

Insurance Accounting Newsletter

The 'OCI solution' is in and convergence is increasingly out



Since our last Insurance Accounting Newsletter¹, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) have delivered the key components of a so called 'OCI solution' that would keep current value measures on the balance sheet of insurers and uses equity (via the Other Comprehensive Income – OCI) to recognise interest rate short term fluctuations.

On the asset side, the Boards agreed to introduce accounting for debt securities at fair value with unrealised mark to market changes through equity. An option to designate investments at full fair value through income will remain when they are matched by changes through income for the effect on liabilities from discount rates fluctuations.

On the liability side, the revaluation of insurance liabilities based on market interest rates will be allocated between equity and income with the impact of market interest rates changes being recognised first to equity. The unwinding of the discounting will go through income at the market discount rate determined at inception. This rate will remain 'locked-in'.

The Boards will discuss how these measures apply to participating business at one of their future meetings.

The Boards also reached an agreement on a narrow scope for the unbundling of investment components, so that clearly linked and attributable cash flows are allocated to the unbundled component and accounted for under the relevant standard.

The unfavourable trend away from a converged accounting standard for insurance contracts was corroborated by the IASB confirming its preference for a two margins model (the risk adjustment, residual margin) with the residual margin unlocked for prospective changes in estimates and by the Boards remaining divergent on acquisition costs with FASB preferring an asset recognition approach, while IASB preferring a deduction from the residual margin.

The decisions summarised above are the results of the Boards' May and June meetings. No major updates emerged from the July meetings and August saw only limited activity at FASB with IASB in its usual summer recess. In this newsletter we cover all these matters and also the IASB Insurance Working Group (IWG) meeting held towards the end of June.

¹ <https://www.iasplus.com/en/publications/insurance-accounting-newsletters/insurance-accounting-newsletter-2014-june-2012-issue-25/view>

The May meeting was a genuine insurance marathon with 11 hours of meetings and 17 agenda papers. Among the items covered was the long anticipated approval of fair value through other comprehensive income (FVOCI) category for eligible debt instruments and the 'OCI solution' for insurance liabilities. Other topics included unbundling, treatment of acquisition costs and an IASB only education session on single margin versus the two margins approach.

The June meetings by contrast were marked with less activity with the sessions building on the earlier decisions. The decision making session focussed on the allocation of cash flows to unbundled components. This completed a substantially defined set of new requirements which should result in an infrequent application of unbundling where the bundled components are not interdependent with the insurance risk transfer component of the contract. The Boards held two educational sessions looking at the measurement of earned premium and the timing and recognition of acquisition costs expense and related premiums. Additionally the Boards held a session clarifying the scope of the newly introduced FVOCI category for financial instruments and re-introducing the option to designate eligible debt instruments meeting FVOCI criteria to be accounted for at fair value through net income (FVNI) instead.

Despite all this progress the possibility of a disengagement from convergence started to increase when on 5 June Ms Leslie Siedman, the FASB Chair made comments to the FASB Advisory Council indicating her view that the two standards will not be converged. "We have twice now gone back to the board table to try and resolve those differences because of a very strong desire to end up with a converged solution on insurance [...] I'm disappointed to report that after a couple of different attempts, we're simply not reaching converged conclusions on insurance in what I would call fundamental aspects of the proposals."

These views were subsequently echoed by Hans Hoogervorst in his report to the IFRS Foundation Advisory Council on 18 June with both Chairs acknowledging the different starting points of the two Boards.

The context that is gradually steering the Boards' attitudes towards this project, presents, on one side, IFRS users with a clear need for an insurance standard that comprehensively addresses recognition and measurement as well as disclosure. On the other side, US GAAP already has an existing comprehensive standard the FASB now considers revising. Several US investors have supported US GAAP as it is. The Boards remain at different stages of progress with their milestone documents: the IASB has already issued an exposure draft (ED) while the FASB has only produced a discussion paper (DP). In her comments Ms Siedman indicated that the future scope of the review of the US standard may be more limited. In view of that and in order to progress as efficiently as possible, the Boards have started a process to prepare for an 'amicable disengagement'.

