply to unit-linked ("UL") and contracts with a discretionary participating feature ("DPF").

The Staff noted that the main difference between UL contracts and those with a DPF is often associated with the nature of the asymmetric risk sharing between the insurer and the policyholders. UL contracts directly pass all investment performance through to policyholders using an equivalent to a total return swap approach. DPF contracts frequently embed minimum guarantees as well as only sharing a percentage of the return on the fund, doing so on a basis that is not necessarily in line with the fair value accounting of the participating assets.

The Staff noted that the same accounting mismatch resolved with the asset-based provisions in the ED for UL business applies to DPF contracts and respondents asked if the consequential amendments could be extended beyond assets backing UL contract liabilities. However the Staff identified additional issues that would follow with the expansion of this option, e.g. deferred tax assets and liabilities could not be measured at fair value, thus concluding that a better way to reduce the accounting mismatch is the measurement of the liability using the same attribute as the underlying item, i.e. if the underlying assets are measured at cost or they are not recognised (e.g. treasury shares), the measurement of the liability relating to this asset should also be measured in the same way.

FASB members were uncomfortable to abandon the current measurement of the building block for the liability. Although they acknowledged that this creates an accounting mismatch in the situation where the underlying item is measured on a different basis or it is not recognised at all they would prefer to deal with the mismatch in a second step which could produce some amendments to the accounting treatment of the assets. In conclusion, the FASB rejected the new Staff recommendations.

The IASB on the other hand generally supported the Staff recommendation to measure participating liabilities on a basis consistent with the underlying items. This would further eliminate undesired accounting mismatches leaving a significant portion of the remaining volatility in the financial statements associated with economic mismatches. Some IASB members asked for the introduction of disclosure requirements whenever assets at other than fair value had been used to measure participating liabilities.

Divergence on this important issue was formalised with the FASB unanimously rejecting the Staff recommendations and a large majority of the IASB members supporting the Staff recommendations (nine in favour, four against, one abstention and one absentee).

Reactions from the IWG on 16 May 2011

Members were generally supportive of the fact that the linkage between the assets and liabilities is recognised, however, we noted that IWG members were generally cautious on this very recent proposal and suggested that it would benefit from more analysis, refinement of the wording and more worked examples.

A few IWG members commented that the proposal seemed to have an implicit contract template that would appear to ignore the contractual structures usually found in the US participating contracts.

Other IWG members noted that the Phase I shadow accounting would seem a superior accounting solution. These IWG members expressed a view against measuring the liability at cost in order to avoid the mismatch in favour of a "current-current" approach where changes in both assets and liabilities associated with fluctuations of market variables are reflected through OCI.

Deloitte observations

In its response to the ED, Deloitte encouraged the Board to work with the preparer, investor, analyst and actuarial communities to explore alternative methodologies for measuring a current fulfillment value that would more faithfully represent the underlying economics of an insurer's asset-liability management strategies. However, it seems the new proposals to address accounting mismatch for participating business are moving away from a "current" measurement objective.

Although we welcome the decisions around the recalibration of the residual margin and the use of discount rates based on a reference asset portfolio, we also recommend that the Boards consider the development of a macro hedge accounting approach capable of reflecting an insurer's asset-liability management under the Board's proposed hedge accounting amendments to IFRS 9.

The IASB confirms that they will not amend the accounting for financial assets backing insurance liabilities (12 May)

Following the disappointing disagreement with the FASB on participating contracts on 11 May, the IASB continued its work on the new IFRS without the presence of the FASB members because it planned to address issues that, at present, are unique to the IFRS accounting literature as they are connected with the IASB position on financial asset accounting as set out in IFRS 9.

As they led the session to the vote on the IFRS 9 amendment which the IASB takes on a regular basis as it advances its re-deliberations the Staff presented an Other Comprehensive Income (OCI) solution that is fully based on the accounting for insurance liabilities. Considering the significant innovation attached with these proposals the Staff structured the session without seeking a vote on it.

