

## Insurance Accounting Newsletter

### Convergence on insurance still at risk despite progress made in recent months



#### Introduction

After the disappointing start to the year, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) have committed in the last fifteen weeks, the equivalent of a whole working week of insurance meetings. In particular the welcomed pick up of the pace in terms of both the extent of time allocated to the insurance project and the productivity of these sessions resulted in several decisions taken on the future requirements.

Regrettably this appears to be only partial progress as the various decisions discussed below do not appear to have made the convergence barometer tilt towards the sunny days of agreement. With this issue, we bring to your attention recent statements made by the FASB chairman. Ms Seidman told the FASB Advisory Council on 5th June that it may be in the best interest of US users if the insurance contract project for US GAAP is developed without converging with the new IFRS.

Despite this recent news, the developments over the last few months are equally of great importance for future implementation work and one of the key outcomes of these meetings was the decision on the Premium Allocation Approach (PAA) [eligibility criteria](#) and the introduction of a practical expedient to simplify its application for several insurers underwriting property and casualty insurance. A key difference remains between the Boards as the IASB decided that the use of the PAA should be permitted rather than required while the FASB voted to require PAA if the eligibility criteria are met. Leaving that aside, convergence has been achieved in [all other related areas for the PAA](#).

Other highlights from the February to April meetings include the agreement on the definition of the **unit of account** at a portfolio level for the accounting of in-force profit, the agreement on the **onerous contract test**, the IASB decision to **disaggregate investment components** purely for presentation purposes and the realisation among FASB members that the accounting for the single margin in PAA and Building Block Approach (BBA) result in **different patterns of profit recognition** potentially opening a route for convergence with the IASB position. On **reinsurance**, the Boards retained their previous decision not to recognise day one gains from the purchase of a reinsurance contract. A significant portion of the recent debate has been allocated to the preparation for the decision on the potential '**OCI solution**' that has now come to a decision-making stage during the most recent joint meeting in May.

The FASB agreed with the IASB decision with a majority of 4 to 3. It did however reject 6 to 1 the BBA approximation principle. The FASB members thought there would be too many instances where the "approximation" would be materially different, i.e. no longer qualifying as an approximation. The FASB's view is that the PAA is a model more akin to revenue recognition.

In this newsletter we also cover other minor items on which the Boards have deliberated on a tentative basis for the future accounting standard on insurance contracts: **unbundling of obligations to render services and deliver goods, financial instruments with discretionary participation features, policy loans and riders and contract modifications and commutations**.

## Premium allocation approach (PAA)

There was significant progress in February as several converged decisions were reached on the subject of accounting for short duration contracts, despite some important differences remaining. The Boards' deliberations can be subdivided into two topics: PAA eligibility and PAA mechanics.

### Eligibility criteria

The philosophical dispute as to whether the PAA represents a separate model or a proxy of the BBA returned on the table at the February meeting, with the IASB Staff proposing that eligibility for the PAA should be determined by an overall principle of producing results similar to those produced under the BBA and the FASB Staff proposing instead that eligibility for PAA should be determined by required eligibility criteria supplemented by additional application guidance as detailed below. This time, the Boards agreed on virtually all the other elements associated with the PAA.

First both Boards approved that, as a practical expedient, eligibility criteria would be deemed to be satisfied for contracts with coverage of one year or less.

Secondly, the required **eligibility criteria** approved by the FASB will be included as application guidance by the IASB in the new accounting standard and will state the following:

*Insurers should apply the BBA rather than the PAA if at the contract inception date either of the following conditions is met:*

- a) *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 contract; or,*
- b) *Significant judgment is required to allocate premium to the insurer's obligation in each reporting period. This may be the case if, for example, significant uncertainty exists about:*
  - i. *The premium that would reflect the exposure and risk the insurer has for each reporting period; or*
  - ii. *The length of the coverage period.*

The FASB also approved some additional **application guidance** that will explain what indicates where the eligibility criteria are not met:

- a) The existence of guarantees or options in an insurance contract may indicate that there is likely to be a significant change in expected net cash flows to fulfil the contract, unless the cash flows resulting from those guarantees and options are substantially offset by variations in premiums.
- b) Some circumstances are likely to cause expected cash flows to change subsequent to contract inception, but such changes will not always significantly change the expectations of net cash flows at contract inception. Other circumstances could cause expected cash flows to change significantly subsequent to contract inception, but are not likely at contract inception.
- c) If at contract inception an insurer believes that during the contract's coverage period it is likely to significantly change premium pricing for future contracts written with similar or identical risks, this could indicate a significant change in the expectations of net cash flows for the existing contract.
- d) The longer the coverage period of a contract the more likely it is that there will be a significant change in the expected net cash flows to fulfil the contract as compared to a shorter coverage period.