This is disappointing to many industry stakeholders, particularly the multinational entities who were expecting a single standard. Many members of the IWG have voiced their dissatisfaction with the increasing likelihood of this outcome and have questioned the IASB and FASB Staff on their efforts to achieve a compromise. Representatives of the industry felt that more could be done by the both Boards to achieve convergence with the single margin and two margin approach given as an example where more could have been done since the underlying principles do not appear so dissimilar. At the same time, against a backdrop of project delays and divergence, many at the IWG meeting felt that, if a converged standard is not achieved then it is important that there are two tight standards that are well received by the respective investment communities and that there is a balance between quality and timeliness in order to complete the project.

Two weeks after the IWG meeting the Staff of the Securities and Exchanges Commission (SEC) published the report titled *Work Plan for the Consideration of Incorporating International Financial Reporting Standards Into the Financial Reporting System for U.S. Issuers*. The report emphasises that the SEC has not made "any policy decision as to whether [IFRSs] should be incorporated into the financial reporting system for U.S. issuers, or how any such incorporation, if it were to occur, should be implemented."

This long awaited report indicates that the US authorities are not yet in a position to consider IFRS for US domestic companies. The absence of any recommendation for policy making at this stage is the most remarkable feature of the report. The IASB Chairman Hans Hoogervorst commented shortly after the release of the report that "The IASB has started working on a new agenda. The era of convergence is coming to an end."

We look at these events as additional evidence of the gradual trend that the Boards' attempts to converge on a single accounting standard for insurance contracts are unlikely to continue for much longer and the publication of the next milestone documents may be used to explain how the two Boards will disengage from their convergence efforts.

The timing of the new milestone documents and their format still remain uncertain. According to the work plan that the IASB refreshed at the end of July they expect to either issue a Staff review paper or to re-expose the ED (to be determined at the IASB meeting) in the second half of 2012. We interpret this target as December 2012 with a material risk of slippage considering the limited activity during July and August.

If the proposed amendments are determined to be not significant the IASB will proceed to the final IFRS issuing only a Staff paper summarising the changes to the ED with no formal requests for feedback or comment period. If the standard is re-exposed it would require a Board ballot and would have a comment period of 120 days (or less with a limited re-exposure). The FASB are planning to issue an ED in the fourth quarter of 2012 with a 3 months comment deadline.

The 'OCI solution'

As noted above, in May the Boards produced two decisions that together are promising to deliver the OCI solution aimed to remove some of the volatility caused by market variables from the income statement to OCI.

The asset side – FVOCI for eligible debt financial instruments

On 21 May the Boards discussed introducing into IFRS 9 a third asset category for debt instruments meeting the contractual cash flow characteristics test (eligible debt instruments). Presently IFRS 9 has two possible measurements for debt instruments: amortised cost (AC) or Fair Value through Net Income (FVNI). The possibility of classifying non-derivative debt instruments not held for trading as Available-For-Sale (AFS) with FV changes recorded in OCI had been eliminated when IASB issued IFRS 9. Some insurers raised concerns that, as a result of that decision, IFRS 9 would not allow them to meaningfully reflect their business model which is to either, hold eligible debt instruments and collect contractual cash flows, or to sell and realise fair value changes.

The Staff proposal in May was to reintroduce the FVOCI treatment to eligible debt assets on the basis of a business model within which they are held. The current US GAAP financial instruments standard includes such classification and this proposal would more closely align IFRS with US GAAP and respond to concerns raised by insurers holding large fixed income portfolios that they often sell to re-balance their portfolio for efficient cash flow and duration matching strategies.

Qualifying eligible debt instruments will be held at fair value in the statement of financial position with fair value changes recognised in OCI. The cumulative changes will be recycled from OCI to income on sale, derecognition or impairment. In addition, the income statement will show interest income using the effective interest rate method and foreign exchange gains and losses. Impairment will be measured based on the same model as applicable to debt instruments measured at amortised cost (currently another IASB-FASB joint project).

During the discussion some IASB members asked why FVOCI debt instruments would be recycled on derecognition but FVOCI equity instruments would not.