The Staff proposal is based on allowing a designation of individual portfolios to be accounted for with an OCI element calculated based on the difference between the original discount rates at the inception of the contracts in the portfolio and the current discount rate determined based on the current decisions. The insurer is allowed to make such designation if and only if it would eliminate or substantially reduce an accounting mismatch.

The reaction we observed from the IASB members was not particularly positive with some Board members expressing their views that this proposal would be "a step too far", in particular, given the approval of the basis on participating contracts during the previous day and the decision to use a top-down method to determine the discount rate.

We also noted concerns that this proposal could potentially conceal real economic mismatches (e.g. liability changes associated with the impact of discount rates on embedded options and guarantees) or that it would only shift genuine accounting mismatches into OCI rather than addressing the cause of the mismatch. Finally, some IASB members noted that if insurers were permitted to move volatility into OCI, then other industries may need to be treated the same way and other accounting standards may need to be modified to permit this.

We also observed positive comments whereby this solution was compared with the approach for pension accounting, and that the accounting standards should aim for a consistent approach to the treatment of variances and the use of OCI. Support for the Staff proposal was also motivated by a preference for addressing volatility in the income statement rather than amending asset valuation rules.

Overall, there did not seem to be a significant amount of support for the Staff recommendation.

Reactions from the IWG on 16 May 2011

The general view from the IWG was that although the IASB work is heading in the right direction the proposal does not address fully the concern of accounting mismatch. We noted that many IWG members would prefer to allow for the use of OCI on both sides of the balance sheet and use a "current-current" approach. Some commented that a single sided OCI solution may risk misrepresenting the equity of the insurers.

One IWG member commented that separating earnings from operations and changes in markets could be useful to users. Furthermore, durational mismatch could only be seen through sensitivity information and disclosures, which should be made available.

Some members questioned whether the asset liability management practices would result in the proposed designation being done at a higher level than a portfolio.

Assets backing insurance contract liabilities

As decided at the start of the re-deliberation process the Staff brought back the issue of an amendment of IFRS 9 to present the gains and losses on financial assets backing insurance contract liabilities within OCI rather than in profit and loss (either changing general requirements of IFRS 4 or specifying different requirements for assets backing insurance contracts within the insurance standard). The IASB had agreed in February that it would not amend IFRS 9 as a step of its re-deliberations on the insurance contracts project and the Staff at this meeting confirmed that there are no reasons this presumption should be changed and thus IFRS 9 should not be changed.

As all IASB members present expressed their support for the Staff recommendation some members commented that they believe earnings management through realisation of gains should be avoided and this could be achieved effectively if the available-for-sale category is not reintroduced. Other Board members were concerned that if the use of OCI proposed for the accounting of the liability discount rate noted above was rejected the mismatch between asset and liability valuations would remain making some form of a revision to the measurement rules for the assets backing the insurance contracts necessary. However no IASB members spoke in favour of an amendment of IFRS 9 for assets backing insurance contracts.

Agreement on an unbundling regime founded on a common basis with Revenue Recognition (4 May)

After a significant preparatory and educational session on unbundling, the Staff presented a proposal based on the principles used to identify separate performance obligations in the Revenue Recognition project. The Boards agreed that the proposals are promising, although they acknowledged some refinements to the criteria are needed.

The Staff reiterated the objective of unbundling being the measurement of non insurance components of an insurance contract where the requirements of another standard would provide more useful information than the building blocks approach. A non insurance component is defined as one that is associated with an obligation performed irrespective of the occurrence of the insured event.

Unbundling goods and services

The Staff presented three potential approaches. The approach it recommended requires that goods and services be unbundled from an insurance contract in accordance with the principles on identifying separate performance obligations developed for the Revenue Recognition project. Once separated, those goods and services would be measured in accordance with relevant requirements of the applicable IFRSs and US GAAP. The alternatives presented were to:

- Require unbundling of non-insurance services and goods only if they have been combined in a contract with the insurance coverage for reasons that have no commercial substance (this was the recommendation that Deloitte put forward in its comment letter last year);
- Require further unbundling of non-insurance services and goods (in addition to those combined for reasons that have no commercial substance in the alternative above).

