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The Boards refine their divergent positions
IFRS 4 Phase II Update

IASB and FASB meetings – September 2011

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Agenda

- Highlights of decisions from latest meetings
- Detailed analysis of Staff recommendations and Boards decisions for the meeting held on 19 September and FASB meeting on 7 September
- Update on the timetable and next steps

Highlights of Board meetings – September 2011

- **Both Boards' revised technical plans put the target publication date of the final accounting standard beyond 2012**
- **FASB meeting on 7 September**
  - FASB deliberated on the composite margin accounting model
  - For short term contracts the composite margin is earned upfront over the short coverage period
  - Subsequent measurement is the mean value of a probability weighted discounted cash flow liability
  - For long term contracts the composite margin earning is back loaded based on decreases in the underlying uncertainty
- **Joint IASB / FASB meeting on 19 September**
  - Joint decision on disclosure confirmed the requirement to publish the discount rate yield curve and simplified the aggregation principles compared to the ED
  - Disagreements emerged on the disclosure of the measurement uncertainty and on the expected maturities disclosures
  - IASB defined the risk adjustment objective and developed application guidance for it
  - IASB decided to retain the compulsory disclosure of confidence intervals for all insurers irrespective of the technique selected
  - IASB decided to remove the restriction to three risk adjustment techniques only

Details of meeting – FASB 7 September

Accounting for a Single Margin Approach – Short term contracts

- The staff presented a comprehensive paper setting out their recommendation on the profit pattern that should be adopted for short-term insurance contracts
- The staff set out three alternative approaches:
  - Alternative 1: retention of existing US GAAP with unearned premium and undiscounted claims liabilities;
  - Alternative 2: use of the unearned premium method during the coverage period with a two-building block liability for the post-claim cash flows; or
  - Alternative 3: use of the unearned premium method during the coverage period with a single margin added to the claims liability based on the reduced variability principle decided on 17-18 May
- FASB staff recommended alternative 3
- The staff provided examples to illustrate the three alternatives and the resulting profit pattern an insurer would report
- The staff noted that at the end of the coverage period there is smaller but still significant variability of cash flows associated with the probability weighted discounted estimate of claims cash flows
- The insurer should add to this liability a single margin that adds the residual exposure to variability at the end of the coverage period

Details of meeting – FASB 7 September (cont.)

Accounting for a Single Margin Approach – Short term contracts (cont.)

- The staff also explained they did not favour the retention of current US GAAP on the grounds that when material the discounting of claims liabilities would be relevant financial information
- FASB members discussed extensively the principle of earning the single margin in this context and rejected the staff recommendation on the grounds that:
  - A number of members had voted for that principle with a reservation that it would not apply to the short term contracts
  - The debate on the short term contracts eligibility highlighted the FASB view that this is a separate model for them
  - The fulfilment of the stand ready obligation is complete when the coverage expires. Any activity to settle the incurred claims does not qualify as a provision of service instead it is "an expense optimisation activity" to quote one of the FASB members
  - Users have indicated to the FASB that they would not accept additional complications to the short term contracts existing model and Alternative 2 achieves that by simply requiring a more transparent and principle based claims liability (a discounted probability weighted cash flow estimate)
  - Loss development tables will inform users of the uncertainty in claims estimates

Details of meeting – FASB 7 September (cont.)

Accounting for a Single Margin Approach – Short term contracts (cont.)

- This decision gives a clearer view as to what it is meant as a separate model for short term contracts
- It increases the focus on developing a set of eligibility criteria that delivers a relevant and reliable basis for separating a sub-set of insurance contracts
- From a practical perspective the fundamental difference with the IASB approach for short term contracts is that the claims liability for the IASB includes a risk adjustment liability that is released after the coverage period is expired
- IASB would only earn the residual margin over the coverage period
- The draft eligibility criteria tabled by the FASB staff at the last July joint meeting included:
  - The benefits payable are variable up to a policy limit rather than being fixed;
  - The period between the premium receipt and the date of the loss is insignificant
  - The pricing of the risk does not include risks relating to future periods

FASB vote
Alternative 2 - unanimous

Details of meeting – FASB 7 September

Accounting for a Single Margin Approach – Key general principles

- The staff presented a comprehensive paper setting out their recommendation on the subsequent accounting for the composite margin
- The recommendations were based on the principle that the composite margin would be earned as the underlying uncertainty of the probability weighted cash flows decreases – this was defined as the “variability of the cash flows of a specified uncertain future event”:

1. For contracts where the variability is primarily due to timing the release to profit would be based on the reduced uncertainty in the timing of the specified event;
2. For contracts where the variability is primarily due to the frequency and severity of the event the release to profit would be based on the reduced uncertainty that follows the emergence of information about the expected cash flows throughout the life cycle of the contract

Details of meeting – FASB 7 September (cont.)

