



Last minute convergence
IFRS 4 Phase II Update - Global
Insurance GAAP

IASB and FASB joint meetings – June 2010

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Agenda

- Highlights of the June joint meetings
- Analysis of Staff recommendations and Boards' decisions
- Timetable and next steps

Highlights of joint IASB / FASB meeting – 1 June

Transitional arrangements

- On transition, liabilities valued using building blocks => difference with old GAAP to retained earnings
- DAC and other intangible assets to be written off to retained earnings
- Post transition margins' run-off to income will be disclosed separately
- Reclassification of financial assets held at amortised cost to be permitted

Business combinations

- Insurance contracts acquired in a business combination or portfolio transfer will be valued at the present value of future cash flows plus a risk margin (NB: only in the model where this is used)
- Positive difference accounted for as residual / composite margins OR taken directly to profit and loss if negative
- Exemption to the normal FV principle used in business combination accounting
- May result in increased goodwill

Highlights of joint IASB / FASB meeting – 10 June

Participating contracts

- Investment contracts with DPF participating in the same pool of assets as participating insurance contracts to be included in scope of insurance standard
- Contract boundary is point at which policyholder has no further right to participation benefits
- On the 23rd June meeting the FASB agreed to align its position to that of the IASB set out above

Risk adjustment techniques

- Staff to prepare guidance on proposed permitted techniques:
 - confidence intervals
 - conditional tail expectation
 - cost of capital

Highlights of joint IASB / FASB meeting – 15 June

Draft application guidance on cash flows

- Boards suggested corrections and clarifications for the Staff to include in the next draft
- Boards requested tightening up of the overall principle wording

Foreign currency cash flows

- Insurance contracts, including items such as unearned premium, classified as monetary items
- This decision eliminates an accounting mismatch experienced under IFRS 4 Phase I

Highlights of joint IASB / FASB meeting – 16 June

Draft application guidance on risk adjustment techniques

- Objective of the risk adjustment:
 - “the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed those expected”
- Three proposed measurement techniques, although not to be limited to those
- Proposed application guidance requested on 10 June has been approved

Reinsurance

- Changes in the valuation principles for reinsurance contract assets to require the accounting for reinsurance gains and not to create negative margins
- IASB – net cash flow approach: ceding commissions shall be considered a reduction in premium paid
- FASB – gross cash flow approach: ceding commissions shall be revenue to the extent that they relate to acquisition costs, with other amounts being a reduction in premium paid.

Highlights of joint IASB / FASB meeting – 23 June

Fulfilment cash flows

- Proposed principle to describe the overall model likely to change to “future cash flows that are integral to the fulfilment of the insurance contracts”

Acquisition costs – New convergent agreement

- Boards agreed to reduce the residual / composite margin by incremental ACs at inception
- Done either by including in cash flows or excluding from initial measurement of margin

Unbundling – New convergent agreement

- Staff was asked to reword principle along the lines of: *“Unbundle if the policyholder can redeem or withdraw investment without losing guaranteed insurability and without the insured event occurring, OR if the benefit amount varies primarily on changes in a financial factor.”*

Presentation – New convergent agreement

- Slight preference for summarised margin approach with supplemental disclosures
- Field testing during comment period

Interest accretion

- Views divided

Details of IASB/FASB joint meeting – 1 June

Paper 1A – Transition

Q1 – Transition of opening balances

Staff proposal: Opening balances should be determined as the expected present value of cash flows (plus a risk adjustment). The difference between this and the amount and previous accounting policies' amount is treated as residual / composite margin if positive, OR taken to profit and loss if negative.

- Rejected second part of proposal unanimously.
- Tentatively agreed to value with building blocks approach, plus a risk margin (which becomes composite margin if the risk adjustment approach not used). The difference goes to transitional retained earnings (debit or credit).
- The margin calculated at inception should be separately run off from any new margin after the point of transition.

Recommendation	IASB	FASB
In favour	6	2
In favour of new approach	9	3

Details of IASB/FASB joint meeting – 1 June (cont.)

Paper 1A – Transition (cont.)

Q2/3 – Transition of intangible insurance assets / deferred acquisition costs

Staff recommendation: Merge insurance assets (e.g. PVIF or VOBA) and deferred acquisition costs with the insurance liability before comparing with amount on transition.

- Effectively means DAC and intangibles are written off to retained earnings

Recommendation	IASB	FASB
In favour	unanimous	
Against	n/a	

Details of IASB/FASB joint meeting – 1 June

Paper 1A – Transition (cont.)

