Global Insurance GAAP

Update from the October 2009 Boards' meetings

2 November 2009
Francesco Nagari

Agenda

- Outcomes of this month's decision making meetings:
  – 28 October joint IASB /FASB
  – 20 October IASB
- Recap on the convergence towards a common accounting model
- Timetable and next steps

Highlights of IASB/FASB October joint meeting

Initial Measurement and role of acquisition costs

- FASB unanimously reaffirmed that their initial measurement of the contract is focussed on the objective of producing revenue recognition for insurance that is in line with the revenue recognition model
- IASB modified their previous tentative decision and agreed that the new IFRS would also prohibit the recognition of income from the initial calibration
- Both Boards reaffirmed that acquisition costs will be expensed as incurred

Third building block and measurement of uncertainty and risk

- FASB acknowledged that they had not understood the issue surrounding risk and uncertainty measurement and agreed that they will consider its explicit measurement and potentially abandon the composite margin approach
- The Staff were asked to draft language to clarify both measurement objectives to arrive at a converged tentative decision on the full measurement model

Reconsidering exclusion - Policyholder accounting

- The Boards decided to reconsider the IASB earlier decision to exclude policyholder accounting from the forthcoming exposure draft

Unwelcomed convergence? Agreement to require accounting losses on sale of all types of insurance contracts

IASB's previous tentative decision

- IASB's decision to release revenue equal to directly attributable incremental acquisition costs noted was based on:
  - the primary focus of initial measurement is to determine the most representationally faithful insurance contract value
  - Customer consideration varies (at least to some extent) with acquisition costs incurred by the insurer requires an adjustment prior to its use in the calibration
  - Insurance contracts are expected to be outside the scope of the Revenue Recognition IFRS thus insurance revenue recognition does not need to follow the general revenue recognition principles
  - This is also avoiding a mismatch between the economic and accounting impacts of writing new business
  - This decision has received support from both preparers and users

Unwelcomed convergence? Agreement to require accounting losses on sale of all types of insurance contracts (continued)

FASB's previous tentative decision

- FASB's view that no revenue should be released on day 1 because:
  - no clear link between the customer consideration and the amount of acquisition costs incurred
  - There are no conceptual reasons for insurance revenue recognition to depart from the general principles and conceding a "special treatment" would re-open the issue of industry-driven revenue accounting that has been a negative feature of US GAAP

Revenue recognition principles

- Entering into a contract is not sufficient to meet a performance obligation under that contract
- Payment of commission to a third party does not represent the meeting of an obligation to the policyholder

No support for deferral of acquisition costs

- Contracts should not be valued – accounting is tied to the consideration
- The significance of acquisition costs is not a reason to depart from the principle of expensing acquisition costs as incurred

Unwelcomed convergence? Agreement to require accounting losses on sale of all types of insurance contracts (continued)

The voting on 28 October

- FASB members voted 5-0 to reaffirm their previous decision
- IASB members voted 8-6 to revise their previous decision and converge to the FASB view that no revenue should be released on day 1 (Jan Engstrom was not present)

Convergence on the third building block – FASB acceptance of the need for a measured risk margin

Third building block – measuring risk and uncertainty

- No vote was taken
- Following an educational session received from the IAA earlier in October FASB members indicated that FASB may revise its previous tentative decision on margin
- FASB members appear to be prepared to accept the IASB position that the insurance accounting model should include an explicit margin for uncertainty and that it should be remeasured at each reporting date
- FASB members stated during the meeting that their thinking has evolved and they now accept that:
  - Probability weighted cash flows include the full estimated uncertainty from the probability distribution
  - Additional uncertainty remains and is not reflected simply by the mean of the probability weighted cash flows especially where a distribution is skewed – this additional uncertainty needs to be included as an additional separate liability that should be remeasured at each reporting date

Convergence on the third building block – FASB acceptance of the need for a measured risk margin (continued)

Next steps

- The Staff will draft language to clarify each Boards' measurement objective including the use of an "uncertainty adjustment" (new converged name for the margin for risk)
- The goal of this Staff paper is to allow the Boards to agree on a converged measurement model
- One IASB member raised the issue of diversification as an aspect of this matter that would also need to be discussed in the finalisation of the common model

Measurement: what differences remain?