FASB members were generally in favour of the Staff's recommendation except for the restriction to unbundle only when "the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract". FASB argued that this wording from the Revenue Recognition project does not transfer well to a liability measurement model as it would prevent unbundling in cases where the components are clearly unrelated, but the pattern is the same. The majority of the FASB therefore supported the Staff's recommendation only if the criterion that would limit unbundling only to situations where the accounting profit would be different was removed or substantially reconsidered. In other words, FASB members felt that unbundling for presentation purposes only would still be an enhancement of the financial statements, even if the profit remains substantially the same.

The IASB were generally supportive of the Staff's recommendation without any caveats. Some members argued that without guidance, it may be difficult to interpret the principles, and that if examples are provided, their status must be made clear. Most IASB members were of the view that the insurance standard should be consistent as far as possible with the Revenue Recognition separation principle and therefore the "transfer pattern" criterion should be kept or removed from both standards.

At the time of voting the IASB majority voted in favour of the recommendation as drafted. The IASB asked the Staff to reflect on the various concerns raised and agreed to take this issue to the Insurance Working Group meeting (IWG), scheduled for 16 May.

Unbundling of investment components

The Staff had planned to deal with the unbundling of obligations to deliver goods and services prior to tackling the issue of unbundling "investment components". These components are obligations to deliver cash to the policyholder that are not subject to the contingency of the insured event. However the Staff proposal narrowed the "investment components" that should be unbundled presenting a refined definition of the "explicit account balance" that had already been introduced in the ED.

The Staff proposal was that "explicit account balances" in insurance contracts that meet specified criteria should be unbundled. The specified criteria are adapted from those that are being developed for identifying separate performance obligations in the Revenue Recognition project. If the account balance meets the definition and these specified criteria, that component should be accounted for in accordance with the relevant requirements for financial instruments in IFRS and US GAAP.

The revised definition is as follows:

“An insurer should account for an explicit account balance separately if:

- *the pattern of exposure to financial risk arising from the account balance is different from the exposure to insurance risk in the contract; and*
- *the account balance has a distinct value. The account balance has a distinct value if either:*
 - *the insurer regularly issues separately a financial instrument with the same rights and obligations as the explicit account balance (e.g. it issues unit-linked/variable contracts with no insurance risk and those contracts credit returns at the same rate as the bundled contract); or*
 - *the policyholder can benefit from the explicit account balance on its own (e.g. benefit from investment returns)”.*

The FASB questioned whether a cash surrender value should qualify as an explicit account balance. The Staff clarified that it would not because the cash surrender value is an integral part of the contract and would therefore consider it as an implicit account balance. Despite a residual amount of scepticism on the robustness of the revised definition, FASB members generally agreed with the recommendation subject to further clarification or rewording of the “explicit account balance” definition.

The IASB briefly discussed and generally agreed with the Staff’s recommendation, although it asked for the issue to be brought before the IWG to gather its feedback. The two other elements in the Staff’s recommendation, i.e. the criteria for unbundling in line with the Revenue Recognition standard and the alternative measurement bases were very briefly discussed by the IASB and they received general support along the lines of the Staff recommendation to account for the explicit account balance under the IFRS and US GAAP for financial instruments.

FASB members added that they would like the criteria for unbundling of explicit account balances and for goods and services to work efficiently from an implementation perspective to avoid duplication of efforts. Despite having voted to support the Staff recommendations thus far the FASB members decided not to vote on how to measure an explicit account balance. IASB members also agreed to bring this issue forward to the IWG meeting.

Reactions from the IWG on 16 May 2011

The general view from the IWG was that the modified criterion proposed seemed sensible and that as little unbundling as possible would be the best outcome.

Most IWG members agreed that embedded derivatives should be unbundled under the existing IAS 39 criteria. It was however noted that some important issues remained to be discussed and dealt with, such as embedded riders that do not meet the definition of an embedded derivative (i.e. the option that a policyholder has to modify his insurance coverage).