One issue raised by IASB members on the application guidance (b) above was that for many contracts and especially for infrequent high severity events (e.g. catastrophe insurance) there is likely to be a significant change in the expected cash flows during the pre-claim period and it was not clear whether this would affect eligibility for PAA. The Staff confirmed that the wording of guidance (b) would be clarified to ensure these contracts are eligible for PAA. Subject to that clarification the IASB voted unanimously in support of the overall eligibility guidance and the one year practical expedient.

The FASB agreed with the IASB decision with a majority of 4 vs. 3. However it rejected by 6 to 1 the BBA approximation principle on the grounds that it could see too many instances where they would result in material differences in measurement thus denying the idea of an approximation – a difference which is highlighted as a result of decisions made by the FASB and the consensus view that the PAA is a model more akin to revenue recognition.

The only area for disagreement across the new decisions on the PAA was on the use of the criteria. The IASB nearly unanimously decided to permit but not require the use of PAA where the eligibility criteria including the practical expedient are met. In contrast, the FASB rejected by 6 to 1 the above proposal to permit but not require the use of the PAA and instead voted to require the PAA to be used where the eligibility criteria are not met.

#### **Mechanics of the PAA**

The mechanics paper presented at the February meeting was substantially unchanged from the January 2012 paper and discussed whether to adjust the liability for the time value of money in the remaining coverage using two alternatives:

- a) no discounting of the liability for remaining coverage and no interest accretion on the liability (FASB Staff proposal), or
- b) require discounting and interest accretion of the liability for remaining coverage for contracts with significant financing component (IASB Staff proposal).

In assessing whether a financing component of a contract is significant, an entity shall consider various factors, including any of the following: a) the expected length of time between the receipt of initial premium and the coverage period; b) whether the amount of consideration would differ substantially if the customer paid in cash upfront or over the coverage period; and c) the interest rate in the contract and prevailing interest rates in the relevant market.

#### ***The PAA practical expedient on accounting for time value of money***

If the Boards decided to require discounting and accretion of interest in the measurement of the liability for remaining coverage (i.e. alternative b), the Staff recommended that, as a **practical expedient**, insurers need not adjust the liability for remaining coverage to reflect the time value of money if specified conditions are met. The Staff asked the Boards if they agreed with this proposal and which of the following practical expedients they would support:

*Alternative 1:* to permit insurers not to adjust the measurement of the liability for remaining coverage to reflect the time value of money aligned with the proposals in the exposure draft Revenue from Contracts with Customers. **OR**

*Alternative 2:* to permit, insurers not to adjust the liability for remaining coverage to reflect the time value of money if the insurer expects at contract inception that the period between payment by the policyholder of all or substantially the entire premium and the insurer's corresponding obligation to provide insurance coverage will be one year or less.

At the outset, both Boards accepted unanimously the IASB Staff recommendation (Alternative b above) to require discounting and interest accretion on the liability for remaining coverage where there is a significant financing component. As part of the discussion, the Boards considered the potential differences between the insurance contract language and the discounting mechanics discussed in the revenue recognition ED, although they noted that the practical expedient in the revenue recognition ED is expected to be revised to align it with the insurance contracts standard. Accordingly, the Boards unanimously agreed with the wording proposed in alternative 2 above.

#### ***The PAA treatment of acquisition costs***

The Staff presented the Boards with two alternatives:

*Alternative 1: (consistent with the decisions made under the BBA):* The measurement of acquisition costs should include directly attributable costs (for the FASB, limited to successful contract acquisition efforts only), and insurers should be permitted to expense directly attributable costs that are not incremental. **OR**

*Alternative 2: (consistent with the revenue recognition exposure draft):* The measurement of acquisition costs should include only incremental costs, and insurers should be permitted to expense all acquisition costs if the contract coverage period is one year or less.