Service margins

- The FASB model includes service margins as a component of the composite margin (on the assumption that the service margin at inception is included in the customer consideration)
- This implicit service margin is not remeasured but run off (over a period to be confirmed by FASB) as part of the composite margin
- The IASB model includes a service margin representing the profit on other activities cash flows
- This liability is measured on the “subcontractor profit” principle if sub-contractor markets exist or the entity specific expected profit
- Service margins are remeasured at each reporting date
- Service margins could be the last major difference between the FASB and IASB measurement models
- There was no discussion on possible convergence on this issue

Measurement: what differences remain? (continued)

Composite margin

- Under the FASB model this includes the residual and service margins
- FASB has still to decide on the basis of releasing the composite margin
- These two margins are separate under the IASB model with the service margin remeasured at each reporting date and the residual margin released over the insurance coverage period

IAS37 transfer principle

- FASB members noted that in their view this principle was not relevant to fulfilment value

Future premiums and policyholder behaviour

- FASB has not yet discussed the accounting for cash flows from renewal and cancellation options

Unearned premium method

- FASB has not yet discussed the requirement to use the unearned premium method under certain conditions

Policyholder accounting – in or out? The same or different accounting result?

Scope of the exposure draft – policyholder accounting

- IASB tentatively decided to exclude policyholder accounting (other than by insurers for reinsurance contracts held) from the proposed exposure draft and to consider further this issue during the exposure period
- It was understood that symmetry of accounting between insurers and policyholders would be addressed in the standard and in particular the insurance contract boundary
- The joint debate led to the conclusion that it was premature to scope out policyholder accounting from the exposure draft until the issues arising had been identified, discussed and understood

Policyholder accounting – in or out? The same or different accounting result? (continue)

Next steps

- The Boards asked the Staff to analyse policyholder accounting to identify:
  - issues from lack of symmetry between policyholder and insurer accounting
  - any similarities with accounting for reinsurance contracts from the perspective of the policyholder
- Based on this analysis the Boards will then need to decide whether policyholder issues should be included in the exposure draft, and if so what effect that will have on the timetable, or whether a separate exposure draft will be needed to deal with policyholder accounting

Highlights of IASB October meeting

Unbundling

- No decision reached. The IASB directed the Staff to:
  - Develop a more detailed explanation of the notion of “interdependence”
  - Compare “interdependence” and “contract segmentation” from revenue recognition
  - Consider whether “interdependence” results in the fair value of a the whole contract being different from the sum of the fair values of its components

Deposit floor and contract boundaries

- The Board confirmed that no deposit floor should apply in measuring insurance contracts
- This is a consequence of the May 2009 decision on the inclusion of cash flows from renewal/cancellation options within the contract boundary
- The Staff will develop more specific proposals for identifying the boundary of an existing contract

Unbundling

IASB Staff proposals

- The exposure draft should:
  - require unbundling for recognition and measurement where there is no interdependency between the components of an insurance contract.
  - not state whether unbundling is prohibited or permitted in other situations

IASB Staff rationale to support their proposals

- Unbundling would be required if it is likely that it can be done in a clear way. This is when there is no “interdependence” between the various components
- The Staff propose a definition of interdependence based on factors that may indicate when components are subject to interdependencies, for example:
  - the cash flows from one component affect the cash flows from another component.
  - for some or all elements that need to be considered when separating the components, the insurer cannot identify evidence to decide what to allocate to each of the components; the allocation would require an arbitrary split.
  - the contract is priced as a package, no components were negotiated separately and the whole contract has a single commercial objective
  - the components involve interrelated activities, services and costs, etc.