The Staff explained that the equity instruments classified as FVOCI are often held for strategic rather than performance reasons and recycling information is less relevant. A majority of the IASB members voted in favour of the Staff proposal.

The IASB and FASB then discussed jointly whether the FVOCI category for eligible debt instruments should be permitted or required based on the business model within which they are held. Under the FASB current tentative decisions the three categories are based on the entity business activity: holding (AC), investing (FVOCI) or trading (FVNI) and neither of the categories is residual. The US respondents raised concerns that there was a lot of cross over between the definitions used to describe investing and trading activities. They also suggested introducing a fair value option and designating one of the categories as residual.

The Boards tentatively concluded that debt instruments included in a portfolio that is managed with the objective to both collect contractual cash flows and sell financial assets should be measured at FVOCI. Eligible debt instruments not meeting the business model test for AC or FVOCI categories would be in a FVNI residual classification. The Boards also tentatively decided to require reclassification when the business model changes, which is expected to be very infrequent. The mechanics of the new proposal essentially reproduce the measurement requirements of the IAS 39 AFS requirements for debt instruments but the difference lies in the scope of the eligible instruments and in the new impairment model.

In a follow up meeting held on June 13 the Boards confirmed their intention that to qualify for FVOCI category the eligible debt instruments would have to meet both the contractual characteristics test and to be managed within the relevant business model. As a result of the joint discussions the IASB decided to support the Staff recommendation and to extend the fair value option to eligible instruments that would otherwise qualify for FVOCI category if doing so eliminates or significantly reduces an accounting mismatch. This would align it closer to the US GAAP standard and would bring back the option currently existing in IAS 39.

The FASB Staff proposal for financial assets was to introduce an irrevocable fair value option for financial assets on initial recognition, if it eliminates or significantly reduces an accounting mismatch. While several Board members raised concerns about having too many options, the Staff confirmed to the FASB Chair that having the options would address constituents' concerns. The FASB then voted for an irrevocable fair value option at initial recognition for a group of financial assets and liabilities if the entity manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis and reports to management on that basis.

In discussing the 'OCI solution' at the IWG June meeting the industry members present welcomed the fact that the Boards had listened to their concerns and voted for the proposal. However, users and regulators were much more concerned about the complexity of the approach. When the details of the solution were discussed some industry representatives expressed concern that banks might be forced into this category though they had not requested for it.

The liability side – changes in the liability caused by movements in discount rate go to OCI

The idea of using OCI for insurance liabilities has enjoyed a long run-up of educational sessions. On 24 May the Boards met to discuss 7 Staff papers, most of which were carried over from April meetings. The Staff summarised the three objectives for the use of OCI as 1) to reduce short term volatility in the income statement; 2) to isolate the results from insurer's core underwriting operations; and 3) to reduce measurement inconsistencies between insurance liabilities and assets backing them.

The Staff firstly proposed to recognise changes in insurance liability due to changes in discount rate in OCI. This produced strong debate around two topics: 1) whether the isolated change should be between the current discount rate and the rate locked in at inception or whether it should be the change in discount rate period to period, similar to pensions and 2) whether the isolated change should be presented in OCI or separately presented in the income statement.

One IASB member raised the point that because FVOCI assets are recycled on derecognition and insurance liabilities are not there would be a room for accounting mismatch and potential 'cherry picking' through asset sales. The degree of asset sales would determine the degree of the mismatch. This possibility was admitted but was expected to be rare. Overall most were in agreement that both current value and cost information was valuable and users wanted to see the sources of volatility and to isolate various types of gains and losses.

The same IASB member then used Staff paper examples to effectively demonstrate the inconsistencies produced in the income statement and OCI when viewed individually as a result of duration mismatches and asset sales. This member saw the helpfulness of isolating different gains/losses by source in OCI but objected to the potentially misleading numbers, when viewed in isolation. Others believed that the Staff proposal while not perfect (as not full fair value) was necessary in light of the current fulfilment value model for liabilities and the Boards' decisions on the assets. It was better than having a cost only model as it was still giving current information about management's asset-liability position, but required looking at comprehensive income as a whole.

On the second point noted above, while some liked the idea of isolating gains in the income statement overall most members in both Boards were in agreement on the use of OCI to remove volatility.

