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Insurance Accounting Newsletter
The post-Tweedie insurance project: an uncertain horizon

Introduction

In the last two months we have seen significant setbacks in the efforts of the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to develop the new insurance accounting standard for both IFRS and US GAAP. The greatly reduced pace of progress, with a little more than six hours of Board activity over June and July, forewarned a further delay in the target publication date for the new insurance IFRS. The release date for the new insurance IFRS has now been pushed back to the second half of 2012, with re-exposure likely in the next six to eight months.

In respect of the technical deliberations, the business that we report in this newsletter took place at three joint meetings on 13 and 15 June and on 21 July. At all these meetings the lack of agreement between the two Boards was an indicator of the growing uncertainty that now surrounds the continuation of this project. The meagre progress in terms of new decisions includes the joint agreement to consider only direct acquisition costs as part of the contractual cash flows (13 June) and a preliminary compromise between the Boards on the requirements for the presentation of insurance contracts in the Statement of Comprehensive Income (15 June).

On 13 June the IASB also decided to unlock the residual margin and formulated some of the principles that would govern this new feature of their accounting model. This decision is crucial for the emergence of profits from insurance portfolios. The FASB embraces a composite margin versus the IASB's view of risk adjustment, and, as a consequence, did not vote on this topic.

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 these summaries on our dedicated IFRS website IASPlus (www.iasplus.com).

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A highly uncertain timetable

We reported recently that the IASB and the FASB decided to allow a few more months to complete their major standard setting projects (financial instruments, leases, revenue recognition and insurance contracts). However, on 30 June and then again on 26 July the IASB released a revised technical plan with a further significant delay on all of these projects.

The announcement did not come as a total surprise given the significant reduction in activity during June and the decision of the IASB and FASB on 16 June 2011 to re-expose the draft revenue recognition standard. This decision was taken despite admitting that the re-deliberations had not changed the proposal as much as their own re-exposure criteria would have required for such a decision to be taken.

The significant revisions of the timetable in a short space of time are reflective of the Boards' heightened sensitivity to the need for new standards that reflect a strong convergence between US interests and those of IFRS reporting jurisdictions.

The theme of continuing delay developing around the post-Tweedie management of the IFRS-US GAAP convergence efforts was confirmed on 21 July when the Boards also decided to re-expose the draft standard for leases and the subsequent release of an updated technical plan for the 12 month period beginning on 1 July 2011.

At this time our expectation is that the insurance contracts project is destined for the same fate as the other three major projects, with formal re-exposure of the draft insurance IFRS. At some point between the end of this year and next year we expect the IASB will publish either a review draft[1] or decide to formally re-expose the draft insurance IFRS. We believe that the latter is the most likely outcome. This would push the target publication date for the new IFRS well into the second half of 2012 as confirmed in the revised plan released last week.

In summary the new dates for the four major joint projects are set out in the table below to illustrate the update of the IASB 30 June 2011 work plan to reflect the 26 July IASB work plan.[2]

It is clear that with the IASB's focus on quality standards that are transparent and converged with US GAAP the timing for three of the four major projects is slipping, and in particular the review draft or re-exposure of the Insurance IFRS may now extend well into 2012. The latest IASB plan no longer states that there will be a 2012 target publication date for the insurance IFRS although it is still our expectation that the Insurance IFRS will be published late in 2012.

Based on our past experience the target dates for publication of the final IFRS on leases and revenue in the June work plan did not appear to be realistic and publication in the second half of 2012 would be more consistent with the four month exposure period that would need to be added to the release in the third or fourth quarter of 2011 of new exposure drafts.

The financial instruments project is more complex due to its segmentation in individual components. However, with a re-exposure of the impairment proposals expected in September 2011 and a new ED on macro-hedging during the last quarter of 2011, the most realistic date for the completion of the whole project would also appear to be the second half of 2012 at the earliest. The 26 July IASB work plan does not refer to a target date for macro hedging or impairment IFRSs as it is normal for the IASB work plans to refer only to specific developments in the 12 months after the issue of the work plan.

In addition, there is growing expectation that the FASB will soon announce the re-exposure of its own financial instrument classification and measurement proposals, which would be exposed as a Discussion Paper by the IASB thus triggering further convergence efforts for this crucial standard.

