

## Insurance Accounting Newsletter

### Old disagreements and new delays make convergence uncertain



#### Introduction

Since our last newsletter the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) have had one joint meeting and each has held a few education sessions.

Several core issues such as, the unit of account and consideration of risk diversification, discounting of claims liability, onerous contracts and issues relating to participating contracts have been discussed and progress has been made on most of them. The Boards discussed the premium allocation approach in two separate education sessions, but the highly anticipated joint FASB/IASB meeting was cancelled at the last minute and deferred to the February joint meeting.

A disappointing piece of news was announced recently via the IASB and FASB's websites' revised work plans. It appears that the 'review draft or revised Exposure Draft (ED)' is now planned for the third or fourth quarter of 2012 instead of the second quarter, making an effective date of 2015 less likely.

Together with a delay on the insurance project the Boards also announced delays on their projects on financial instruments, revenue and leases. On average all projects have seen the publication dates of the 2012 milestone documents (review drafts, re-exposure of draft IFRS or discussion papers) delayed by three to six months compared to the last version of the plan released in late 2011.

None of these standards are now targeted for 2012 completion and the intention of the IASB to hold the 2015 effective date for what is a substantial re-writing of IFRS will have to be revisited.

## Joint efforts and work plans of the Boards, including the revision of IFRS 9

There continues to be fundamental differences in the way IASB and FASB approach accounting for insurance contracts liabilities. On the 12 January, Hans Hoogervorst, the IASB Chairman, publicly acknowledged the difficulties experienced in achieving convergence on the insurance project. In the Chairman's Report to the trustees of the IFRS Foundation he states: "We have also had difficulties reaching converged solutions with the FASB on financial instruments and insurance. [...]Delays in completing these much needed improvements to financial reporting for those using IFRSs and US GAAP are unfortunate, but they should not be seen as a failure. They reflect the IASB being cautious, responsive and responsible." Additional observations were made by Mr Hoogervorst:

- Insurance, although not a convergence project, was a project on which common accounting between IFRS and US GAAP issuers was highly desirable.
- US insurers were lobbying the IASB hard to retain the current US GAAP accounting. The IASB was reluctant to make this a joint project as this would delay the issue of an IFRS by several years.
- He noted that it would be preferable to achieve convergence 'from the bottom up', but that there was 'no substitute for clear decisions from the top down'.

These comments can be viewed as casting doubt on the ability of the Boards to achieve full convergence on a single model in time for the publication of the final IFRS and preparing the ground for a potential IASB disengagement from their commitment to reach a converged solution for insurance contracts.

Despite these differences, important progress was made in addressing the accounting for asset-liability mismatch and revising IFRS 9. On 27 January, the two Boards announced their decision to work together to review certain aspects of their financial instruments classification and measurement models, with an objective to reduce key differences. In particular, they will consider 'the basis for and scope of a possible third classification category (debt instruments measured at fair value through other comprehensive income)' that would take into account the interaction with the insurance accounting project.

However, this decision came only a few days before the Boards' announcement that there will be new additional delay in the next stage of the insurance contracts project, as noted above.

### Unit of Account and Portfolio Definition

The unit of account is an important concept to insurance liability measurement because it determines at what level of granularity the risk adjustment liability is estimated; i.e. policy, portfolio, etc. This concept and the definition of a portfolio were discussed at the 16 December joint meeting at which the Staff presented three comprehensive papers each containing its own recommendations, outlined below:

#### Definition of portfolio

The Staff recommended that

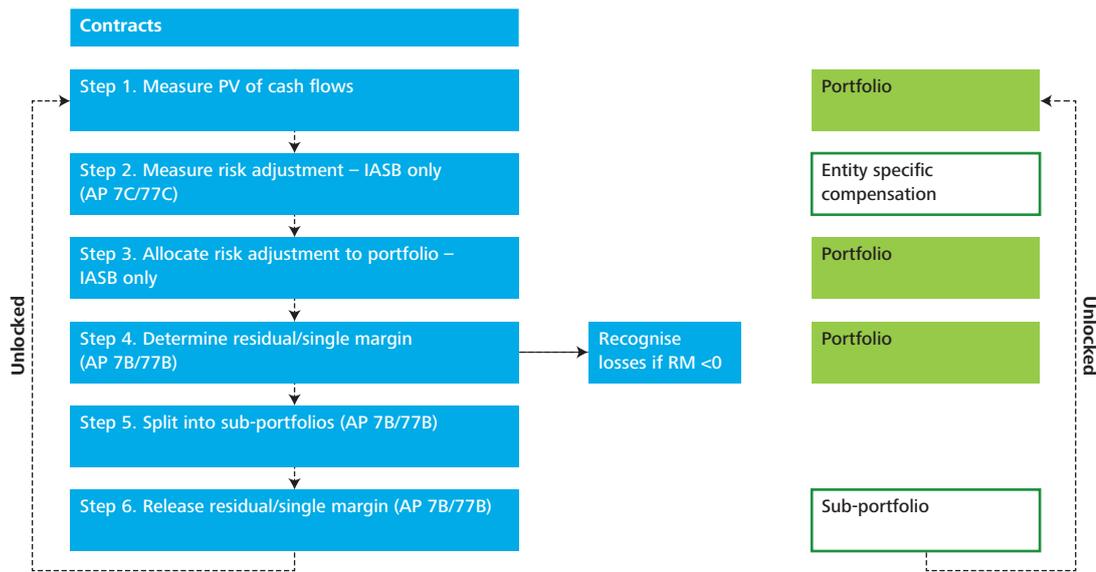
- a) the standard should define a portfolio of insurance contracts as a group of contracts that:
  - i. are subject to similar risks;
  - ii. have similar expectations of profitability; and
  - iii. are managed together as a single pool.
- b) application guidance should be added to help insurers interpret the terms 'similar risks', 'similar expectations of profitability' and 'managed together'.

#### Unit of account: residual/single margin and onerous contracts

The Staff recommended that:

- a) the residual/single margin at initial recognition should be determined at the portfolio level;
- b) subsequent to initial recognition, the residual margin should be determined at the portfolio level (IASB only);
- c) in allocating the residual/single margin to profit or loss of particular periods, an entity should group contracts, within a portfolio, that have similar inception dates, expected end dates and expected patterns of release of the residual/single margin;
- d) the onerous contract test should be performed at the portfolio level both:
  - i. during the pre-coverage period; and
  - ii. under the premium allocation approach.

Figure 1. Extract from IASB/FASB December 2011 accounting paper 71/771 titled Unit of account – overview:



**Unit of account: risk adjustment**

The Staff recommended that the unit of account used when calculating the risk adjustment should not be prescribed, as long as the objective of the risk adjustment is achieved.

The basis for this conclusion is that contract level provides most detailed information but is too granular, does not reflect pooling of risks and often the risks and expected cash flows of individual contracts are less predictable than those of a portfolio, which is why a portfolio unit of account is proposed. However, to ensure that the entire residual/single margin is released by the end of the contract’s coverage period in the context of an open portfolio, a further allocation to a sub-portfolio is necessary based on the recommended criteria.

The Staff prepared a short example and a diagram (Figure 1) illustrating the proposed approach on unit of account.

To determine the building blocks on initial recognition those contracts that are managed together are grouped into a portfolio based on similarity of risks and expectations of profitability. The present value of expected cash flows is aggregated for all contracts in each portfolio to determine the risk adjustment based on how it perceives the resulting aggregated risk and the compensation it requires for bearing that portfolio risk that the ultimate portfolio cash flows will exceed those expected.

In the event that the entity considers the diversification benefits from pooling risks at the entity level, then the entity level becomes the unit of account for measuring the risk adjustment.

The insurer would then allocate the risk adjustment back to the individual portfolios to determine the residual margin as the amount that stops the recognition of an accounting profit. However, if the residual margin at portfolio level is negative, it is immediately taken to profit and loss account as a day one loss.

The resulting portfolio liability is then split into sub-portfolios (cohorts) based on the insurance contract inception dates, expected term dates, and patterns of release from risk, with each cohort having its allocated residual margin balance.

Subsequently, the residual/single margin is systematically released to profit or loss in each period at the cohort level, and it is adjusted for any unlocking adjustments that the insurer’s reassessment of valuation assumptions (at portfolio level) would cause.