Q4 – Transitional disclosures

Staff recommendation: Existing disclosure requirements from IAS 8 and FASB ASC Subtopic 250-10-50 already provide a comprehensive set of disclosure requirements. No additional disclosure requirements needed.

- IASB: no objections although would like to disclose both the margin created on transition to margin arising after transition.
- FASB members raised concerns ASC Topic 250 which is related to voluntary accounting changes and is therefore not relevant to the adoption of the new insurance standard. Agreed with IASB to split margin disclosure in two streams.

Recommendation	IASB	FASB
In favour + split run-off of margin post and prior	11	5
Against	4	0

Details of IASB/FASB joint meeting – 1 June

Paper 1A – Transition (cont.)

Q5 – Reclassification of financial assets

Staff recommendation: Entity should be permitted, not required, to re-designate financial assets as measured at fair value through P&L if that would reduce measurement or recognition inconsistencies.

- No objection although reclassification should be done at portfolio of assets level.
- The Boards also stipulated that this reclassification shall only take place towards fair value – changing towards an amortised cost (or other) basis would not be permitted.

Recommendation	IASB	FASB
In favour	unanimous	
Against	n/a	

Details of IASB/FASB joint meeting – 1 June

Paper 1A – Transition (cont.)

Q6 – First time adoption (IASB only)

Staff recommendation: The agreed transitional provisions should apply equally to insurers applying IFRS or US GAAP, and to insurers adopting IFRS for the first time.

- The Boards did not discuss the effective date of the standard, or whether to permit early adoption.
- The Boards will consider whether, if the IFRS 4 Phase II adoption date is delayed beyond 2013, to delay the effective date of IFRS 9 to synchronise implementation dates

Recommendation	IASB	FASB
In favour	unanimous	
Against	n/a	

Details of IASB/FASB joint meeting – 1 June

Paper 1B – Business combinations and portfolio transfers

Q – Portfolio transfers

Staff recommendation: For insurance contracts assumed in a portfolio transfer, the insurer should compare the amount that results from the expected present value (plus risk adjustment) with the consideration received and:

- a) If consideration received exceeds PV, treat difference as the residual / composite margin;
- b) If the PV exceeds the consideration received, recognise difference in P&L.

- FASB agreed with the treatment of negative differences at a subsequent meeting and, in this area, at the meeting on 23 June FASB aligned its proposals to those of the IASB

Recommendation	IASB	FASB
In favour	Majority	
Against	n/a	

Details of IASB/FASB joint meeting – 1 June

Paper 1B – Business combinations and portfolio transfers (cont.)

Q – Business combinations

Staff recommendation: The present value of the future cash flows (plus risk adjustment) should be compared with the fair value of those contracts and:

- a) If the FV exceeds the present value, treat difference as the residual / composite margin;
- b) If the present value exceeds the FV, then measure the contracts using the present value (exception from IFRS 3 requirements and ASC Topic 805).

- This would increase carrying amount of goodwill recognised on business combination on the assumption that the fair value of insurance liabilities is lower than the 3-building-block approach

Recommendation	IASB	FASB
In favour	Majority	
Against	n/a	

Details of IASB/FASB joint meeting – 10 June

Paper 1A – Participating investment contracts

Q1 – Include participating investment contracts in which standard

Staff recommendation: Include participating investment contracts in

- a) For the IASB, the insurance accounting standard;
- b) For the FASB, the financial instruments accounting standard.

- The IASB agrees as long as contracts participate in same pool of assets as insurance contracts.
- As a result of the change on the block 1 definition reached on 23 June, FASB is now changing its position on participation contracts to align it to the IASB

Recommendation	IASB	FASB
In favour	Majority	
Against	n/a	

Details of IASB/FASB joint meeting – 10 June

Paper 1A – Participating investment contracts (cont.)

Q2 – Accounting for participating investment contracts as insurance

Staff question: If the Boards decide to include participating investment contracts in the insurance standard,

- a) should this apply to such contracts that share in the same pool of assets as participating insurance contracts?
- b) should the contract boundary be defined as the point where the policyholder has no further right to benefits arising from the discretionary participation feature?

- IASB agreed with the staff recommendation and tentatively agreed that only these participating investment contracts should be included within the insurance standard.

Recommendation	IASB
In favour of a)	Majority
In favour of b)	Majority

Details of IASB/FASB joint meeting – 10 June

Paper 1B – Risk adjustment techniques

Q – Inclusion of risk adjustment techniques

Staff recommendation: if the measurement model includes a separate risk adjustment, the range of permitted techniques should be limited by specifying the available techniques for estimating the risk adjustments.