IASB work plan dated 26 July 2011

Project	Q3 2011	Q4 2011	2012
Revenue from customers' contracts	To be re-exposed		Target publication of the final IFRS
Leases		To be re-exposed	Target publication of the final IFRS
Insurance contracts		Review draft or re-exposure	
Financial instruments – Impairment	Review draft or re-exposure of the impairment project		
Financial instruments – General Hedging	Ballot	Target publication of the IFRS on general hedge accounting	
Financial Instruments – Macro Hedging		Target publication of the ED on macro-hedging	
Financial Instruments – Offsetting		Target publication of the IFRS on offsetting	

1 A review draft is an IASB Staff document that is published for the convenience of the general public without formally seeking comments. The IASB Staff have already used this device in the past for example when they published review drafts of their work on fair value measurement and liabilities.

2 The full IASB Technical Work Plan released on 26 July 2011 is reproduced in Appendix 1

Another factor has affected this substantial extension of activities beyond the end of 2011 deadline the G20 governments initially gave to the IASB and FASB. This is the uncertainty of the outcome of the US Securities and Exchange Commission's (SEC) assessment of IFRS as a suitable financial reporting framework for the US capital markets. The SEC released a Staff Paper on 26 May 2011 setting out a work plan for the consideration of incorporating IFRS into US capital markets. Subsequent public statements from SEC officials have indicated that a decision is expected towards the end of 2011. It would seem to us that the outcome of that decision will have a significant impact on the Boards' activity to converge IFRS and US GAAP. We hope this impact would confirm their mutual commitment to developing a single set of global accounting standards, albeit we recognise that the convergence efforts will require more time to reach an agreement on all of the new standards.

Likely mandatory effective date of the new insurance IFRS

The last issue to consider is the likely mandatory effective date of the new insurance IFRS. At their meeting on 22 July 2011 the IASB voted to amend the current effective date of the IFRS 9 "Financial Instruments – Classification and Measurement" from financial periods beginning on 1 January 2013 to 2015 on the grounds that "moving out the mandatory effective date is consistent with the comments received in response to the Request for Views and the IASB's prior intention to transition concurrently to all phases of the project to replace IAS 39, as well as potentially the effective date of the proposed insurance contracts guidance"[3].

All the four major projects now seem to target this date as their mandatory effective date. However, if any or all of the four major projects are not issued in 2012 then 2015 could slip to 2016. The impact of this "big bang" introduction of the four new standards could be said to mark a new beginning for IFRS as a whole.

It is our hope that the effect of the introduction of these new IFRSs will be greater convergence with US GAAP and that the delays will have been a worthwhile price to pay for quality standards that deliver more transparency and the progress towards convergence.

The decision to "unlock" the residual margin will contribute to reducing accounting volatility

Deloitte position on remeasurement of the residual margin

We support the risk adjustment model in the context of 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 profit 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. It is earned via the recalibration against 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 representative of the fulfilment of the insurer's obligations towards the policyholders whose contracts form that particular portfolio.

The IASB supported their Staff recommendation and decided to unlock the residual margin but the FASB did not vote on this topic as they continue to favour a composite margin without a separate risk adjustment and residual margin. The vote was narrow (8 vs. 7) and many members indicated concerns that unlocking the residual margin conceptually moves the insurance accounting model towards a Revenue Recognition approach focusing on the accounting for future earnings rather than an asset/liability approach focused on the measurement of insurance assets and liabilities.
We have observed that the FASB Staff did not support this proposal as they had concerns that unlocking the residual margin risks would conceal movements in the liability and noted the current US GAAP methodology.

The concerns noted above on the conceptual basis for an unlocking of the residual margin stem from the fact that a number of IASB members are of the view that the residual margin represents the difference between premium and the insurance liability which cannot be recognised on day one and that it should remain outside of the Building Blocks model with an independent and fairly simple amortisation process.

The minority of IASB members raised additional concerns including that this approach could conceal movements on the face of the balance sheet and profit and loss, rendering the financial statements less transparent, that unlocking could introduce additional accounting mismatches between assets and liabilities and that it would increase the complexity of the new insurance IFRS. A parallel to the corridor approach that applied to pension accounting and recently repealed from IFRS was also drawn.