**Deloitte position on the application of the unit of account to the open portfolio (extracts from Deloitte comment letter)**

*'Application guidance on determining the risk adjustment to open portfolios – As drafted, the ED fails to address the fact that portfolios are often open portfolios. Addressing this characteristic is fundamental for a consistent application of the new standard. The definition of portfolio becomes very relevant when future cash flows associated with new contracts need to be allocated to a cohort in order to calculate the risk adjustment (for the portfolio) and the residual margin (for the cohort). In practice, an insurer would first need to allocate the risk adjustment to the cohort and in turn determine the residual margin; that concept relating to new contracts is missing from the ED. A possible approach to determine the margins could be to perform the calculation at a portfolio level, with and without the new cohort and take the difference as the residual margin on the new cohort.'*

This process seems to introduce an open portfolio accounting approach that insurers could use at their chosen frequency (e.g. daily, monthly, quarterly etc.). It would appear though that the publication of financial statements could offer a time limit to the cohort. In other words it would seem logical to assume that, at most, a cohort could include all contracts issued in a given financial year which are part of a given portfolio and share the other two characteristics of timing and pattern of profit release.

The Staff proposals generated a lively debate and members of both Boards actively contributed to it in spite of the fact that the FASB is not in favour of a risk adjustment liability. As a result of this debate, the IASB decided to support the recommendation "not to prescribe the unit of account when calculating the risk adjustment as long as the manner in which the risk adjustment is calculated achieves the overall objective of the risk adjustment". This decision represents a significant change from the ED in response to the comment letters. As the FASB does not support the risk adjustment approach, it did not vote on this issue.

The ED proposed that the risk adjustment be determined at portfolio level, prohibiting taking into account the benefits of diversification benefits arising from negative correlation with other portfolios (e.g. mortality risk being negatively correlated with longevity risk). One argument put forward at the time for not allowing the diversification benefit to be taken into account was the lack of fungibility, i.e. an insurer's ability to use the surplus in one portfolio to cover the deficit in another. The majority of respondents commented that the pricing of the insurance contracts reflects the diversification of risks available to insurer and this should be reflected in the measurement to avoid the recognition of losses that are only the result of an accounting rule. The Staff summarised the reason for its proposal stating that risk adjustment objective is to measure the compensation a particular insurer requires for bearing the risk that ultimate cash flows will exceed those expected. As the risk adjustment in the current fulfilment value model is entity specific, it should incorporate all factors that the entities' management would consider in its determination.

Several implications result from this decision:

- If the reporting entity considers diversification of risks available to it from other portfolios in determining the amount of compensation it requires for bearing the risk that the ultimate cash flows will exceed those expected it should include these diversification benefits in the measurement of the risk adjustment. This will also affect the determination of the residual margin at the portfolio level resulting in a larger residual margin if cross portfolio diversification benefits are recognised by the insurer.
- The legal structure of the entity will have an impact on the risk adjustment. Within the same group, the risk adjustment may vary depending on the reporting entity level, if the consolidated group can benefit from more diversification than the subsidiaries which own only a subset of the group-wide insurance contracts in-force.
- Insurers will need to develop a method for determining the level of diversification benefits relevant to its measurement of the risk adjustment and a method of allocating it back to individual portfolios to compute the residual margin from the new contracts issued.
- A larger amount of data will have to be collected and tracked at each reporting entity level to determine and allocate the risk adjustment to individual portfolios, and to update the measurement of diversification benefits at each reporting period which should take into account, not only the natural movement in the individual portfolio risk pooling, but also the more complex dimension of correlation and its fungibility.

Unfortunately, the rest of the discussion on the unit of account was not as productive. Both the IASB and FASB disagreed with the Staff proposal to include in the definition of a portfolio a criterion of similar expectations of profitability. There was a concern that it would increase complexity and result in too many portfolios, as well as precluding the offsetting of profitable and unprofitable contracts within a portfolio. Following the discussion, they agreed that the Staff should revise the portfolio definition based on criteria of similar risks, similar economic duration based on the definition of the contract boundary and similar pattern of release from risk.

If the definition of portfolio is widened by excluding the "similar expectations of profitability" criterion, further consideration may be needed on the basis of allocation of residual margin by cohort to deal with the unprofitable ones.

**Deloitte position on the valuation of the risk adjustment liability (extracts from Deloitte comment letter on the ED)**

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.