Board members did not support different acquisition costs treatment under the BBA and the PAA but wished to allow insurers a practical expedient consistent with the revenue recognition ED of expensing all acquisition costs, not just the non-incremental ones. Consequently, the Boards rejected the Staff proposals and instead suggested a **third alternative**: the measurement of acquisition costs should include directly attributable costs (for the FASB, limited to successful contract acquisition efforts only), consistent with the decisions made under the BBA, and insurers should be permitted to expense all acquisition costs if the contract coverage period is one year or less (consistent with the revenue recognition ED). This was approved by the IASB with a majority of 12 and by the FASB unanimously.

The Staff then asked the Boards whether acquisition costs should be recognised as an asset (resulting in a liability for remaining coverage presented gross of acquisition costs) or whether they should be amortised consistent with the Boards' tentative decisions on reducing the liability for remaining coverage (i.e. over the coverage period on the basis of time or, if that pattern differs significantly from the passage of time, on the basis of the expected timing of incurred claims and benefits).

Board members were concerned about different presentation of acquisition costs under the PAA and BBA. One suggestion was to further consider the earlier decision to have acquisition costs as part of the cash flows under an insurance contract. The Boards did not vote on the Staff proposals. Instead all Board members indicated nearly unanimous support for the Staff to consider the proposal made by a FASB member that acquisition costs should be netted against the liability for remaining coverage under PAA or netted against the residual or single margin under the BBA rather than disclosed as an asset under PAA as proposed by the Staff in one of their proposals. This was addressed again at the May meetings and further divergence emerged as the FASB prefers to recognise acquisition costs as an asset for US GAAP

## Unit of account

The notion of a portfolio is important to the measurement of insurance contracts because it is used in the determination and measurement of a residual or single margin, the identification and measurement of onerous contracts, the determination of a contract boundary under certain circumstances and the classification of investment contracts with DPF.

In the March meeting the Boards looked at the definition of portfolio for the purpose of determining a residual/single margin and the identification and measurement of onerous contracts.

The IASB Staff recommended that the unit of account used to determine the residual/single margin and to perform the onerous test should be portfolio level. A portfolio of insurance contracts should be defined as contracts that are:

- 1) subject to similar risks;
- 2) managed together as a single pool; and
- 3) priced similarly relative to the risk taken on.

The unit of account used to release the residual/single margin should not be prescribed. However, the release of the residual/single margin should be performed in a manner consistent with the objective of releasing the residual margin over the coverage period to the period(s) in which the service is provided [for the IASB]; or of releasing the single margin in the period(s) in which the insurer is released from risk [for the FASB]. For the IASB, the service is seen to be provided over the coverage period, and for the FASB the insurer is seen to be released from risk by a reduction in the variability of cash outflows across the combined coverage and subsequent claims settlement periods.

The FASB Staff recommended that the unit of account used to determine and to release the residual/single margin as well as that used to perform the onerous contract test should be the portfolio level. A portfolio of insurance contracts should be defined as a group of contracts that:

- 1) are subject to similar risks and are priced similarly relative to the risk taken on; and
- 2) have similar duration and similar expected patterns of release of the residual/single margin.

This latter definition would effectively align the portfolio definition with the previous concept of a cohort addressed in the context of accounting for the residual/single margin release to income.

The Staff explained that 'similar risks' would consider the type of risk insured (e.g. theft, fire, mortality, etc.), the product line (e.g. annuity or income protection, etc.), the type of policyholder (e.g. commercial or personal, etc.) and the geographic location (e.g. across continents, states, provinces). The concept of 'management of contracts in a single pool' would depend on how contracts are acquired (e.g. broker channels or direct, etc.), serviced, managed (linking it with the organisational form of the insurer) and the geographic location of all these management dimensions. 'Similar pricing' criterion would mean that similar compensation is required for taking on similar insurance risks as opposed to similar pricing by number of currency units.

Many IASB and FASB members questioned whether the proposed indicators were all necessary and thus meant to be considered individually or whether they should be viewed together as an indication of a broader principle. One FASB member commented that some may interpret the need to disaggregate portfolios under each indicator as a 'narrowing effect' that reduces the size of individual portfolios. The Staff confirmed it was not its intention to produce a requirement that deliberately reduces the size of portfolios. However it was trying to define a limit for the highest level of aggregation.