3 Extract from IASB Staff paper "Agenda paper 2" for the IASB meeting on 22 July 2011

It has been agreed to have additional analysis on this topic to address all of the concerns that the minority IASB members raised. We expect that the September IASB meeting will discuss the result of this additional Staff work.

Unlocking principles agreed except for changes in the discount rate

Having passed the hurdle of agreeing to adopt an approach that would unlock the residual margin the IASB reached a substantial number of decisions on the principles that would govern this critical element of the new accounting model. With the exception of the unlocking principle vis-à-vis the changes in the discount rate, the IASB deliberated on all the other recommendations on the unlocking principles. The table below summarises the outcome of their deliberations:

Staff question for the Boards	IASB's Decision
1. Whether to "consume" or "float" the residual margin?	11 vs. 4 in favour of floating the residual margin.
2. Whether changes in experience to date and/or changes in assumptions be reflected in the unlocked residual margin?	12 vs. 3 in favour of changes in assumptions being reflected in the residual margin without setting a limit to possible increases in the residual margin but a prohibition for it to become negative.
3. Should changes in discount rate be reflected in the unlocked residual margin?	No decision was reached.
4. Should changes in the risk adjustment be reflected in the unlocked residual margin?	9 vs. 6 No – changes in the risk adjustment should be reflected in the statement of comprehensive income.
5. Should any unlocking adjustment be determined prospectively or retrospectively?	10 vs. 5 in favour of prospective remeasurement.

Deloitte position on unlocking the residual margin
Three of the four decisions (1, 2, and 5 above) reached by the IASB are in line with Deloitte's recommendations. In our view the recognition of prospective changes to the risk adjustments outside the unlocking mechanism is not in line with the conceptual basis that the risk adjustment liability is a direct function of the volatility of the cash flows' probabilities utilised in the first Building Block. Furthermore we are supportive of the IASB Staff proposal that changes in discount rate should not be reflected in the unlocked residual margin but should be reflected in the statement of comprehensive income, when recognising the adjustment in the residual margin would result in an accounting mismatch. In our comment letter we articulated this view by recommending the accounting for the changes in the discount rate against the residual margin only when the insurer's asset backing those liabilities are accounted for at amortised cost.

'Consume' or 'float'

The first topic raised by the Staff was whether the residual margin should be "floated" (i.e. adjusted for positive and negative changes) or "consumed" (i.e. adjusted only for negative changes). The Staff recommended that the residual margin should be floated, and that no limits should be applied to the adjustments other than that the floated residual margin could not become negative.

IASB members raised a number of concerns about the practicality of this approach and the potential complexities involved in implementing and were reassured by the Staff who explained that companies accounting under Australian GAAP were already doing something similar under the Margin on Services accounting methodology. Comments were also made that, having decided to support the unlocking of the residual margin, the decision to support floating over consuming the residual margin was a more logical conclusion.

The IASB then voted (11 vs. 4) to support the Staff recommendation to float the residual margin and to impose no limitations to the adjustments made other than that the floated residual margin could not become negative. The FASB, given its support for a composite margin, elected not to vote on this and subsequent four topics.

What cash flow and discount rate changes should adjust the margin?

The next topic considered was about changes that should be reflected in the residual margin; the Staff recommending that:

- all changes in the assumptions to estimate future cash flows should be recognised in the adjustment to the residual margin; and
- insurers are permitted, but not required, to recognise the adjustments arising from changes in the discount rate in profit and loss when recognising the adjustment in the residual margin would result in an accounting mismatch.

The IASB agreed with the Staff recommendation to reflect the prospective changes in the cash flow estimates against the residual margin and, when they discussed the need for any limitations in the residual margin, they voted 12 vs. 3 to not limit increases in the residual margin but to prevent it to become a negative element within the insurance contract liability (in other words the residual margin cannot become an explicit debit balance).

Changes in discount rates

The IASB then discussed whether changes in discount rate should be recognised as an adjustment to the residual margin or in profit or loss in the period of the change to the extent that these changes create an accounting mismatch.

No decision was made, as Board members commented on the complexities that would arise, with some commenting that the issue was not fully understood and that they would prefer to defer the decision until more work had been done.

Changes in risk adjustment

The Staff recommended that all changes to the risk adjustment should always be recognised in profit and loss.