We believe it would not be a faithful representation of the insurance contract portfolio liability to include in that liability the extent of the diversification benefits that the insurer may have from other portfolios it has assembled.

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 believe the Board should specify in the final IFRS that when the insurer determines the risk adjustment the portfolio it considers would include the group of contracts as defined and the benefits from the purchased reinsurance contracts that reinsure those insurance contracts. The calculation of the risk adjustment before and after the benefit of the purchased reinsurance contracts will be used to measure the reinsurance asset.

In particular, we believe that when a reporting entity determines the risk adjustment margin for a portfolio of contracts, that amount should not reflect the benefits of diversification from contracts held by a parent or sister entity within the group, unless enforceable intercompany agreements exist that would allow access to the diversification benefits. This limitation exists even if contracts held at the reporting entity level are similar to contracts held at the parent or sister entity level, and such contracts are managed together as a single pool by a parent of the reporting entity. For example, if the reporting entity is Subsidiary A, it would consider contracts issued by Subsidiary B, or those held by the parent of Subsidiary A and B, if and only if an enforceable agreement exists that allows Subsidiary A to access these diversification benefits.

## Discounting of incurred claims liabilities and availability of practical expedient

The Staff asked the Boards to reconfirm their earlier decision for the premium allocation approach to require discounting of the liability for incurred claims (when the effects of discounting were material). The Boards' chairmen noted that a letter from the Hub Global Insurance Group had requested the deferral of the session on discounting of claims liabilities in order to complete the Boards' own due process which should include outreach with the Boards' constituents. The assessment of the two chairmen though, was that their due process on this important topic had been completed at this stage and they were comfortable to allow the discussion at the joint meeting in December. On that basis they had asked the Staff and the members of both Boards to proceed with their deliberations.

The Staff noted that currently, under certain GAAPs, and in particular under US GAAP, the general insurance liability for incurred claims is not discounted. The Staff noted in its paper that a number of respondents argued against discounting post-claim liabilities under the premium allocation approach on the grounds that it is not in line with the business model of many non-life insurers and it would produce less relevant and potentially less reliable financial results.

However, both the IASB and FASB have unanimously supported a general principle requiring discounting where its effect would be material, with no additional guidance (as there already is guidance on materiality in both IFRS and US GAAP). It was noted that money has a time value and that it is an essential component of insurer's business model given that it is an implicit component of asset valuation. Recording insurance incurred claim liabilities on undiscounted basis would introduce a potential asset-liability mismatch.

To address the concerns about the possible loss of valuable undiscounted information it was agreed that all the undiscounted liability information currently included in the financial statements, including the 10-year development table, will continue to be disclosed.

For contracts which qualify for the premium allocation approach, the Boards unanimously approved a practical expedient not to require discounting of any portion of the incurred claims liability that is expected to be paid within twelve months of the claim occurrence date.

There are several practical implications from this decision:

- The undiscounted incurred claims liability will need to be reassessed at each reporting date to ensure that only the portion expected to be settled within twelve months from incurred date qualifies for the discounting exemption. Statistical information on actual settlement patterns will assist insurers in the revision of their expectation of settlement for the new claims incurred in the most recent reporting period.
- The practical expedient will not apply to the incurred claims arising from insurance contracts accounted under the building blocks model from initial recognition which will be accounted for under the same single model without a change between the pre-claim and the post-claim phase of the contract life cycle.

**Deloitte position on discounting of short duration contracts (extracts from Deloitte comment letter on the ED)**

In our proposed short duration contract accounting model 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.

## Onerous contracts

Both the building blocks and the premium allocation approach require an onerous contract test during the pre-coverage period. In addition, under the premium allocation approach this test is also needed during the coverage period.

Both the IASB and FASB were in broad agreement with the Staff proposals. However, because these proposals did not include the effects of the practical expedient on discounting for contracts under the premium allocation approach, the issue has been considered further at the February joint meetings.

Among the proposals supported by the Boards were the re-confirmation of the definition of the onerous contract as defined in the ED, and agreement that the onerous test would need to be performed only when facts and circumstances require it (trigger events) rather than being a requirement at each reporting date. Finally, there was an agreement that these same principles would apply to performing the onerous test during both the pre-coverage and coverage periods.