FASB voted unanimously and IASB voted with a majority of 10 in support of the Staff recommendation.

The second Staff recommendation was split with IASB Staff proposing that OCI should reflect only changes in insurance liability due to changes in discount rate and FASB Staff suggesting to also include the changes from interest rate sensitive cash flows assumptions.

Several Board members noted that under the IASB proposal changes in assumptions would not go through the income statement due to the earlier decision to unlock the residual margin. The discussion was brief. FASB voted 5:2 in favour of the IASB Staff proposal and IASB voted 13:1.

The Staff then moved on to the third set of questions which included whether:

- the use of OCI should be permitted or required. Staff recommendation was to require it unless presenting changes in net income would eliminate or significantly reduce an accounting mismatch;
- the unit of account for OCI should be portfolio (FASB Staff preference) or based on insurer's asset mix (IASB Staff preference); and
- the choice of using OCI for insurance liabilities should be irrevocable (if unit of account is the individual contract) or can change only if there is a change in a fundamental strategy of the portfolio resulting in a new accounting mismatch (expected to be rare).

In looking at these three questions the Boards noted that the complexity of OCI solution required mandating it to ensure transparency and comparability. They decided that performance linked contracts will be discussed separately in a future meeting. When the Boards were asked whether they would support a modification to the permit/require question to require presenting all changes in OCI without the possibility of moving changes from OCI to the income statement, even if it creates an accounting mismatch, FASB supported this recommendation 5:2 and IASB 8:6. Consequently the other two questions were not discussed.

In discussing the mechanics of implementing the OCI solution the Boards firstly looked at what discount rate should be used to produce the income statement entry. The Staff considered three options: 1) the original rate determined based on market interest rate when the insurance contract is initially recognised, 2) an asset based rate, 3) the current rate locked in at the beginning of the reporting period. The Staff also proposed two methods of presenting the interest expense, each resulting in the same net interest expense amount based on the original locked in rate. However under the first option (option A in the Staff paper) the interest rate would simply be presented using one line based on the discount rate locked in at inception while under the second option (option B in the Staff paper) it would be presented using two lines: one showing the interest expense/income based on the current rate and another line showing the amount transferred from OCI to equal the interest based on discount rate locked in at inception. The use of the original rate and a single line presentation was approved with FASB voting 6:1 and IASB 12:2 on the first set of options and IASB voting 9:5 and FASB voting unanimously in support of the single line presentation.

Finally the Boards discussed the loss recognition test. The Staff presented a split proposal with FASB Staff recommending a loss recognition test to accelerate the recognition of losses on insurance contracts in the income statement, and IASB Staff recommending against it. The discussion was brief with both Boards stating that they would not consider an adequacy test for another liability and insurance liability should be no different. FASB rejected their Staff proposal with a majority of 6:1 agreeing with IASB who approved their Staff recommendation 13:1.

Unbundling of investment components

The Boards have now reached a converged decision on unbundling having resolved their previous concerns around the necessary definitions and ensuring that there is an anti-abuse clause requiring unbundling in certain situations.

During the March 2012 meetings, they tentatively agreed on the principle of disaggregation instead of unbundling except in limited circumstances (intended to avoid intentional structuring) where unbundling would continue to apply resulting in a separate accounting of the unbundled component as if it was a separate contract. However at the 22 May meeting both Boards felt they wanted to reconsider whether unbundling was still appropriate in some situations where the elements are distinct and not interrelated.

To avoid unbundling of inter-related elements and measuring them outside the insurance model, the Staff proposed the following guidance:

If both the investment component and insurance component are distinct, an insurer shall unbundle the investment component and apply the applicable IFRS or US GAAP guidance in accounting for the investment component.

Except as specified in the following paragraph, a component is distinct if the insurer or a third party regularly separately sells in the same market and jurisdiction contracts that are essentially equivalent to that component.

Notwithstanding the requirements in the previous paragraph, an investment component or an insurance component in an insurance contract is not distinct and the insurer shall therefore account for the investment component together with the insurance component under the insurance contracts standard if the investment component is highly interrelated with the insurance component.