Accounting for a Single Margin Approach (cont.)

- The FASB discussed extensively these proposals and supported unanimously the staff recommendation
- Application guidance was also approved which included references to events that an insurer would need to consider in the implementation of the two principles
- The debate also highlighted that these principles could apply to certain insurance contracts that are issued by the P&C industry if they are not captured under the eligibility criteria for short term contracts

FASB vote
Unanimous

Details of meeting – Joint IASB / FASB 19 September

Disclosure requirements

- The staff presented five recommendations on the disclosure principles proposed in the ED
- The first recommendation was to delete the requirement an insurer should not aggregate information if this is arising from different operating segments
- The staff explained that the general principle of aggregation and disaggregation to ensure that:

information that is useful is not obscured by

either the inclusion of a large amount of insignificant detail

or the aggregation of items that have different characteristics

Is sufficient to deliver the relevant disclosures

- The overlap of the requirement to avoid aggregation of data reported in different operating segments could create an unnecessary conflict

IASB Vote	FASB Vote
Unanimous approval	Unanimous approval

Details of meeting – Joint IASB / FASB 19 September (cont.)

Disclosure requirements (cont.)

- The combined second and third recommendation was to retain the requirement that an insurer should disclose changes to inputs and to add a requirement to disclose the change in methods used to calculate the insurance contracts amounts. In addition the insurer would need to disclose the full yield curve used to discount cash flows of non participating contracts
- The addition of a requirement to disclose changes in methods recognises the need to inform investors on the qualitative characteristics of the models used
- The addition of the yield curve disclosure for the discount rate ratified a decision already taken last March on the discount rate deliberations for non-participating contracts
- All these disclosures will always be developed within the overriding materiality principle of IFRS and US GAAP

IASB Vote	FASB Vote
14 v. 1 approval	Unanimous approval

Details of meeting – Joint IASB / FASB 19 September (cont.)

Disclosure requirements (cont.)

- The fourth recommendation was to delete the requirement an insurer should disclose an analysis that measures the underlying uncertainty and to replace it with a cross-reference to the requirements set in IFRS 13 *Fair Value Measurement*
- The IFRS 13 disclosure requirements in this area focus particularly on the "level 3" fair values and include for example
  - Quantitative disclosure on the nature and changes in the unobservable inputs
  - Sensitivity of the "level 3" values to changes in the unobservable inputs that reflect reasonably possible alternative assumptions
- FASB was uncomfortable to rely on their equivalent of IFRS 13 and rejected the proposal on the grounds that the accounting standard on insurance could develop the more appropriate language for the disclosure of uncertainty of a non-fair value basis

IASB Vote	FASB Vote
14 v. 1 approval	2 v. 5 rejection

Details of meeting – Joint IASB / FASB 19 September (cont.)

Disclosure requirements (cont.)

- The fifth and final recommendation was to remove the optional disclosure on expected maturities leaving only a requirement to disclose a table based on expected maturities with a mandatory minimum five year prospective analysis
- The option removed would have allowed the use of contractual maturities instead of expected
- The requirement of a five years minimum table aligns this requirement to the leases disclosures
- The staff also proposed to remove the disclosure of the amount payable on demand
- FASB expressed their preference for their recent decision on the same topic that would apply to all financial institutions where the liquidity table will include also assets and information surrounding the distribution of liquidity between different entities in a consolidated group

IASB Vote	FASB Vote
14 v. 1 approval	Unanimous rejection

Details of meeting – Joint IASB / FASB 19 September (cont.)