## Participating contracts

In November 2011 the FASB agreed with the IASB that the measurement of participating contract liabilities, where some or all of the cash flows arise from non-discretionary performance-linked participating features, would reflect the IFRS/USGAAP measurement basis of the underlying instrument ("mirroring"). A participating contract is one where the policyholder is given the right to participate in favourable performance of the relevant class of contracts, specified assets or both or even the insurer itself.

At their joint December meeting the Boards took the opportunity to clarify that this converged decision should be applied in one of two ways:

- use the 'normal' Building blocks approach, without taking into account the changes in the value not reflected in the accounting measurement of the underlying items (e.g. because they are measured at amortised cost); or
- develop a building blocks approach (accounting for all guarantees and options) that would directly reflect the accounting measurement basis of the underlying item, so that any changes in value of the underlying items not included in their accounting measurements are eliminated.

The FASB's preference would be to include in the insurance liability the changes in value of the underlying items that are reflected in their accounting measurement.

At the same meeting the Boards looked at the accounting for insurance contracts' embedded options and guarantees that are not bifurcated under the embedded derivative accounting rules and how they would be accounted for within participating contracts liabilities. Many participating contracts provide minimum guarantees to policyholders (e.g. death benefits, investment return) protecting them from some of the downside risk of participation. Board members agreed that in scenarios where the minimum guarantees kick in, the cash flows used to measure the liability should be those of the guarantee and not those of the underlying asset. The Boards unanimously approved the staff recommendation that "*options and guarantees embedded in insurance contracts that are not separately accounted for as derivatives when applying the financial instrument requirements, should be measured within the overall insurance contract obligation, using a current, market-consistent, expected value approach.*"

Another participating contracts' related issue that was discussed in December was whether the cash flows used to measure the insurance contract liability should include all payments resulting under existing contracts, irrespective of whether they are due to current or future policyholders. The Staff clarified that contractual terms of the participating contracts usually require some of the performance from the specified underlying items to be distributed to the specified community of policyholders associated with that participating feature. When Policyholders forgo their entitlement to future distributions, these are then re-allocated within that community and new policyholders inherit the performance of the pool when they enter in a new participating contract. The past event obliging the insurer is the participating feature of the existing contracts, which would result in outflows to both current and future policyholders. In fact the Staff noted that also in IAS 37 Provisions, Contingent Liabilities and Contingent Assets it is stated that a liability exists even if the reporting entity does not know the identity of the party to whom the obligation is owed. The Staff further clarified that in certain instances, for example where there is a large unallocated surplus owed to a small number of surviving policyholders, insurers may be able to apply to regulators to effect a payout to parties other than policyholders (e.g. the insurer's shareholders). Although this is rare, there are well known cases all of which required a legal process and regulatory approval to be completed thus providing corroborating evidence that the obligation from the participating feature remains even with declining policyholders' numbers.

The Boards unanimously approved the Staff recommendation that in measuring contractual obligations, such as non-discretionary participating features, insurers should include in the measurement of insurance liability all such payments that result from a contract, whether paid to current or future policyholders.

We note however that this decision does not address the accounting for so called 'orphan' or 'inherited' estates, where surpluses are not necessarily allocated to current or future policyholders, and the issue of whether a mutual insurer would present the surplus associated with participating features as a liability or a component of equity.

## Premium allocation approach

The discussion on the eligibility criteria to apply the premium allocation approach (PAA) was highly anticipated however, at the last minute, the joint FASB/IASB meeting was cancelled and two separate education sessions were held instead, on the 18th and 25th January for FASB and IASB respectively. This was the fourth attempt (last attempt was at the October 2011 meeting) to achieve clarity on this topic. As the sessions were purely educational, the question has now been brought back at the February joint meetings.

The Staff proposed a new set of principles-based eligibility criteria for the January sessions on PAA. Before the meetings took place, they consulted with a number of users, including Deloitte and other accounting firms, asking whether various insurance products would qualify to apply PAA based on the proposed criteria. At the meetings, they then reported on the results of this "study" concluding that overall most respondents classified the products consistently. A few products, such as surety bonds, catastrophe, long-term disability and directors' and officers' insurance contracts, and to some degree health and one year life insurance contracts, attracted different responses. This was mainly due to the differences in the economic environment in which the respondents operated and the degree of judgement required. Also, a number of respondents that classified products as not eligible for PAA appeared to have disregarded the mitigating factor that an onerous test would be in place for contracts accounted for under the PAA.