- Issues raised:
 - measurement techniques proposed may not meet the measurement objectives;
 - inappropriate methods for certain types;
 - capital should be based on financial reporting rather than regulatory.

- The Boards declined to vote, and directed the staff to develop additional information for presentation at later meetings.

Details of IASB/FASB joint meeting – 15 June

Paper 2C – Draft application guidance on cash flows

Q – Guidance on cash flows

Staff question: Do the Boards have any comments on the draft application guidance prepared by the staff:

- include only future cash flows from the fulfilment of an insurance contract in the measurement of the contract.
 - cash flows should reflect the insurer's estimate of its cost to fulfil the contract.
 - where a replicating portfolio exists, such a portfolio should be used in the measurement of the insurance liabilities.
 - expectations at reporting date should be taken into account for measurement.
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- Overall, the Boards felt that the application guidance was well drafted.
 - FASB: some of the proposed costs to be included in the cash flows did not tie in well with the fulfilment notion.
 - Suggested clarification needed on the impact of future events on the estimates of CFs to avoid equalisation reserve accounting
 - The staff were asked to tighten the wording of the overall principle to link it more closely to the more detailed guidance that follows it.

Details of IASB/FASB joint meeting – 23 June

Paper 1A – Fulfilment cash flows

Q – Fulfilment cash flows

Staff question: Do the Boards agree with the staff recommendation that all future cash inflows and outflows arising from fulfilment should be included in the expected present value of the future cash flows?

- New principle proposed by Board and agreed around *“incremental future CFs that will arise directly from insurance contracts”* (not clear whether at portfolio or contract level)
- As a result of this change, FASB is aligning its position on participation contracts to that of IASB. This would remove another of the remaining differences between the two Boards

Details of IASB/FASB joint meeting – 15 June

Paper 2D – Foreign currency cash flows

Q – Monetary or non-monetary items?

Staff question: Do the Boards agree with the staff recommendation that insurance contracts, and each of the components of such contracts, are monetary items?

- After discussion, the Boards have agreed unanimously to that insurance contracts, and each component thereof, are monetary items.
- Insurance contracts with foreign currency cash flows will therefore be subject to the foreign currency retranslation rules.
- Pre-claims liabilities of short-duration contracts using the unearned premium approach will also, contrary to current accounting rules, be monetary items.

Recommendation	IASB	FASB
In favour	Unanimous	
Against	n/a	

Details of IASB/FASB joint meeting – 15 June

Paper 2F – Recoverability of acquisition costs

Q – Acquisition cost assets

Staff recommendation: Acquisition costs recoverable from third-parties should be treated as assets, measured at the amount of commission paid and in accordance with a claw-back schedule

- Agreement reached on 23 June on acquisition costs in general (see later slides) should assist the resolution of these specific issues
- Issues raised:
 - Whether ACs would be recoverable from a third party in the event of a contract lapse.
 - IASB noted a discrepancy on the accounting for ACs depending on whether they were received directly from the policyholder or via the broker.
 - Should recoverable ACs be expensed (with revenue set-off) as, if recoverable, not really an expense.

Details of IASB/FASB joint meeting – 16 June

Paper 2G – Application guidance for risk adjustment techniques

Q – Guidance on risk adjustment techniques

Staff question: Do the Boards have any comments on the draft application guidance including the proposed objective for risk adjustment and with the proposed risk adjustment measurement techniques?

- Agreed to modify objective to *'the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed those expected'*.
- Agreed to provide descriptions of the three permitted methods to assist with application.
- Subject to change above, approved the draft application guidance for risk adjustment techniques.

Details of IASB/FASB joint meeting – 16 June

Paper 2E – Reinsurance: follow up issues

Q1 – Negative margins

Staff question: Do the Boards agree with the staff recommendation that negative margins on reinsurance assets should be recognised in profit and loss after confirming that the negative margin does not arise from a measurement inaccuracy?

Recommendation	IASB	FASB
In favour	Majority	
Against	n/a	

Details of IASB/FASB joint meeting – 16 June

Paper 2E – Reinsurance: follow up issues (cont.)

Q2 – Ceding commissions

Staff recommendation:

- a) IASB should treat ceding commissions as a reduction in premium paid, and
- b) FASB should treat ceding commissions as a gain in profit and loss to the extent that they refer to the reinsurers' incremental acquisition costs.

- The FASB noted that any amount in excess of ceding commission that is due to be paid to the cedant would need to be treated as a reduction in premium paid.