Deloitte observations

We believe that the Board should provide additional application guidance and/or illustrate the application of the unbundling guidance to common contracts to ensure that similar contracts are accounted for consistently by different entities. Furthermore, to limit the number of components that are not measured with the building blocks, we believe only those components that are not interdependent with the insurance coverage and which have been combined for reasons that do not have commercial substance should be unbundled. Treating the account balance within the insurance liability would achieve a substantially equivalent measurement as if it were accounted for separately using IFRS 9.

Regarding the requirement to unbundled embedded derivatives, we see very little benefit in the efforts necessary to assess whether there is a close relationship of embedded derivatives with the host insurance contract. The resulting bifurcation is also of a limited additional benefit compared to leaving the embedded derivative as an integral component of the insurance contract to be accounted for under the ED as there is a sufficiently clear requirement to use market prices to ensure the embedded derivatives cash flows are substantially aligned with their stand alone market value.

“U-turn” on gains from purchased reinsurance (31 May)

The FASB and IASB met for more than two and a half hours to discuss the topic of reinsurance which was originally scheduled to be discussed on 11 May. The paper presented eight staff recommendations which were mostly agreed upon by the Boards. The Staff recommendations were developed considering feedback received from constituents that more details are required on the subject of reinsurance.

Definition of significant risk transfer

The Staff’s first recommendation was to add new application guidance to the significant risk transfer test. The guidance states that a reinsurance contract is deemed to meet the definition: “If substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer”.

Board members from both the IASB and FASB were uncomfortable with the words “substantially all” and, although they tentatively agreed with the principle behind the new guidance, they asked the Staff to refine the wording. Some Board members suggested using similar wording to that in paragraph 35 of the paper – “if the economic benefit to the reinsurer for its respective portion of the underlying policies is virtually the same as the ceding company’s economic benefit, then the reinsurer has assumed substantially all the insurance risk related to the reinsurer policies.” The staff also explained that the guidance is effectively a short cut, and that if the “substantially all” condition is not met the reinsurer would have to perform the full significant risk transfer test.

Both Boards tentatively agreed with the Staff’s recommendation, assuming the wording is changed in line with that in paragraph 35 of the paper.

Interdependent contracts

The second proposal from the Staff is for the guidance to be clarified such that an “insurer shall assess the significance of insurance risk contract by contract and that, contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent, shall be considered a single contract”. Both Boards tentatively agreed with the Staff’s recommendation without much debate.

Recognition of reinsurance contract

The Staff recommended that, “when the amount recoverable from the reinsurer for a loss on an underlying insurance contract is independent of the recoverable for losses on other underlying insurance contracts, the cedant should recognise a reinsurance asset when the underlying contract is recognised, otherwise the cedant should recognise a reinsurance asset when the reinsurance coverage period begins”. Although the Boards tentatively agreed with the principle proposed, they asked the Staff to clarify the wording as many found it confusing. The Staff clarified that this guidance should deal with non-coterminous contracts which cover a class of insurance that may include contracts that will be issued in the future. In these cases, if the reinsurance policy is on an aggregate loss basis, a reinsurance asset would be recognised at the effective date of the reinsurance policy. The reinsurance asset would be re-measured to account for the new reinsurance asset arising on subsequently issued insurance contracts, at the date the insurance contracts are initially recognised.

Ceded risk adjustment

The Staff recommendation is for the “ceded portion of the risk adjustment to represent the risk being removed from the use of reinsurance”. In the Staff view, an insurer should arrive at the same answer whether it calculates the ceded risk adjustment based on the gross or net basis and it does not propose to specify the method that should be used to calculate it. The IASB tentatively agreed with the recommendation. The FASB did not discuss this topic given its preference for a composite margin.

Treatment of gains and losses

The Staff recommended a significant change from the ED/DP approach proposing that gains on purchase of reinsurance contracts are not recognised on day one. FASB unanimously supported this recommendation whilst a significant minority of four members of IASB out of the fifteen present voted against it.