The Boards' members commented that this approach was inconsistent with previous Staff recommendations to recalibrate the prospective remeasurement of the future cash flows against the residual margin. Several members indicated at this point that they were reconsidering their votes to previous recommendations. A key issue is that changes in the risk adjustment are inextricably linked to changes in cash flows' probabilities that arise as the risk unwinds; it would create an accounting mismatch were any such compensating changes to be recognised differently – one on profit and loss and the other offset against the residual margin.

Eventually though, the IASB voted 9 vs. 6 to support the Staff recommendation.

Adjust prospectively or retrospectively?

The Staff recommended that changes to the residual margin should be made only on a prospective basis. With fairly minimal discussion, the IASB voted (10 vs. 5) to support the Staff recommendation.

In conclusion, these tentative decisions on unlocking the residual margin indicate that the future IFRS will have a recalibration approach as Deloitte recommended and that this will take into account the prospective remeasurement of the probability weighted cash flows (Building Block 1) but will exclude remeasurement arising from the risk adjustment (Building Block 3) with an open item on the treatment of discount rate changes.

The final decision on this last element of the unlocking principles is a key issue for insurers with assets held at amortised cost. Such insurers would be exposed to the accounting mismatch arising from the fluctuation of the corresponding discount rate used to measure their asset matched insurance liabilities without any compensating adjustment to the matching assets held at amortised cost if the unlocking of the residual margin does not capture changes from the insurance liabilities' discount rate. This has been described as the "cost-current" mismatch (from the fact that the assets are at cost and the liabilities are on a current basis) or the liability driven mismatch.

Amortisation/earning principles underpinning the unlocked residual margin

The IASB deliberated also a number of principles that define the basis for allocating the residual margin to profit in parallel with the unlocking principles. These decisions set an underlying amortisation/earning pattern that works in conjunction with the unlocking principles.

Staff question for the Boards	IASB's Decision
1. Should the unlocked residual margin be allowed to become negative (i.e. to carry forward an expected loss)?	15 vs. 0 that the unlocked residual margin should not be allowed to become negative.
2. Should the residual margin be allocated over the coverage period on a systematic basis using a pattern that reflects services provided to the customer?	9 vs. 6 in favour of allocation over the coverage period.
3. Should the residual margin be determined on a level that aggregates similar contracts?	No decision reached in advance of further work on the definition of portfolio for all aspects of the project.

Deloitte position on allocation of the residual margin
We agree that the unlocked residual margin should not be allowed to become negative. However we do not agree with allocation over the coverage period only. We believe that the residual margin should be allocated over both the coverage and settlement period to faithfully reflect the economics of fulfilling the obligations arising from a portfolio of insurance contracts.

No opposition was raised to the proposal that the residual margin should not be negative.

During the discussion on the amortisation/earning period some members raised concerns that if the residual margin was meant to represent the unearned profitability on the insurance contract (as indicated in papers and decisions earlier in the day), then earning the full amount over the coverage period was inconsistent with the fact that the contractual obligations continue to be fulfilled during the claims settlement period. Other members were concerned that this topic had implications for day one gains and onerous contracts that had not been adequately explored.

However the IASB voted (9 vs. 6) in support of the proposal to recognise the residual margin over the coverage period. This means that all prospective changes in cash flows identified after the coverage period would be reflected in the statement of comprehensive income. Consequently, after the coverage period, insurers would have no residual margin to use against the remeasurement of prospective cash flows.

No decision was taken on the third recommendation, as the Boards felt that decisions on the definition of a portfolio should be taken prior to considering this issue.

The Staff agreed that they will consider the aggregation definition for this aspect and other aspects of the new IFRS at future meetings. There are many other areas where the aggregation issue has still to be determined (e.g. in determining day 1 profits or losses) and it is logical that this issue should be considered for the project as a whole not in isolation for individual issues.

Deloitte position on the definition of portfolio
The definition of a portfolio is not supported by any application guidance. This may lead to diversity in practice. We recommend that guidance should be included in the final IFRS to explain how portfolios are defined vis-à-vis different legal structures. We believe that it would be more relevant for users if the definition of portfolio is independent of the insurer's legal structure. Guidance would need to be developed in the final IFRS to explain that the degree of diversification in a portfolio is established at the highest level at which a reporting entity is consolidated if enforceable intercompany agreements exist that would allow access to the portfolio diversification benefits. In addition we believe that our recommendation to designate the recalibration approach at a portfolio level would also contribute to the application of the definition and it should be included in the application guidance.