Unbundling (continued)

Individual Board members' comments on the Staff proposal

- On one side certain members commented that the principle of interdependence is too wide and it may result in becoming irrelevant in practice
- On the other side it was noted that requiring unbundling in circumstances other than those Staff proposed would be unlikely to produce meaningful information
- Other comments included:
  - Interdependence and contract segmentation in the revenue recognition IFRS should be compared
  - Some expressed the view that insurers manage their business on an unbundled basis and it would be possible to use that for accounting purposes although they may not prefer it
  - Insurers often present their earnings by sources that would appear linking to an unbundled business model (investment margin, underwriting profit and expense margins)
  - A measure of whether components are interdependent may be whether when measured separately they sum to the aggregate fair value of the contract

Unbundling (continued)

IASB consensus

- General support for requiring unbundling in more circumstances than required by the Staff proposal but more work needed to develop a clear definition of interdependency for use in a revised unbundling requirement.

Unbundling next steps

- The IASB directed the Staff to:
  - develop a more detailed explanation of the notion of interdependence
  - clarify how this notion relates to the notion of contract segmentation being discussed in the project on revenue recognition
  - Consider whether “interdependence” results in the fair value of a the whole contract being different from the sum of the fair values of its components
- Staff noted that they would investigate the practicability of unbundling with the 16 firms carrying out field testing and report back to the IASB
- The IASB will consider unbundling further at its December meeting

Deposit floor

IASB Staff proposals

- The Staff noted that not requiring a deposit floor is a consequence of the May 2009 decision
- Accounting for insurance contracts should include the expected (i.e. probability-weighted) cash flows resulting from cancellation and renewal options based on whether policyholders exercise such options
- These cash flows are included only within the contract boundary

IASB comments

- The IASB reaffirmed its support to the Staff proposal that as a consequence of the earlier decision no deposit floor should be required
- The earlier decision on contract boundaries and in particular the definition of whether policyholder options included within a contract should be restricted according to the nature of those options requires finalisation at a future meeting

Next steps

- The Staff will develop the detailed text on the boundary of an existing contract
- Among other things, those proposals will consider the application to contracts that are
  - known in some countries as 'universal life contracts' and are characterised by variable premium payments
  - Inclusive of an option for the policyholder to buy future insurance coverage

Presentation of the performance statement

Education session

- Staff presented four options: traditional life, traditional non-life, fee approach and margin approach
- All options produce the same profit in each period

IASB comments

- The fee approach is based on current accounting for universal life contracts and there may be difficulties in applying this model where charges for components are not explicit and separable
- Non life insurers likely to wish to retain current KPIs based on premiums, claims ratios and combined ratio which are not apparent in fee and margin approaches
- The required unearned premium method would appear to be inconsistent with the fee and margin models
- The models may need further disaggregation to show the effect of the risk margin
- The models will need to be considered in the context of the overall IASB Financial Statements Presentation project