The basis for this approach is that the cedant has not been relieved of the obligation it has reinsured (i.e. the reinsurance does not cause derecognition of the insurance liability) and that it could cancel or commute the reinsurance contract at a later stage. For these reasons the measurement of the reinsurance assets using the building block approach noted above is reduced by any positive difference from that calculation. In other words the initial recognition of the reinsurance assets is not greater than any upfront premium paid to the reinsurer to purchase the contract. Both Boards approved this change from the ED/DP and asked that it be included in the final IFRS. An additional reason to prevent the cedant from recognising a gain on reinsurance purchased is the subjectivity in the measure of the ultimate obligation the cedant has reinsured.

The Staff also recommended a change to the ED/DP when reinsurance protection is purchased by the cedant at a loss on day one (i.e. the building block calculation produces a net negative probability weighted present value inclusive of a risk adjustment asset). The Staff proposed that the ED/DP approach that when the reinsurance contract covers pre-claims liabilities a loss should not be taken to profit or loss immediately and it should instead be amortised over the coverage period as a component of the reinsurance asset. However this treatment would not be permitted for reinsurance of post-claims liabilities (e.g. retrospective reinsurance) where a negative building block net result would have to be recognised immediately through profit or loss.

Although the FASB members found the language used unclear and over-complicated, they generally agreed with the Staff's recommendation. A very large minority of seven out of fifteen IASB members voted against deferring the loss over the coverage period and expressed a preference for immediate loss recognition also for reinsurance purchased to cover pre-claims liabilities.

Cession of residual/composite margin on underlying insurance contracts

The Staff proposal was that on initial recognition of the reinsurance contract the "cedant shall estimate the present value of the fulfilment cash flow for the reinsurance contract, including the ceded premium and without reference to the residual/composite margin on the underlying contracts, in the same manner as the corresponding part of the present value of the fulfilment cash flows for the underlying insurance contracts". Although one IASB member disagreed, both Boards tentatively agreed with this recommendation without much debate.

Ceding commissions

The Staff recommended that the "ceding commissions and expense allowances from the reinsurance contract be included in the expected cash flows of the measurement of the liability to the extent that the cedant has included their direct costs in the expected cash flows. Any excess amount should be recorded as a reduction in the ceded premium." There was confusion among Board members on this topic as it was not clear to them whether this was a question of measurement or presentation. The Staff clarified this is related to presentation and the Boards asked the Staff to bring back this discussion when they address presentation in a wider context.

Credit risk of reinsurer

The Boards were in agreement with the Staff recommendations and they approved the following tentative decisions:

- a. "The cedant shall record an allowance for the risk of non-performance by the reinsurer when estimating the present value of the fulfilment cash flows when there is an indication that the current information and events suggest the cedant will be unable to collect all amounts due according to the contractual terms of the reinsurance contract.
- b. The determination of risk of non-performance by the reinsurer should consider all facts and circumstances, including collateral.
- c. Losses from disputes should be reflected in the measurement of the recoverable when there is an indication that the current information and events suggest the cedant will be unable to collect all amounts due according to the contractual terms of the reinsurance contract."

Deloitte observations

We believe that the ability to recognise an accounting gain from reinsurance transactions is aligned to the economics of the risk diversification differential between cedant and reinsurer, although a requirement to disclose management's rationale for the accounting gain would be particularly useful to investors.

Insurance Working Group (16 May)

The IWG meeting took place on 16 May 2011. As well as most Boards member and Staff, the incoming IASB Chairman, Hans Hoogervorst, attended most of the meeting. In addition to the various issues noted earlier after each individual item we observed two additional topics at the IWG that we believed are noteworthy.

A suggestion to align the IFRS and US GAAP timetables

Several members from the IWG made a plea for the IASB and the FASB to align their timetables and publish their respective final insurance accounting standards at the same time. It was also noted that investors in the US have not yet been fully engaged in the project because of the absence of an exposure draft. European entities rely on US investors for their capital and the input from the US investors' community is essential to be reflected in the IFRS due process before a final standard is issued. Most IWG members that spoke on this subject noted that the importance of a high quality standard for insurance contracts could justify a two or three years delay as a reasonable price to pay if it allowed the two Boards to achieve a better outcome.