The same FASB member noted that for single margin model where the release is based on release from risk and it is unlikely to be straight line it is particularly important to ensure that portfolios have contracts of a similar pattern of risk release and similar duration. In fact he viewed it as an indicator as essential as all others.

The 'managed together' criterion was not viewed as essential by a few members of the Boards. However several IASB members insisted that it is retained as an important indicator of what the insurer manages together as a single pool of obligations and risks and thus, should define a portfolio.

Many IASB and FASB members felt that the main objective from introducing a portfolio definition that operates as the unit of account for the measurement model was to ensure profitable contracts are not grouped with loss making ones and that objective could be stated more simply. However, others felt that without explicitly stating the indicators, contracts with different patterns and levels of profitability would still be aggregated.

Overall the IASB supported the IASB Staff proposal and the FASB approved, with amendment, the FASB Staff proposal. While the Boards wanted to achieve convergence, they did not want to change their votes for fear of unintended consequences. The IASB and FASB Staff were tasked to work on the converged drafting of the definition.

#### **Extracts from Deloitte ED Comment Letter**

*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. 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.*

**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.**

## Onerous Contracts

In December 2011, the Boards tentatively agreed that a contract is onerous when the expected present value (PV) of future cash outflows from a contract (plus the risk adjustment for the IASB) exceeds either the expected PV of future cash inflows or the carrying amount of the liability for remaining coverage (PAA). During the February and March meetings, the Boards broadly agreed on this aspect of the new accounting standard.

The Boards agreed unanimously with very limited discussion that the measurement of the liability for onerous contracts should be updated at the end of each reporting period. The IASB also agreed that the risk adjustment should be considered when identifying onerous contracts and that the measurement of the liability for onerous contracts should include a risk adjustment.

The Boards considered interaction of three tentative decisions:

- 1) Applying the onerous contract test for PAA contracts;
- 2) Discounting is not required on the liability for incurred claims on contracts where the claims are expected to be paid within 12 months (the practical expedient); and
- 3) Measuring onerous contracts on the same basis as the liability for incurred claims.

As a result, if an entity elects not to discount the liability for incurred claims (by opting for the approved practical expedient), then the onerous contracts, as tentatively decided, would be identified and measured on a different basis and hence the need for clarification on measurement for these contracts arose. The Boards considered instances when an insurer elects not to discount the liability for incurred claims because it is expected to be paid within 12 months of the date of the incurred loss. Some Board members suggested that because discounting is a key factor for onerous contracts testing an entity should not be allowed to take advantage of the PAA practical expedient for the accounting of time value of money. However, one Board member has proposed and the Boards tentatively agreed that insurers should identify and measure onerous contracts on the basis chosen for claims liability measurement. If the practical expedient on time value of money is not applied, an insurer should identify and measure the onerous liability on a discounted basis. If the insurer applies the practical expedient not to discount claims liabilities, then the onerous contract liability should also be identified and measured on an undiscounted basis.

## Measurement for High Severity, Low Frequency Events

The Boards considered whether the Insurance Contracts and Subsequent Events standards should be modified for infrequent, high severity events. This would consider catastrophes and whether in situations where there is significant inherent uncertainty and volatility of cash flow estimates around the reporting date there should be some adjustment for subsequent events. It is worth noting that according to current market practice, insurers do not use expected value model. Rather, they use an incurred loss model which is deemed justified by volatility in estimates.

The Staff considered two ways of modifying the proposed requirements: a) by providing an exception from the expected value model for catastrophe-type insurance; and b) by requiring insurers to take subsequent events into account.

To that effect the Staff put forward three options for the Boards' approval:

Option 1 – make no amendments to the ED (expected value approach).

Option 2 – amend the ED: update measurements using subsequent events.

Option 3 – amend the ED: require recognition of an insurance contract if it remains onerous after the balance sheet date.