An indicator that an investment component is highly interrelated with an insurance component is a lack of possibility for one of the components to lapse or mature without the other component also lapsing or maturing.

The debate focused around two main concerns. The first was whether the proposed guidance was too narrow. Some members felt that even if there is not an equivalent insurance contract sold separately, that fact should not prevent the unbundling of a distinct investment element provided the two were not interrelated. Some suggested the removal of the words 'in the same market or jurisdiction'. Others thought that if the insurance element was not sold separately, perhaps it is an indicator of some interdependency or pricing cross-subsidy and unbundling being not appropriate.

The other concern was around interpretation of lapsing features. If the deposit can be withdrawn on demand and this would cause the lapse of the whole insurance policy and derecognition of the whole contract then unbundling the non-insurance component could present potentially misleading results. For example recording unbundled on-demand deposits at repayment value under IFRS 9 would lead to a day one loss, which would not reflect economic reality. Some Boards' members questioned whether unbundling requires meeting both criteria: the ability to be sold separately and to mature separately or whether either condition, if met, is sufficient, provided the elements were not interrelated. It was noted that if the elements can mature separately, the amounts are still likely to be interrelated and therefore not distinct (e.g., the investment element has matured but the insurance element 'tops up to the agreed value').

The Staff summarised the debate as follows: an insurer shall unbundle an investment element if it is distinct. It is distinct if it is not interrelated. Indicators that it is interrelated are:

- One element cannot mature/lapse without the other.
- Products are not sold separately in the same market and jurisdiction.
- The value of one component depends on the value of the other.

The Boards approved this Staff summary, subject to it being reflected in the new draft wording (IASB voting 12:2 and FASB unanimously).

The Boards then unanimously reconfirmed their previous decisions on unbundling from insurance contract of embedded derivatives, investment components and non-insurance obligations to deliver goods and services.

Finally, they looked at whether it is possible to permit unbundling where it is not required. One member felt that if the decision not to unbundle is made based on operational difficulties, then unbundling should not be precluded, especially if local practice requires it already (e.g. under Australian GAAP). However others felt that this would require additional guidance and the information can be presented as a non-GAAP measure. All but one IASB member voted in support of the Staff recommendation to prohibit unbundling where it is not required, with FASB voting unanimously in support.

Extract from Deloitte 2010 Comment Letter

"We believe that the Board should modify the proposed unbundling principle to require separation of components from an insurance contract only when those components (i) are not interdependent with the insurance coverage and (ii) have been combined with the insurance coverage for reasons that do not have commercial substance."

Allocation of cash flows to unbundled components

The meeting on 12 June built on the unbundling decisions reached in May. For those components that the Boards tentatively decided to unbundle, both the IASB and FASB Staff recommended that:

The cash flows allocated to an investment component and considered in the measurement (including interest credited) should be measured on stand-alone basis which means as if the insurer had issued the investment contract separately (without including the effect of any cross-subsidies or discounts/supplements).

After excluding any cash flows allocated to unbundled investment components (or embedded derivatives recognised separately), the amount of consideration and discounts/supplements should be allocated to the insurance component and/or the goods and service component. The allocation should be done in accordance with the current revenue recognition proposals, and

Cash outflows related to more than one unbundled component (for example, acquisition and fulfilment costs) should be allocated to those components on a rational and consistent basis. Once allocated, the insurer would account for those costs in accordance with the recognition and measurement requirements that apply to that component.

The Board members were concerned over the nature of 'allocation'. Nearly all Board members felt the Staff should be clear on what disbursements are eligible for not being treated as an expense because the customer has substantially prepaid them. They wanted clearer guidance on attributing those disbursements to the various components given the different measurement attributes of investment, revenue and insurance component disbursements. For example, disbursements can be treated as costs, assets or deduction of a liability depending on what they are and the component they relate to. Finally for shared costs only, more guidance is needed on how to allocate them across different components.

Both Boards voted unanimously in favour of the Staff recommendations, with a caveat that the attribution versus allocation language would be refined when drafting. Importantly, the Staff were asked to draft language such that when cash flows are clearly linked and attributable, those cash flows are kept within the unbundled component and treated according to the standard that governs the financial reporting of that component.