The new Staff proposal is to use a building blocks rather than premium allocation approach if at the inception date either of the following two conditions are met:

- it is likely that during the pre-claim period there will be a significant change in the expectations of net cash flows required to fulfil the liability that would not be captured by the onerous contract test (expected cash flows criterion); or
- significant judgement is required to allocate premium in each reporting period, for example if there is significant uncertainty about the length of the coverage period (allocation of premium criterion).

The proposal also suggests deleting the criteria relating to options & guarantees and risk (IASB only) proposed previously and has been further revised for the February meetings.

A lively debate took place among the FASB members who met first on this set of papers and questioned the mention of the onerous test in the first criterion. The staff explained that the proposed test would capture both positive and negative changes in the expected cash flows, whereas the onerous contract test is one-sided. Some FASB members pointed out that if these tests are done at the contract level there could be significant variation in the cash flows for nearly all contracts. At portfolio level, the distribution of expected future cash flows is more stable. The Staff confirmed that the proposed tests would have to be performed at contract level. This was rejected by the FASB and the Staff agreed to either strengthen the proposal or withdraw it. The Staff also clarified that the second criterion is concerned with the allocation of premium within the reporting period. Many FASB members found that unhelpful because with quarterly or six-monthly reporting periods, most insurance contracts would qualify for it. The Staff agreed to review and revise the wording.

Both Boards raised the question of whether the PAA should be viewed as a proxy for the building blocks approach (BBA) or whether it is a separate model. The FASB members on the whole were not decided but a large number expressed a strong preference for a two-model approach. The IASB members tended to view PAA as a proxy and some were concerned that the current criteria wording would suggest that there are two models. A suggestion was made to clarify that the PAA should be viewed as a proxy for the BBA from an IFRS perspective.

The result of these comments is that the fundamental question of whether the PAA represents a proxy to the BBA or separate model remains very much at the centre of the FASB / IASB divergence and it puts added focus on developing a comprehensive set of eligibility criteria.

At the January IASB meeting, almost everyone agreed that a twelve-month duration would be a good practical expedient to allow the use of the PAA. There still remains a question as to whether more application guidance is needed to determine if contracts with a coverage period greater than 12 months can apply the PAA. The question was brought back for February joint meeting to review again the various insurance products against the newly IASB-proposed twelve-month practical expedient criterion and to attempt reaching a convergent response to the question of whether the PAA would be a separate model from the BBA.

A number of questions regarding eligibility were not addressed in the January sessions and were brought back to the boards in February. In particular, whether the PAA should be permitted or required for those contracts that would meet the eligibility criteria has been carried forward to the February joint meetings.

**Deloitte position on premium allocation approach (extracts from the Deloitte comment letter on the ED)**  
'We believe that there should be a modified accounting approach for short duration contracts' pre-claims liabilities as a practical approximation of the building blocks measurement that 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, often referred to as general insurers or property and casualty insurers. We believe that any modified accounting approach should be permitted, but not required.

However, using a bright line of 12 months to determine whether insurance contracts would qualify for this modified accounting approach appears to be arbitrary. We recommend that the Board considers alternatives such as that currently applied in US GAAP where there is no specific limit on the duration of the contract to determine the classification of insurance contracts. Insurers would disclose in their accounting policies the parameters selected to define short duration, similar to the approach adopted for the IFRS 4 definition of significant insurance risk.

We do not agree with the mechanics of the proposed modified accounting approach. Instead, we recommend that the Board adopts an accounting approach for short duration contracts similar to the unearned premium approach currently used under US GAAP. Under this approach, premiums from short duration contracts are recognised as revenue over the period of the contract in proportion to the amount of insurance protection provided. If the period during which the insurer must stand ready to pay claims differs significantly from the contract period, premiums would be recognised as revenue over the period of risk in proportion to the amount of insurance protection provided. This methodology generally results in premiums being recognised as revenue evenly over the contract period (or the period of risk, if different). Premiums subject to adjustment (e.g., retrospectively rated or other experience-rated insurance contracts) would be recognised as revenue over the period of the contract.