We agree that it is appropriate to estimate the residual or composite margin for a group of contracts; however, we believe the Board needs to clarify further, or provide additional application guidance on, the definition of "portfolio" to avoid diversity in practice.

We also understand, and agree in principle, with the rationale behind requiring portfolios of contracts to be disaggregated further into cohorts for the purposes of determining the residual margin. However, for entities that write a large volume of contracts it is possible that this requirement could become burdensome in practice.

We believe, it would be helpful if the final IFRS further clarified what is meant by "similar" and provided examples of how this principle might be applied in practice (e.g., grouping all contracts written in the month of September 201X having a coverage period of 2 years) or by setting some minimum level of aggregation. The final IFRS should also clarify that such cohorts could still be combined and reported at the portfolio level in the statement of financial position.

Clash of Boards continues on the accounting for acquisition costs

Despite agreeing at their June meeting that only direct acquisition costs should be included within the insurance contract cash flows (IASB – 14 vs. 1; FASB – unanimous) they remained divergent (IASB – 6 vs. 9; FASB – unanimous) on the proposal to include only costs associated with successful sale activity.

Principally, the Boards' debate focused on the unit of account (i.e. at what level acquisition costs should be measured) and on whether the acquisition costs to assemble a portfolio, however defined, should include the costs associated with unsuccessful attempts to issue a contract.

Some Board members commented that all acquisition costs incurred in assembling the portfolio are considered by the insurance company and priced into the consideration charged for issuing new contracts thus confirming the logic of including all acquisition costs. Other members rebutted this argument on the basis that a) the portfolio includes only the product of successful efforts, and b) no other industry is permitted to defer acquisition costs on unsuccessful efforts to sell a contract with a customer even though they also price their contracts accordingly and even if all acquisition costs are necessary to assemble a portfolio the justification to have a different approach for insurance contracts appears to be controversial.

The agreement on the cost definition resulted in both Boards accepting that only direct acquisition costs would be considered to be part of the contractual cash flows and they should exclude indirect costs such as:

- software dedicated to contract acquisition;
- equipment maintenance and depreciation;
- agent and sales staff recruiting and training;
- administration;
- rent and occupancy;
- utilities;
- other general overhead; and
- advertising.

Deloitte position on acquisition costs
We agree with the concept of including in the expected present value of an insurance contract those incremental costs identified in the ED. However, we believe that the cash flows to be included in the Building Blocks should also include directly attributable costs related to the issuance of an insurance contract. Including these directly attributable costs would be consistent with the economics of the insurance contract.

We believe that the following language from FASB Accounting Standards Update (ASU) No. 2010-26 Financial Services – Insurance (Topic 944) would be an appropriate guideline for identifying those costs that should be included in the expected cash flows. As stated in the ASU:

"The portion of the employee's total compensation […] and payroll-related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:

1. Underwriting

2. Policy issuance and processing

3. Medical and inspection

4. Sales force contract selling.

Other costs related directly to those insurers' acquisition activities described above that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred".

We have noted that the IASB Staff paper produced for the July joint meeting appears to have taken a new approach to acquisition costs in relation to short term contracts.

Despite not having this discussed at the July meeting, the IASB Staff paper on short term contracts proposed that only incremental costs to secure short term contracts should be excluded from the insurer's expenses when incurred and that they would need to be recognised as an asset on the balance sheet.

This very surprising turn of the IASB Staff goes against all prior decisions taken by the IASB and seems to entirely contradict the IASB view that the simplified method for short term contracts is only a shortcut to the main accounting model based on Building Blocks.

It is hard to see the logic of this approach that the IASB Staff justified in their paper as aiming to converge with the treatment of acquisition costs under the Revenue Recognition project.

Deloitte position on the proposed definition of acquisition costs under the Premium Allocation approach
In our comment letter we did not recommend a different definition of acquisition costs within the same IFRS.

The key issue here is not the balance sheet presentation as an asset or as a deduction from the insurance contract liability but the difference in underwriting profit that will arise in quarterly reporting during the coverage period of contracts accounted for under the simplified method (re-branded Premium Allocation approach at the July meeting) compared to similar contracts accounted for under the Building Blocks approach.