Other options were also considered as alternative to Option 2 above. The first one, Option 2A, proposed to update the measurement of onerous contract liabilities meeting specified criteria. The Staff asked the Boards whether they agreed that, for onerous contract liabilities under PAA, if the effects on the financial statements are material, insurers should update CF estimates made at the balance sheet date for events that occur after the balance sheet date but before the financial statements are issued when all of the following conditions are met:

- a) An infrequent, high-severity event, such as a catastrophe is impending at the reporting date, but has not yet occurred;
- b) Where the expected losses related to the event in (a) are based on information that is subject to substantial deviation prior to the event occurring; and
- c) The time period between when the insurer first estimated the expected losses from the event and its occurrence is relatively short.

The second alternative to option 2, Option 2B, proposed to update the measurement of all insurance contract liabilities meeting all of the specified criteria described above irrespective of the contracts being onerous.

Another option was put forward which was called the “recognition hurdle”. The Staff asked the Boards whether they agreed that, if the liability is already known to have reversed in the post balance sheet period as a result of subsequent events occurring prior to the financial statements being filed, insurers should not recognise an onerous contract liability at the balance sheet date.

The debate on this subject was lively, although from the onset most members of the Boards were in agreement to reject all Staff recommendations. One IASB Member said plainly that the Staff should drop the subsequent event paragraph in the ED adding an explicit reference to IAS 10 and SFAS 165 Subsequent Events standards that seem to deal already with these issues in a satisfactory manner. Guidance should be added that, whether an event occurs or not after the reporting date does not constitute an adjusting event at the balance sheet date. The Staff pointed out that an entity would continue to update assumptions with the best information available to them at the reporting date but may get different answers based on the data they used. The IASB Chair favoured a simple solution as these “events” are followed very closely by users.

The Boards approved their own position rather than any of the Staff recommendations with the IASB voting 12 in favour, and the FASB unanimously.

## Separation of investment components from insurance contracts

The two Boards have once again revisited the accounting for investment components in insurance contracts. The IASB ED and the FASB DP both proposed to unbundle investment components if they were not closely related to the insurance coverage specified in the contracts. In response to feedback, both IASB and FASB agreed in May 2011 to unbundle only explicit account balances that are credited with explicit return on the account balance. In November 2011, the FASB clarified the definition of explicit account balance and decided to separate them. The IASB did not vote on the definition but expressed a preference for separation through disaggregation rather than unbundling i.e. to separate the investment components purely for premium and benefits presentation purposes without requiring a separate measurement and profit being calculated. With this in mind, the Staff developed proposals assuming Boards’ preference for the disaggregation and the objective of presentation in the statement of comprehensive income being the meaningfulness of the total aggregate premium volume information.

### Identification of investment components

In the March 2012 meeting the Staff proposed a principle to identify an investment component. Several alternatives were presented: a) no separation; b) separation of explicit account balances; c) separation of an amount payable regardless of insured event occurring; and d) separation of an amount insurer estimates it will return (including for claims and benefits) to individual or groups of policyholder or their beneficiaries.

The Staff recommended option c): ‘an investment component in an insurance contract is an amount that the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs.’

The FASB members were in favour of the Staff proposal although they were concerned with the potential for structuring if investment contracts independent of insurance coverage could be included within insurance contract. They proposed to modify the scope of alternative c) to apply only after all independent ‘distinct’ financial instrument contracts have been unbundled. This was referred to as alternative “c) prime” with the FASB members supporting it unanimously although no formal vote was recorded as the wording was different from the Staff proposal.

Many IASB members supported the “c) prime” alternative, however some were concerned with the ‘cliff effect’ of contracts with similar economic outcomes but which would result in different treatment depending on whether the policyholder was contractually entitled to the investment component amount or whether it was merely probable.

Given this debate, the Boards focused on whether to unbundle or disaggregate and whether to disaggregate investment components only in comprehensive income (profit or loss) but not in the balance sheet. The Staff explained that the objective for comprehensive income was to present meaningful volume information excluding investment deposit elements from aggregate premium, whereas they felt that the main objective for the balance sheet was comparability to similar instruments. The investment components once disaggregated were not comparable to similar instruments due to cash flow interdependencies and apportionment of acquisition costs.

The IASB members explained they were uncomfortable with unbundling ‘distinct’ independent financial instruments. Their argument was that the investment components in an insurance contract are not comparable to financial instruments issued by non-insurers as the insurer would reflect the effects of pooling different components into the pricing. In addition they noted that investment contracts with DPF were in the scope of the insurance contract standard when they were ‘managed together with insurance contracts’ and the decision to unbundle distinct investment components under “c) prime” would contradict that. The Boards decided to adjourn their discussion on ‘distinct’ investment components and whether they should be unbundled or disaggregated but have since come to agreement to unbundle distinct investment components based on the proposal presented in the May 2012 meeting.