The IASB Chairman clearly expressed his disagreement saying that they had been working at this project for 14 years and that, in his experience, it would take a lot more than six months for the FASB to finalise its development of a new insurance standard and that a two to three years period was more likely, which is a period of time that IASB would not be able to accommodate in its plans. He also noted that the efforts for convergence remain unaltered in both Boards and the likelihood of the final two accounting standard being materially different is very small if the emphasis on the convergence agenda remains.

Taking stock on the discount rate top down decisions

The Staff's paper reported back on the discount rate tentative decisions to date and how the Staff proposes to implement those decisions.

Although a number of IWG members continue to have concerns that the credit spread volatility would continue to be a primary source of accounting volatility within insurers' profits under the new standard, we noted several members arguing that the decisions on the top down discount rate would be applied with a high degree of consistency and a beneficial impact on accounting profit volatility.

Next steps

The Boards were meeting again in the week of the 13 June during which more than four hours were devoted to discussing insurance accounting. Items for discussion on the agenda were the Statement of Comprehensive Income, unlocking of the residual margin and acquisition costs.

The IASB Chairman-elect, Hans Hoogervorst, has been attending several of the insurance discussions, including the IWG meeting, and will officially take his post as Chairman of the IASB on 1st July 2011. At the same time, Sir David Tweedie, Tatsumi Yamada and Warren McGregor will have reached the end of their term and being ineligible for reappointment will retire from the IASB. It is however encouraging to see that some of the members who recently joined the IASB have considerable experience in the insurance industry, which should help to ensure a smooth completion of the insurance project.

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

Kumiko Aso

Japan
+81 90 3910 2898
kumiko.aso@tohatsu.co.jp

EMEA

Fabien Sauvage

France
+33 1 55 61 41 63
fsauvage@deloitte.com

Latin America

Gustavo Bohórquez

Mexico
+52 55 50806201
gbohorquez@deloittemex.com

North America

Rebecca Amoroso

U.S.
+1 973 602 5385
ramoroso@deloitte.com

Simon Walpole

Hong Kong
+852 2238 7229
siwalpole@deloitte.com.hk

Mark FitzPatrick

U.K.
+44 20 7303 5167
mfitzpatrick@deloitte.co.uk

Carlos Srulevich

Argentina
+54 11 43202734
csrulevich@deloitte.com

Aniko Smith

U.S.
+1 213 688 4110
anikosmith@deloitte.com

Mark Ward

Switzerland
+41 44 421 62 72
maward@deloitte.ch

Neil Harrison

Canada
+1 416 601 6307
nharrison@deloitte.ca

Peter Wright

Czech Republic
+420 246 042 888
pewright@deloitte.com

John Johnston

Bermuda
+441 292 1500
jojohnston@deloitte.com

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, 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 Limited and its member firms.

"Deloitte" is the brand under which tens of thousands of dedicated professionals in independent firms throughout the world collaborate to provide audit, consulting, financial advisory, risk management, and tax services to selected clients. These firms are members of Deloitte Touche Tohmatsu Limited (DTTL), a UK private company limited by guarantee. Each member firm provides services in a particular geographic area and is subject to the laws and professional regulations of the particular country or countries in which it operates. DTTL does not itself provide services to clients. DTTL and each DTTL member firm are separate and distinct legal entities, which cannot obligate each other. DTTL and each DTTL member firm are liable only for their own acts or omissions and not those of each other. Each DTTL member firm is structured differently in accordance with national laws, regulations, customary practice, and other factors, and may secure the provision of professional services in its territory through subsidiaries, affiliates, and/or other entities.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or its and their affiliates are, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your finances or your business. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser.

None of Deloitte Touche Tohmatsu Limited, its member firms, or its and their respective affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

© 2011 Deloitte Touche Tohmatsu Limited

Designed and produced by The Creative Studio at Deloitte, London. 12002A