The IASB Staff paper seems to assume that borrowing an accounting model from another standard would result in a simplification of the Building Blocks model. This assumption does not appear to be supported by any empirical evidence. It is likely that IASB Staff proposal would instead result in more complexity and it would lead to less relevant and less reliable financial statements.

The added complexity would arise from forcing insurers to develop different cost allocation systems depending on the type of business sold rather than utilising the same cost allocation basis. Relevance and reliability would be undermined because this proposal would produce both profit and balance sheet differences within transactions that are covered by the same IFRS with different profits recognised between insurers selling insurance contracts that only differ for the duration of their coverage and different liabilities depending on whether the simplified method is used for the same identical cover.

Making the simplified method a requirement as proposed in the Exposure Draft or an accounting policy choice would only have a very limited mitigation impact leaving the comparability of insurers seriously dented under both options.

An uneventful discussion on the simplified accounting model for short duration contracts

The Staff introduced the discussion topic, the simplified approach for short term insurance contracts, and provided a summary of the relevant decisions made to date as well as the outreach that had been undertaken. In particular, the Staff discussed the feedback on the ED proposals and the Insurance Working Group feedback on the post-ED discussions to date.

The Staff proposed two approaches, with the IASB and FASB Staffs each supporting one of them. The IASB Staff prefers a "one-model" approach, under which the simplified model for the pre-claims accounting phase of a short term contract is based on the revenue recognition project and serves as a proxy for the Building Blocks approach which is then used for the post-claims accounting phase of these contracts. The FASB Staff prefers a "two-model" approach, under which the simplified model and the Building Blocks approach are separate accounting models and short term and long term insurance contracts are different types of contract.

The IASB Staff noted that the two approaches are expected to have largely similar practical results. This statement seems at odds with the new acquisition costs approach proposed under the IASB "one model" approach commented above. In addition, we note that despite both approaches triggering the calculation of an onerous portfolio liability, using the same test the determination of the liability would include a risk adjustment under the IASB approach whilst it would only include the probability weighted net present value of future cash flows under the FASB approach.

As the Boards opened the debate on the eligibility criteria, the Staff noted that it is likely that approximately 90% of the contracts eligible for one approach would also be eligible under the other approach. The Boards were, however, unable to reconcile the "one-model" and "two-model" concepts with their understanding of the insurance project overall direction so far and whether specific contract examples would meet the eligibility criteria under the two approaches. The allocated time was largely spent debating whether a one-model approach or a two-model approach should be used and whether that approach was justified by the economics of the underlying transactions.

Other than to decide that the simplified method would now be called the "Premium Allocation" approach, no decisions were reached and none of the other topics in the Papers were considered.

The Boards directed the Staff to prepare additional information for the next meeting. This additional work is primarily a review of insurance contract types to identify those contracts that are likely to meet the eligibility criteria for one approach but not the other so that the Boards could then consider whether changes should be made to the eligibility criteria proposed by the Staff in the meeting.

Deloitte position on the Premium Allocation approach
Deloitte recommend that the Premium Allocation approach (previously known as the 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 Premium Allocation approach 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 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.

Presentation of insurance contracts in the statement of comprehensive income

At their June meeting the Boards discussed the income statement presentation of insurance contracts. The FASB Staff introduced the paper explaining that, in developing the current recommendation, consideration had been given to the feedback received from the Boards and the feedback from the outreach on the alternatives presented at a previous meeting. It was also noted that this paper does not cover the statement of financial position (balance sheet), the presentation of purchased reinsurance, nor that of unbundled deposit components.

Volume of insurance contracts sold

According to feedback received by the Staff, most users and preparers of financial statements want to see both volume and margin information. The Staff proposal to accommodate this request considered three alternative approaches for the premium recognition criteria:

- premium due – consistent with the cash flow estimates in the liability for the next period only;

- premium written – consistent with initial liability measurement as it would include the whole of the present value of expected cash inflows; or

- premium earned – consistent with the release of the margins.

The Staff recommended that, for contracts measured using the Building Blocks approach, the premium due should be presented in the statement of comprehensive income, with no indication that it is revenue. Although several of the Board members expressed a strong preference for using premium earned, which is what they believe users of accounts are used to seeing, the Staff explained that this approach does not fit with several insurance contracts, in particular those with saving components. Under IFRS4 Phase I general insurers report written and earned premium, with most focus on earned premium, but life insurers generally report premium due, and do not report earned premium.