### Presentation in comprehensive income

As mentioned earlier, the Staff proposed to 'exclude from aggregate premium presented in the statement of comprehensive income the present value of those amounts to be paid to policyholders or their beneficiaries regardless of whether an insured event occurs, measured consistently with the measurement of overall insurance contract liability'.

The FASB members obtained a clarification from Staff that 'the amount payable to policyholder regardless of the insured event occurring' includes also the amount of cash flow paid on the occurrence of the event that would have been paid out regardless. On that basis, the FASB members expressed general support for this principle. The IASB discussion focused on whether the investment components are disaggregated pre or post surrender charges and how representative it is of surrender values. The IASB recorded their decision as follows:

"The IASB tentatively decided that insurers should exclude from the aggregate premium presented in the statement of comprehensive income the present value of the amounts that the insurer is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs, determined consistently with measurement of the overall insurance contract liability.

Twelve IASB members supported this decision and two opposed it. The FASB did not vote on this issue."

### Presentation in the balance sheet

The Staff proposed not to require separate presentation of investment components in the statement of financial position. Instead, insurers should disclose both 1) the portion of the insurance contract liability that represents the aggregated portions of premiums received (and claims / benefits paid) that were excluded from the statement of comprehensive income (as discussed above); and 2) the amounts payable on demand.

One IASB member pointed out, and the Staff confirmed, that there is no prohibition on separate presentation in the balance sheet. Several members were concerned that if the investment component amount is important enough to disclose, why is it not presented separately in the balance sheet? The main objection was that, invariably, when splitting the components, one element would be a residual. Additionally, while it was very important to exclude deposit elements from aggregate premiums to avoid distortion of revenue indicators, disaggregating these elements any further would add computational difficulties and questioned reliability/accuracy of the whole measurement model. The interdependency of cash flows and the difficulty of estimating it are the main issues combined with the judgment on the apportionment of acquisition costs. The main objective of the balance sheet is comparability and disaggregated amounts would not be comparable to similar instruments issued by other institutions.

The Staff addressed the Boards' wish to give a picture of liquidity in the balance sheet by recommending that the new standard requires separate disclosure of the amounts payable on demand. The IASB supported the Staff proposal with 11 votes.

The FASB members were divided on the issue. Some felt it important to see some disaggregation on the balance sheet based on the same method as proposed for comprehensive income so that the users could see the split of products and the economics behind an insurer's returns. Others felt the disaggregation would be too complex. In particular, reconciling the amounts year-on-year, explaining the movements and tying back to the profit and loss amounts would be challenging. It was felt that users needed different measures; one addressing liquidity risk and another explaining the different economic components of an insurance contract. Four FASB members, i.e. a majority, initially voted against the Staff proposal. However, one of them changed his vote and convergence with the IASB was achieved, thus resulting in a final narrow support for the Staff proposal.

#### **Unbundling of certain components of insurance contracts**

*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.*

*Like the Board, we view an insurance contract as a bundle of rights and obligations that generates a package of cash inflows and outflows, and we generally believe that the bundle should be the unit of account. We also recognise that insurance contracts may be written alongside, or bundled with, other forms of obligations, and that such components may not be interdependent with the provision of insurance coverage.*

*For example, a car dealer might sell cars complete with insurance coverage for the first year's use. Clearly the different elements of such transactions should be accounted for separately in accordance with the relevant Standards. However, a unit-linked policy which incorporates a death benefit equal to the higher of a fixed amount or the value of the units clearly has two features that could be unbundled but which in fact are "interdependent". As such, we believe that these unit-linked contracts should be accounted for as a single unit, but we are not certain as to whether that would be the accounting outcome under the unbundling principle in the ED.*

*Introducing an unbundling principle that requires separation when 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 would achieve the Board's objective with a better cost-benefit balance.*