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.

The mechanics of the PAA with regards to measurement of the liability for remaining coverage and treatment of the acquisition costs were also discussed. The Staff presented two options for the liability:

- a) not to discount and not to accrete interest or,
- b) require discounting and accretion of interest for contracts with significant financing component; as a practical expedient not to require it for contracts with a coverage period less than one year.

The majority of the IASB members were in favour of the second option because it is similar to the Revenue Recognition exposure draft and because the 12 months practical expedient is likely to apply to many contracts eligible for the PAA. The FASB members were more split on this point. The question has been carried forward to the February joint meetings.

The two proposals for the treatment of acquisition costs under the PAA were based on the building blocks approach or on the revenue recognition exposure draft.

1. to measure acquisition costs including directly attributable costs (limited to successful efforts only for FASB) consistently with the building blocks approach and to permit expensing of directly attributable costs that are not incremental; or
2. consistent with the revenue recognition exposure draft, to include only incremental costs in the measurement of acquisition costs and to permit expensing of all acquisition costs if the contract coverage period does not exceed one year.

The FASB members were split on this proposal. Some viewed the PAA as an alternative model to the BBA and wished to align more with the Revenue Recognition exposure draft favouring the second option. Some wished to achieve consistency with both the BBA model and the Revenue Recognition exposure draft and would like to re-open and re-align the two projects. There was also a feeling that permitting capitalisation of some costs and expensing of others would introduce inconsistency in the measurement. The Staff were asked to develop a stronger rationale to justify the treatment.

The IASB members preferred the first option based on the BBA. There was a question as to at which level should incremental costs be assessed, with a majority preferring the assessment at portfolio level. Finally, on the presentation point, a majority did not view acquisition costs as a separate asset and preferred instead a net insurance liability approach.

The treatment of acquisition costs has been considered further at the February joint meetings.

**Deloitte position on acquisition costs (extracts from the Deloitte comment letter on the ED)**

'Acquisition costs incurred would be netted against the unearned premium and amortised in proportion to the premiums earned.'

'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".*

## Next steps

Other joint meetings have taken place in the week beginning 27 February. The following papers were scheduled to be discussed:

- Onerous contracts
- Onerous contracts – implications of tentative decision
- Measurement of liabilities of infrequent high-severity events and
- Unbundling – Goods and services
- Premium allocation approach: amendments to the January staff recommendations
- Premium allocation approach – eligibility criteria
- Premium allocation approach – mechanics
- Premium allocation approach – IASB staff recommendations
- Premium allocation approach – FASB staff recommendations
- Financial instruments with discretionary participation features – overview
- Financial instruments with discretionary participation features – background information
- Financial instruments with discretionary participation features – applicable standard
- Financial instruments with discretionary participation features – definition

Deloitte's observer reports on the outcome of the February meetings are posted on [www.IASPlus.com](http://www.IASPlus.com) shortly after the closure of the Boards' discussion.

## Deloitte Insurance contacts

### Global insurance network

#### **Gary Shaw**

Global Insurance Leader  
U.S.  
+1 973 602 6659  
gashaw@deloitte.com

#### **Francesco Nagari**

Global IFRS Insurance Leader  
U.K.  
+44 20 7303 8375  
fnagari@deloitte.co.uk

#### **Asia Pacific**

##### **Kumiko Aso**

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

#### **EMEA**

##### **Fabien Sauvage**

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

#### **Latin America**

##### **Gustavo Bohórquez**

Mexico  
+52 55 50806201  
gbohorquez@deloittemex.com

#### **North America**

##### **Rebecca Amoroso**

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

#### **Simon Walpole**

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

#### **Mark FitzPatrick**

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

#### **Carlos Srulevich**

Argentina  
+54 11 43202734  
csrulevich@deloitte.com

#### **Aniko Smith**

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

#### **Mark Ward**

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

#### **Rajiv Basu**

U.S.  
+212 436 4808  
rbasu@deloitte.com

#### **Peter Wright**

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

#### **Neil Harrison**

Canada  
+1 416 601 6307  
nharrison@deloitte.ca

#### **John Johnston**

Bermuda  
+441 292 1500  
jojohnston@deloitte.com

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