Both Boards agreed to accept the Staff recommendation to use the premium due for the Building Blocks contracts and the premium earned for the contracts under the Premium Allocation approach.

Presentation of insurance contracts income and expenses

The Staff presented three examples (two of the examples as presented in the Staff paper can be found in Appendix 2) of an income statement complete as far as the lines arising from insurance contracts are concerned. The first two examples separate the underwriting margin between the margin from contracts measured using the Premium Allocation approach, where the premium earned is presented, and the margin from contracts measured using the Building Blocks, where the premium due is presented instead. The difference between Example 1, recommended by the Staff, and Example 2 is slight. In the first example the expected net change in liability is presented as one number rather than analysed into its three components (premiums, benefits and expenses).

Example 3 is a combined presentation which aggregates the premiums earned from the Premium Allocation approach for short term contracts with the premiums due from the Building Blocks approach. This third example, if selected, could be adapted to show separate amounts for the Premium Allocation approach and Building Blocks approach either on the face of the statement of comprehensive income or on in the footnotes

Together with the volume information, the statement of comprehensive income will also show as separate items the changes in assumptions, release of the margins, investment income and changes in discount rates.

The Boards' preference appeared evenly split between the Examples 2 and 3 rather than Example 1, which was the Staff recommendation. Those favouring Example 2 liked that it offered a dual statement presenting separately the contracts measured using the Premium Allocation approach and those measured using the Building Blocks approach, and showing the detail of expected versus actual cash flows for the latter. These Board members argued it was easier to see the profit drivers and how the Building Blocks developed. It was noted though that the wording should be simplified to remove some of the insurance jargon. A final advantage of this presentation would seem to be the clarity on revenue presentation as in Example 3 premiums are presented on one line leading to an implicit association to a revenue line despite the earlier agreement that volume information should not have this connotation.

On the other hand, those in support of Example 3 noted that it resembles more the traditional statement of comprehensive income, showing premiums due, claims and expenses incurred, release of margins and changes in margins and assumptions. Those in favour of Example 3 also argued that it may have most appeal to the industry as it is closer to what they are used to. Where an insurer presents a combination of life insurance business and general insurance business under IFRS4 Phase 1 then Example 3 may be closer to the status quo. However, where a composite insurer presents disaggregated data for its life insurance business and its general insurance business then Example 2 would be closer to the status quo, or possibly Example 3 with data disaggregated to show separately the data separately for the Premium Allocation approach and the Building Blocks approach.

In addition, Example 3 would seem to offer a clearer way to set minimum requirements and allow preparers to put additional information in the footnotes. Such an approach would also have the benefit of avoiding the development of a statement specific to the insurance industry that users would find difficult to understand. The information in the footnotes would still be important and the IFRS should contain specific requirements to allow a consistent disclosure of key performance indicators.

The vote at the meeting was evenly split between Examples 2 and 3 as far as the IASB was concerned and FASB majority supporting Example 2 with five votes against 2.

Subsequently the IASB Update reported the outcome of the fragmented support to Example 2 as follows:

"Five FASB members supported and two opposed this direction. Seven IASB members supported and seven opposed this direction. One IASB member was absent. The IASB then indicated that it would not oppose proceeding on this basis. Three IASB members objected to this approach.

The boards discussed whether they would require all insurers to present each of the above line items in all cases on the statement of comprehensive income, rather than in the notes. No decision was made."

Deloitte position on reflecting volume information in the statement of comprehensive income

Insurers and investors frequently comment to us on the limited information the ED presents on the volume of contracts that an insurer sells in a reporting period. We believe that the presentation of an insurer's performance would be more relevant if it also included information related to contracts sold in the reporting period.

One possible way to achieve this objective under the current fulfilment value model would be to present the elements of the initial calibration of the residual margin as separate lines at the top of the statement of comprehensive income. This approach would have the following benefits: (a) it would capture consistent information for contracts issued in the reporting period; (b) it would be consistent with the underlying measurement model; and (c) it would allow the calculation of common ratios that investors have developed.

The recent decision to adopt the premium due is not in line with our recommendation and it would require insurers' systems to separately analyse from the expected net present value of the probability weighted cash flows the respective components of inflows and outflows that are expected to occur in the reported period. This information would then be compared against the actual inflows and outflows to provide a granular explanation of the experience variances on the face of the income statement.