## Joint education session on Single Margins

The Staff presented a paper on the mechanics of single margin accounting and how it may be released to profit or loss. The paper illustrated the single margin being earned over the period during which an insurer is released from risk. The release from risk is evidenced by the reduction in uncertainty over the variability of future cash flows. Several scenarios were presented showing different patterns of release (based on passage of time, claim frequency and or severity). The key point was that the earning pattern is adjusted prospectively such that the single margin balance reflects the remaining future uncertainty. The single margin is not re-measured to recapture previously recognised margin and acts as a buffer for changes in assumptions given that it can be reduced but not increased. When the contract becomes onerous, the entire remaining single margin is released to reduce the onerous contract loss. Many Board members noted that the single margin is released over the combined coverage and claims settlement periods with some uncertainty remaining sometimes, until the final settlement. In contrast, under the FASB version of the PAA model, the whole single margin is implicitly released over the coverage period, resulting in a difference between the two models. It was noted that, for the IASB residual margin, the release over the coverage period applies in all cases whether the BBA is used or its proxy, the PAA. It was noted also that, for many contracts under the FASB BBA model, the release of the single margin would achieve a similar effect to the combined release of residual and risk adjustment margins under the IASB BBA.

This topic will be brought back in future meetings at which the Boards will discuss the Staff recommendation to reconsider the decision to release all of the single margin to profit or loss for onerous contracts, given that even slight changes in estimates can indicate the contract is onerous under the FASB BBA.

## Reinsurance

During the April joint meeting the IASB and FASB Staff presented several papers elaborating some of the purchased reinsurance accounting issues left outstanding after the May 2011 meeting. This was the last time purchased reinsurance was discussed with the Boards voting to depart from the ED/DP and not to recognise day one gains on reinsurance contracts purchased but instead to defer them as a reinsurance residual/composite margin.

### Period of margin release for profitable retroactive reinsurance contracts

The first issue discussed at the meeting was how to treat reinsurance contracts written in relation to policies whose coverage has already expired. The decision to defer day 1 gains on reinsurance as a reinsurance residual/single margin did not address the period of release. In previous tentative decisions concerning insurance contract single margin the FASB implicitly decided to release composite margin over the coverage period for contracts accounted under PAA. The IASB also decided for all insurance contracts the residual margin should be released over the coverage period. One could argue that since retroactive reinsurance contracts relate to policies whose coverage has expired, the cedant can recognise a day one gain on purchase of the retroactive reinsurance contract. The Staff suggested that the new standard should explain that the coverage in this instance is the period of the ultimate cost discovery of the reinsured claims liabilities, which is similar to the underlying claim settlement period and therefore resulting in no day one gain.

For retroactive contracts the residual/single margin included in the cedant's reinsurance asset and in the reinsurer's liability should be amortised over the remaining settlement period in the same manner as the release of the single/residual margin, based on release from risk (FASB) or based on the pattern of services provided under the contract (IASB).

With very little deliberation the Staff proposal was approved unanimously.

### Loss sensitive features in reinsurance contracts

#### *Presentation*

Many reinsurance policies have features (adjustments to premiums, commissions, etc) based on the loss experience of the cedant. Some of these loss experience adjustments are mandatory for the cedant and others are optional, allowing purchase of additional reinsurance cover at rates specified at the original contract's inception. The Staff paper defined such compulsory contractual adjustments as "loss sensitive features" of the contract, with coverage fixed at inception. Currently accounting for these adjustments varies by jurisdiction, with the two main practices being the adjustment of premiums and commissions (for example under US GAAP) and the adjustment of claims and benefits.

The Staff proposed that loss sensitive features that are not accounted as investment components would always adjust the claims and benefits line for the reinsurer and the reinsurer recoveries line for the cedant, rather than being an adjustment to premiums. The aim is to produce consistent presentation between contracts with loss sensitive features and economically equivalent contracts without such features. This proposal was approved unanimously by the Boards.

### **Recognition**

There is also at present a variety of approaches concerning recognition of loss sensitive features. Consistent with the earlier decision on presentation the Boards unanimously agreed that cash flows from loss sensitive features should be recognised in the same way as other cash flows. Therefore for contracts accounted under the PAA, cedants and reinsurers should recognise an asset or liability based on the expected cash flows from incurred claims whilst for contracts accounted under the BBA these would form part of expected cash flows irrespective of whether they relate to incurred or expected claims.