Recommendation	IASB	FASB
In favour	Majority	
Against	n/a	

Details of IASB/FASB joint meeting – 23 June

Paper 1B – Acquisition costs

Q – Acquisition costs

Staff question: Do the Boards agree with the following staff recommendations:

Acquisition costs should be expensed as incurred; and either

- a) Reduce residual / composite margin (but not below zero) by the amount of incremental acquisition costs either by excluding it from initial measurement, or by including it in the cash flows. Each would result in recognition of revenue. OR
 - b) Recognise any rights to recover incremental acquisition costs as an asset, amortised over the period of the cash flows.
- Discussions around whether to split between successful / not successful sales costs did not produce new tentative decisions
 - The incremental test would be performed at a contract rather than a portfolio level

Details of IASB/FASB joint meeting – 23 June

Paper 1C – Follow up on unbundling (part 2)

Q – Unbundling

Staff question: Do the Boards agree with the staff recommendation to keep the previously agreed principle, provide additional guidance on application thereof, and open the issue to commentary from the stakeholders? Do the Boards have any other guidance they would like to include?

- FASB member suggested “if a policyholder can withdraw or redeem investment without an insured event occurring OR if amount of benefits varies primarily based on changes in financial factor, then unbundle”
- Staff suggested added condition that the guaranteed insurability is not lost as a result
- Staff is to work on new wording, as long as same result can be achieved

Details of IASB/FASB joint meeting – 23 June

Paper 1D – Presentation

Q – Presentation

Staff question: Do the Boards prefer an expanded margin approach, or an approach that recognises written premiums as revenue? If the Boards prefer an expanded margin approach, would they add actual claims and expenses incurred in the period to the margin released, or would they add claims and expenses determined at inception adjusted for in force contracts?

- Boards are divided on this point.
- Summarised margin approach, with supplemental disclosures, marginally favoured
- Will use consultation period for field testing

Details of IASB/FASB joint meeting – 23 June

Paper 1F – Interest accretion

Q – Presentation

Staff question: Do the Boards prefer a locked-in interest rate or an updated rate at each reporting period? Should the rate be based on a one-year, risk-free rate?

- Some FASB members changed their mind and agree to accrete interest
- However, views are generally divided
- If there is accretion, locked-in rate marginally favoured (more consistent with Revenue Recognition)
- Will give both view in Exposure Draft

Details of IASB/FASB joint meeting – 16 June

Paper 2B – IASB/FASB differences in tentative decisions

Staff presentation

Summary: The staff presented a summary of the differences in tentative decisions reached by the two Boards for the consideration of the two Boards in an attempt to resolve outstanding differences prior to the release of the ED.

Risk adjustment margin

- FASB confirmed that they still favour a composite margin, seeing it as more relevant to a fulfilment approach.
- IASB remained split, and voted (9:6) to retain the risk and residual margin approach.

Details of IASB/FASB joint meeting – 16 June

Paper 2B – IASB/FASB differences in tentative decisions (cont.)

Staff presentation (cont.)

Definition of insurance risk

- After debate, the IASB agreed (10:5) to support the FASB position and amend the current IFRS 4 definition with a loss scenario test.

Embedded derivatives

- After debate, the IASB agreed (14:1) to support the FASB position that the unbundling rules should be consistent across the whole insurance standard, rather than applying the IAS 39 rules.

Details of IASB/FASB joint meeting – 16 June

Paper 2B – IASB/FASB differences in tentative decisions (cont.)

Staff presentation (cont.)

Derecognition

- Although no vote was taken, the IASB and FASB indicated convergence on the use of the IAS 39 principle for derecognition – when the obligation is discharged, cancelled or expires – subject to the inclusion of guidance that the contract is extinguished when the insurer is no longer at risk and no longer required to transfer economic resources for that transaction.

Details of IASB/FASB joint meeting – 17 June

Basis of dissenting opinions

Summary: The Chairman of the IASB requested that those who were intending to dissent should explain the basis for their opinion.

- Potentially, there are 4 dissenting opinions, although one will not be valid if the vote takes place after 30 June 2010 (as appears likely).
- The dissenting opinions are generally fairly broad in scope, covering such things as risk adjustment vs. composite margin, the treatment of acquisition costs in comparison to other industries and the scope of the standard being too broad.
- The potential dissenters seemed to feel that, overall, the new standard was not a significant improvement over the previous one in terms of improving financial reporting.

Timetable

Commitment to an exposure draft in 2010

- Exposure draft issue date will be July 2010
- 4 month comment period
- Standard remains due in June 2011 – explicitly confirmed in the revised convergence programme sent to the G20 ministers

Future meetings

- No more meeting expected before publication of exposure draft

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