However the premium due approach would not assist investors to appreciate the inflows that arise from new contracts issued during the period from inflows that arise from contracts in force at the beginning of the period that have yet to receive the full extent of their expected inflows (e.g. regular premium contracts). Ratios like the margin on new business would not be possible under this approach unless the insurer provides the information on a voluntary basis.

Next steps

The IASB is now in their summer break and no meetings are scheduled until September.

The FASB continues to work throughout August. However no sessions on insurance have been planned.

Appendix 1

IASB Work Plan – projected targets as at 26 July 2011

Financial Crisis related projects	2011 Q3	2011 Q4	2012	MoU	Joint
IFRS 9: Financial instruments (replacement of IAS 39)					
Deferral of mandatory effective date of IFRS 9	Publish ED				
Impairment	Re-exposure or Review draft			✓	✓
Hedge accounting					
General hedge accounting	Ballot (target IFRS Q4)			✓	
Macro hedge accounting		Publish ED			
Asset and liability offsetting	Ballot (target IFRS Q4)			✓	✓
Consolidation – Investment companies[1]	Publish ED				✓

Memorandum of Understanding projects	2011 Q3	2011 Q4	2012	MoU	Joint
Leases		Re-exposure	Target IFRS	✓	✓
Revenue recognition	Re-exposure		Target IFRS	✓	✓

Other projects	2011 Q3	2011 Q4	2012	MoU	Joint
Insurance contracts		Re-exposure or Review draft			✓
Annual improvements 2009-2011 [ED, comments due 21 October 2011]	Comment period				

Agenda consultation	2011 Q3	2011 Q4	2012
Three-yearly public consultation [Comments due 30 November 2011]	Comment Period		

[1] The exposure draft will be published in August so that it can be published on the same day as the equivalent FASB proposal.

Source: © IASB Work Plan, 26 July 2011

Key

AD	Agenda Decision (to add the topic to the active agenda)	RT	Roundtables
PS	IFRS Practice Statement	RV	Request for Views
Ballot	See note below	TBD	To be determined
DP	Discussion Paper	IFRS	International Financial Reporting Standard
ED	Exposure Draft		

Ballot
The formal process of seeking the Board's approval to publish a due process document (discussion paper, exposure draft or IFRS). Once the Board has concluded its deliberations on a particular stage of a project the technical staff prepare the relevant due process document. Each Board member is required to vote, indicating whether they approve the document for publication. Balloting takes place outside of Board meetings. If a document receives enough support it is prepared for publication (print and online). Publication of the approved document normally takes place several weeks or more after the balloting process has been completed. That time is necessary for the discussion paper, exposure draft or IFRS to be formatted and any accompanying documents, such as a feedback statement, to be prepared.

Appendix 2

Examples from Staff Paper 3A, prepared for meeting of 15 June 2011.

Appendix A – Example 2

Modified approach		
Premiums earned		2,139
Claims incurred		(1,422)
Expenses incurred		(341)
Release of composite margin		123
Change in risk margin		–
Experience adjustment		(22)
Changes in additional liability for onerous contracts		–
Amortization incremental acquisition costs		(331)
Change in assumptions		3
Underwriting margin (modified approach)		149

Building Block approach		
Release of composite margin		252
Change in residual margin		–
Change in risk margin		–
		252
Premiums due	4,228	
less premiums expected	(4,221)	7
Actual benefits	(2,992)	
less benefits expected	2,919	(73)
Actual expenses	(607)	
less expenses expected	611	5
Experience adjustment		(61)
Change in assumptions		(39)
Underwriting margin (Building Block approach)		152

Appendix A – Example 3

Premiums	6,367
Benefits/claims incurred	(4,409)
Expenses incurred	(948)
Expected net changes in the liabilities for the period	(1,093)
Experience adjustment	(83)
Release of composite margin	751
Change in risk margin	–
Change in residual margin	–
Change in assumptions	(36)
Changes in additional liability for onerous contracts	–
Amortization incremental acquisition costs	(330)
Underwriting margin	**302**

The official recording of the 15 June meeting, as found on the IASB's website, slightly modifies the example 2 above for the Building Block approach, by aggregating the expected items as well as showing the gains and losses at initial recognition.

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