Next steps

- A decision making session is scheduled for November

Recap on the convergence towards a common model

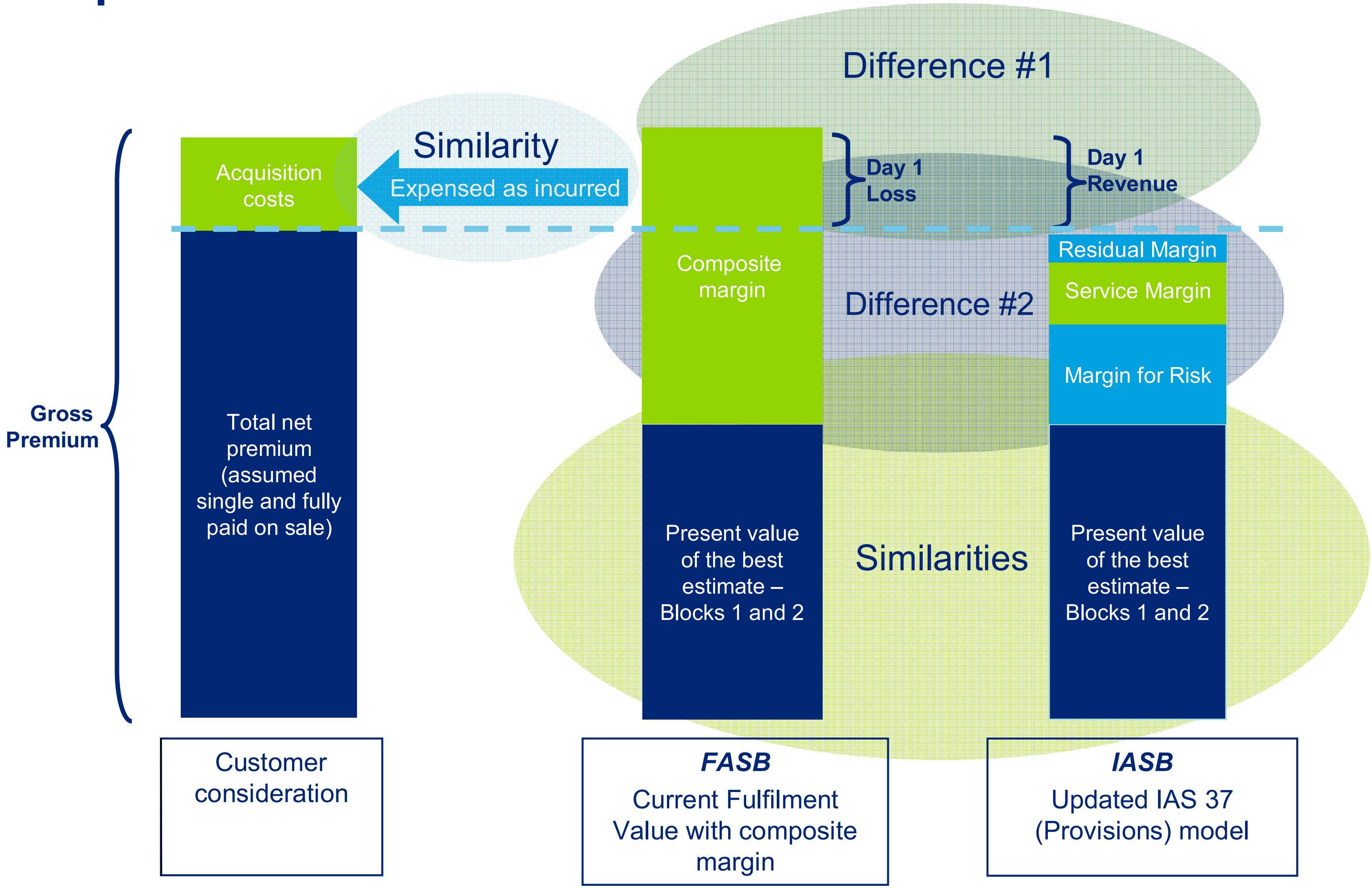
IASB /FASB agreement prior to October joint meeting

- The new model will be based on a “three-building-blocks” approach
- It will be a single model for all insurance contracts
- Block 1: the undiscounted probability weighted estimate of future cash flows
- Block 2: a market consistent discount rate
- Blocks 1 and 2 must be updated at each balance sheet date – no locked-in assumptions
- Immediate loss through income at point of sale if premium insufficient – “onerous contract test”
- Acquisition costs are taken to income as incurred