Risk adjustment

- Without FASB participation the IASB refined their model by reaching three important decisions one of which was against their staff recommendation
- The first recommendation was to define the objective of the risk adjustment as the *"compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract"*
- The staff also asked the IASB to ratify two previous decisions. The first was that the final IFRS will have guidance on this objective using the following example:

"the risk adjustment would measure the compensation that the insurer would require to make it indifferent between (1) fulfilling a liability that has a 50 per cent probability of being 90 and a 50 per cent probability of being 110 or (2) fulfilling a liability of 100."

- The second is that an insurer would perform the risk adjustment calculation considering both positive and adverse outcomes within the probability distribution underpinning the expected cash flows

IASB Vote	FASB Vote
Unanimous approval	N/A

Details of meeting – Joint IASB / FASB 19 September (cont.)

Risk adjustment (cont.)

- The second recommendation was to remove the requirement from the ED to disclose the equivalent confidence interval percentage that would be derived from re-computing using the confidence interval technique all risk adjustment liabilities calculated with a different technique
- The IASB was uncomfortable with the staff proposal and rejected it on the grounds that its retention would offer a disclosure reference that could assist investors in comparing different insurers

IASB Vote	FASB Vote
4 v. 11 rejection	N/A

Details of meeting – Joint IASB / FASB 19 September (cont.)

Risk adjustment (cont.)

- The third recommendation was to remove the requirement from the ED that the risk adjustment technique has to be chosen from the three techniques of confidence interval, cost of capital and conditional tail expectation. The staff recommended that these techniques and the associated application guidance are retained as examples only
- The IASB majority was supportive of the staff recommendation although a few board members voiced the concern that this would make the IFRS liabilities less comparable
- The previous decision on a disclosure that would provide for any non confidence interval risk adjustment liability the equivalent confidence interval that delivers the same amount alleviated these concerns

IASB Vote	FASB Vote
12 v. 3 approval	N/A

Timetable and next steps

- In July 2011 the FASB published their revised technical plan where they indicate a target publication date for a US GAAP exposure draft during the first half of 2012
- Following two revisions in the space of four weeks in July, the IASB revised their technical plan for a third time on 14 September
- The revised delivery plan set out in the IFRS Project work plan:

	Q4 2011	2012
Insurance contracts	Re-exposure or review draft	

- The target publication date for both Boards is now no longer in sight of the 2012 calendar year end
- It is our expectation that a re-exposure of the draft IFRS will take place together with the publication of the US GAAP exposure draft aligning the two timetables
- With the publication of the final IFRS and US GAAP at some point in 2013 the pressure to move the effective date beyond 1 January 2015 will be significant

Timetable and next steps (cont.)

- The same fate has been suffered by the financial instruments project with both impairment and macro-hedging target publication dates beyond 2012

	Q4 2011	2012
IFRS 9 (replacement of IAS 39)		
• General Hedge Accounting	IFRS target publication date	
• Macro Hedging	Exposure Draft published	
• Asset and liability offsetting	IFRS target publication date	
• Impairment	Re-exposure or review draft	

- The EU accounting body EFRAG has proposed in its draft response letter to the change of the IFRS 9 effective date to 1 January 2015 that it should instead be amended to a three year period from the later of the publication dates of IFRS 4 Phase II and IFRS 9

Timetable and next steps (cont.)

Next steps

- The absence of an updated detailed plan since the version released for the meeting on the 4th of May 2011 leaves the public in the dark as to how the next steps will unfold and their timing
- We understand that significant activity has continued within both Boards during the past months
- The next joint meeting takes place in the US on 19-21 October. No sign yet of the increased frequency of meetings Hans Hoogervorst announced in July
- Insurance topics are expected for discussion but no agenda has been announced. Items that have been discussed recently and for which a return to the Boards could be expected soon include:
  - Short term insurance contracts (following the unproductive July meeting)
  - Unbundling (papers were withdrawn from discussion at the last minute in July)
  - The unlocking of the residual margin (IASB only) for the decision on the unlocking in relation to changes in the discount rate (follow up from the June meeting)
- An Insurance Working Group meeting is planned for the 24th of October in London

Contact details


Insurance Accounting Newsletter
Insurance Working Group meeting

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Link to **Deloitte Insurance Accounting Newsletter (English/German/Japanese versions):**

http://www.iasplus.com/agenda/insure2.htm#newsletter

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