Discussion on whether to abandon the risk adjustment

On 22 May the IASB had an educational session on the FASB 'Single Margin' approach in an effort to reach convergence on this topic. To that effect the Staff asked the Board two questions:

Question 1: (a) Do you think that the IASB should change any of its previous decisions on the risk adjustment and residual margin with the objective of developing an approach that Board members believe would result in a more relevant and faithful representation than would result from the existing tentative decisions? (b) If so, which of the following tentative decisions would you change and why:

- *The remeasurement of the amount attributed to risk at each reporting date.*
- *The allocation basis for the residual margin.*

- *The offset of changes in estimates of future cash flows in the residual margin.*

Question 2: If your answer to question 1 identified any decisions that you believe the IASB should not change solely on technical considerations, should the IASB nevertheless consider changing any of those decisions if that would reduce differences with the FASB's model, even if some or all of the other differences between the Boards, described in appendix B, remain? If so, which decisions would you change and why?

The discussion was lively with arguments put forward in favour of either abandoning or retaining the risk adjustment. Both the risk adjustment and the pattern of release of the single margin based on release from risk were criticised as being too subjective, hard to apply and resulting in potential diversity between entities. Many objected to the subjectivity resulting from it being entity specific and depending on an entity's risk appetite. Some wanted to anchor the risk adjustment in market rather than entity view. Some argued period-to-period development was more important than comparability across entities.

A substantial portion of the debate focussed around the IASB decision to unlock the residual margin. Some members felt that in the 'unlocked' model the residual margin should also be adjusted for changes in the risk adjustment, getting closer to the FASB single margin approach. However the Staff maintained that this would create difficulties in running off the residual margin and the calculation would be circular. A number of the IASB members preferred the single margin approach although not necessarily adopting the FASB's current model.

While different ideas were debated there was not enough conviction that a single margin would be better and the possibility of project delays (IASB Staff estimated at least a four months delay to investigate unlocking the residual for changes in risk adjustment) ensured no change in status quo. The IASB voted 11 in favour of retaining the risk adjustment thus closing the possibility of convergence in this area.

Extract from Deloitte 2010 Comment Letter

As explained in our cover letter, we believe that users would benefit more from a current assessment of the uncertainty of the outcomes of future cash flows than from a reporting basis that does not actively measure this underlying uncertainty. For this reason, we do not support a composite margin model. However, our support for the two margin approach proposed in the ED assumes that a final standard will clarify the definition of risk adjustment margin.

Several votes were then taken on the treatment of the residual margin. Four IASB members voted to keep the residual margin locked. Five members voted to unlock the residual margin also for changes in the risk adjustment. Finally, when asked who wanted to confirm the existing position on the residual margin, there were 8 votes. The IASB Chairman summarised the session by noting, "Clearly we are in favour of leaving it the way it is."

Extract from Deloitte 2010 Comment Letter

"[...] we believe that the residual margin should be recalibrated in subsequent reporting periods to reflect changes in assumptions affecting the expected present value of fulfilment cash flows. In essence, this means that all prospective changes in building blocks 1 and 2 are first offset against any remaining residual margin. Actual experience, i.e. the difference between cash flows anticipated at inception and actual cash flows, would be recognised directly in profit or loss for the period."

Earned premiums

On the 12 June meeting the Boards had an education session on the nature of the volume information that users would find most useful.

The Staff stated that to ensure comparability across industries they aimed to develop a 'revenue-like earned premium model' and presented three possible approaches: earned premium, written premium and premium due.

A few members felt that the revenue recognition concepts did not combine well with a liability measurement perspective, a theme echoed in discussions on other topics. However the majority of views expressed encouraged the Staff that they were supported by the Boards and that they could plan some user specific outreach to assess costs and benefits of this solution and whether it meets users' needs.

This was also extensively discussed at the IWG meeting. There was limited support for the earned premium approach since many participants felt that it was relatively complex to obtain this information for a life insurance company which added limited value to the users. The earned premium approach was supported for non-life companies. Many participants also indicated that there was detailed volume information currently in the financial statements such as segmental disclosure including new business and growth information and this was more useful than a single earned premium line on the face of the income statement. There was some support for the premiums due approach for life companies since this information is readily available but it may not be consistent with the revenue recognition project of the IASB.