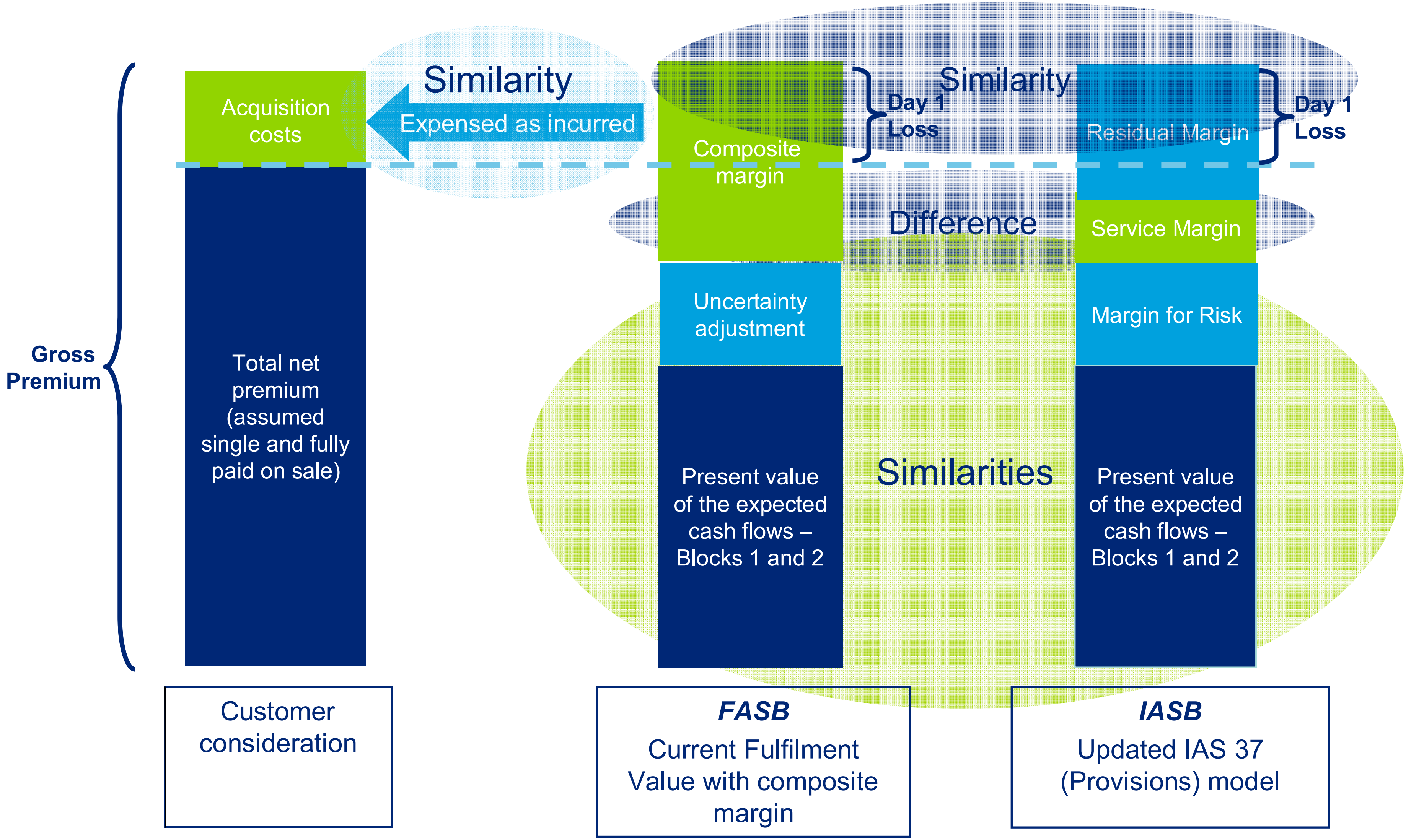
New areas of agreement affecting the accounting profit pattern

- Objective of the initial measurement of an insurance contracts – acquisition costs will not play a role in the initial measurement
- Nature and purpose of Block 3 (margins)
  - FASB likely to converge to IASB view on risk margin
  - Service margin remains a difference between the two models

Proposed models before 28 October



Proposed models after 28 October



Major outstanding issues at the IASB

Unbundling – unresolved question from October

- No consensus reached in October - to be reconsidered in December

Risk margin wording – convergence at joint meeting

- Converged wording for the principle of a separate remeasured risk margin to apply to both the IAS 37 model and the current fulfilment value model

Participating contracts

- Accounting for participating contracts including both the issue of discretionary bonuses and the accounting mismatches from unit-linked contracts

Presentation model

- Finalisation of the presentation of premium receipts and claims/benefits payments

Timetable

Commitment to an exposure draft in early 2010

- Exposure draft issue date moves to January 2010
- Comment period remains until the end of May 2010
- Standard due in June 2011 – before substantial IASB membership changes

Timetable issues

- Potential policyholder accounting inclusion in the ED
- Delayed unbundling decision
- The complexities of participating contracts have not been discussed yet
- Additional IASB meetings are likely to be scheduled to finalise the discussion

Contact details

Francesco Nagari

Deloitte Global IFRS Insurance Leader

+44 20 7303 8375

fnagari@deloitte.co.uk

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Insurance Centre of Excellence:

insurancecentreofexc@deloitte.co.uk

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