Extract from Deloitte 2010 Comment Letter
Reflecting insurance contract sales in the statement of comprehensive income

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

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

Acquisition costs

The decision to revisit the treatment of acquisition costs came as a result of the Boards agreeing to allow an asset for customer sales in the revenue recognition project and whether insurance decisions should be aligned with that. The Staff was also keen to confirm previous decisions in light of volume information now being presented in the income statement instead of the summarised margin approach proposed in the ED.

The Staff presented three options for presenting the portion of premiums that the insurer charges to enable it to recover acquisition costs:

- Option A: Recognises the right to recover acquisition costs as an asset.
- Option B: Include acquisition costs in the cash flows used to determine the margin resulting in the margin reduction when acquisition costs are incurred. The acquisition costs would be shown net against the residual/single margin and allocated to profit or loss the same way as the margin. Changes in the insurance contract liability arising from the acquisition costs would be shown as part of margin release and not as changes in the cash flows. [Option B is a variant of the FASB's view in developing their 2010 DP.]

- Option C: Include acquisition costs in the cash flows used to determine the margin requiring recognition of a reduction in the margin. But unlike Option B, under this proposal when acquisition costs are incurred the insurer would expense them and recognise equal amount of income, achieving nil net impact on the income statement. Changes in the insurance contract liability arising from the acquisition costs would be shown the same way as changes in the cash flows. [Option C is consistent with the IASB's view in developing the 2010 ED].

The Staff proposed to reject the recognition of a Deferred Acquisition Cost Asset (Option A). Then without expressing a recommendation the Staff asked the Boards which of the two options (B or C above) they would prefer for acquisition costs under the Building Block Approach.

The Boards quickly decided that without a decision on volume information for premiums, they could only answer whether acquisition costs should be treated as an asset.

They debated at length whether these costs were fulfilment costs or if they should be outside of the model. The Boards briefly reconsidered expensing the costs, and considered the simplicity of recognising an acquisition cost asset. In the end the same differences between the two Boards regarding the measurement of the liability and the treatment of the margins re-surfaced again.

The IASB supported the Staff recommendation with majority of 10 votes to 2 rejecting recognition of acquisition costs asset. The FASB Chair chose to ask the questions differently and asked first who among the FASB members supported each of the following:

- Option C – FASB unanimously rejected it on the grounds that profit would be released potentially even before the start of the coverage.
- Option A (which considered deferred acquisition cost asset or expense as incurred to be debated further) – FASB unanimously supported it.
- Option B (as a compromise) – FASB expressed a slim 4:3 majority to achieve convergence.

Based on these votes the two Boards arrived at separate conclusions. The FASB would now contemplate recognising acquisition costs asset with FASB Staff needing to develop the proposal further.

The IASB has subsequently held an education session on 14 June to discuss the treatment of acquisition costs and to give a directional steer to their Staff.

Several issues surrounding this topic were considered, reviewed and clarified. The IASB members asked Staff to explain whether the inclusion of acquisition costs as a component of the contract's cash flows would not implicitly adjust the residual margin and therefore the emergence of profit from the release of the residual margin. The Staff, supported by other members of the IASB, clarified that while inclusion of acquisition costs would always reduce the margin irrespective of whether these costs were treated as a component of the contract's cash flows or as a direct deduction from the residual margin, the pattern of release of the margin would follow one of the possible three options.

To illustrate these options, the Staff invited the IASB to consider a simple example where premium is CU 100, acquisition costs are CU 50 and residual margin is CU 50:

Option 1 – would recognise acquisition costs of CU 50 as an incurred expense and immediately recognise revenue of CU 50 from the premium received. The net result would be no profit or loss at the point of sale of the insurance contract but with revenue and expenses recognised at initial recognition. The remaining CU 50 or residual margin would be earned subsequently over time

Option 2 – would recognise revenue over time as CU 50. The impact on the net result would be the same as under option 1 but the accounting would not result in revenue and expenses being recognised at initial recognition because the acquisition costs would be treated as the first actual pay-out of the contract expected liability (balance sheet transaction) or as a direct deduction from the initial residual margin

Option 3 – would recognise revenue of CU 100 and release acquisition costs of CU 50 over time. Also, in this case, there would be the same impact on the result at initial recognition as in options 1 and 2 and the same impact on the initial recognition of revenue and expenses as in option 2. However the subsequent revenue and expense would be greater than option 2 given that the acquisition costs are amortised separately from the earning of the premium.

Many viewed the up-front revenue recognised under option 1 as counter-intuitive because revenue may be recognised before the beginning of the coverage.

The questions of successful and unsuccessful efforts and whether portfolio is the appropriate unit of account were then explored further. If all the efforts were unsuccessful, there would be no portfolio so those efforts would be expensed. The Staff reminded the IASB that acquisition costs relate only to acquisition efforts and not to other expenses arising in the course of service, such as claims handling. Further, the treatment would be the same regardless of whether all acquisition costs were paid upfront or spread and paid over the term of the coverage.

Several members considered reopening the debate on expensing the acquisition costs. Others felt that if expensing is not an option than a contract asset similar to the revenue recognition project would keep the two standards aligned. In response, some members and Staff reminded the IASB that the treatment of acquisition costs is consistent with the treatment of the residual margin under the current fulfilment value approach the IASB has selected for insurance contracts. Inclusion of day one profit as part of the liability could be viewed as a departure from the definition of liability in other accounting standards. Expensing acquisition costs would lead to day one losses on economically profitable contracts and potential overstatement of insurance liability and future profits.

Extract from Deloitte 2010 Comment Letter

"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. [...]"

The Staff concluded their education session presenting the arguments for and against recognising an asset.

The 'pros' included that it would be easier to amortise and present, it would reflect the value of intangible relationship and that any form of deferral is essentially akin to recognition of an asset explicitly or implicitly.

The 'cons' are that if recognised separately it will still need to be considered together with liability for onerous contracts testing, the pattern of release should still be linked with service provided and have no impact on the net result but with the added cost of reporting the associated amortisation expense. Some Board members felt that the asset amortisation should be different from the earning of the residual margin and a straight line over the coverage term should be required while others felt that it should always be done in the same manner as the earning of the residual margin.

This was an educational session so no decisions were taken. However the Board members indicated to the Staff by a majority of 9 votes that they would prefer to explore treating acquisition costs in a way that they do not result in incurred expense at initial recognition and that such costs are instead taken to income with a pattern of release yet to be determined but that would always avoid the recognition of revenue upfront. This conclusion seemed to suggest that the final debate would be to finalise the choice between options 2 and 3 as presented above.

IASB only July meeting

The agenda for IASB meeting on 16 July was only to discuss the issues highlighted by the IWG.

In addition to what was reported above the Staff highlighted two other topics where the IWG members gave their feedback:

1. Transitional requirements – There was unanimous support by the members for retrospective transitional requirements but whether this should be prescriptive or left to judgment of the insurance company is being debated. Analysts commented that transition could affect the share price significantly therefore it is imperative that application guidance be provided in relation to transitional requirements. The IASB will continue to work on the transitional requirements over the next few months with the preparation of detailed guidance in relation to this topic currently in progress.
2. Unlocking of the residual margin – The majority of the members welcomed the decision to unlock the residual margin. They also were in favor of unlocking the risk margin. While industry representatives supported amortising changes in the discount rate to the residual margin, other participants were more skeptical and favored reflecting changes in the discount rate through OCI.

Next steps

Currently there are no planned joint meetings until the week beginning 24 September.

The IASB Staff will continue to work on the insurance project to complete the remaining topics relating to volume information, residual margin, disclosure and transition requirements with an expectation to publish a review draft or a revised ED in December 2012 with a the final standard expected in 2013.

It is important that IFRS 4 and IFRS 9 are implemented concurrently and the IASB is striving to meet the effective date of 1 January 2015 and if this is not possible the effective date for IFRS 9 could be pushed back to 1 January 2016 to accommodate the insurance standard.

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