### **Optional reinstatement of reinsurance premium**

Under some reinsurance policies, if the loss experience is worse than the contractually predefined level, the cedant has a choice to pay additional premium (at originally pre-established rates) to continue coverage, or lapse.

Because of this choice the Boards unanimously agreed that these clauses should not be considered to be loss sensitive features of the contract and instead they should be treated as clauses affecting the estimates of premiums payable to the reinsurer. The payments by the cedant are viewed to be an exercise of the embedded option to buy additional coverage rather than a mandatory reduction in contractual benefits entitlement under the original contract.

### **Which model to use for reinsurance contracts (PAA or BBA) and to permit or require?**

The Boards remain diverged on the issue of whether to have one or two models for certain contracts which are considered short in duration, and this is having a consequential effect on other areas such as purchased reinsurance accounting.

For the reinsurer, the choice of PAA or BBA should be done in the same manner as for direct insurance contracts. So for the FASB, the PAA would be required if the reinsurance contract meets the eligibility criteria. For the IASB, the PAA would be permitted if it provides a reasonable approximation of the BBA, with contracts of 12 months coverage or less considered to qualify automatically for election.

Under the FASB model, the Staff recommended that the cedant should account for a purchased reinsurance contract using the same approach as for the underlying insurance policy (BBA or PAA). Reinsurance contracts covering both insurance policies accounted under PAA and BBA should be split into components based on the respective model used for underlying contracts.

Under the IASB model, the Staff recommended that the cedant should evaluate whether to apply BBA or PAA to a purchased reinsurance contract in the same manner as it would be permitted to do for direct insurance contracts: that is based on reasonable approximation to BBA with a 12 months practical expedient. Since PAA provides a reasonable proxy to BBA it does not matter if reinsurance contracts and underlying insurance policies are accounted for using different approaches.

The Boards approved their respective Staff recommendations with a majority of 12 vs. 1 for the IASB and 6 vs. 1 for the FASB.

## **Possible use of Other Comprehensive Income (OCI) to reflect short term fluctuations of market consistent discount rates**

In the March IASB only educational session the Staff first presented its preliminary views on the potential use of OCI, looking to the Board for direction. The issue was then considered further in the April joint education session and again in May for a decision-making meeting. There is no doubt that interaction between the Insurance and Financial Instruments standards that meaningfully portrays the insurance business model is one of the most significant issues remaining and one that was addressed, in part, by decisions reached for both projects in May. We will give full coverage of this issue in our next Insurance Accounting Newsletter which will comment on the joint meetings held the week commencing 21 May and where the Boards reached decisions on both the improvements of IFRS 9 in the area of classification and measurement of financial assets as well as the OCI solution for insurance liabilities.

## Unbundling Goods & Services

In May 2011 the Boards agreed to unbundle any goods and services consistent with identifying separate performance obligations within Revenue Recognition and to use appropriate guidance outside of the insurance accounting standard to account for the unbundled component. The Staff paper presented at the February 2012 joint meeting addressed how to incorporate the separate performance obligations criteria into the insurance contracts project so that insurers would be able to comply with the requirement to unbundle obligations to deliver goods and services that are separate from the insurance cover. The issue of unbundling asset management services included as part of account driven insurance contracts was not considered at this meeting.

To unbundle separate components an insurer would have to determine the allocation of contractual cash flows between the unbundled element(s) and the remaining insurance component. This introduces complex accounting judgments. Additional complexity and cost would arise from the fact that applying revenue recognition unbundling criteria to insurance contracts would result in the unbundled components being accounted for using an entirely different guidance (e.g. Revenue Recognition). Whereas separating a performance obligation for contracts already within the scope of Revenue Recognition standard only means different accounting for separated elements in the context of the same guidance.

The Boards agreed unanimously to the Staff proposals to remove or revise specific language from the criteria used for separating performance obligations in the revenue recognition project so that the guidance that is applicable to insurance contracts is fully aligned with the original decision to introduce an unbundling regime that separates only obligations that are independent of the insurance cover. Deloitte expects that this situation should be relatively infrequent in practice.

## Financial instruments with discretionary participation features (DPF)

Financial instruments with DPF are currently in the scope of IFRS 4 and the exposure draft proposed to keep it that way, adding the additional criteria that “there exist insurance contracts that provide similar contractual rights to participate in the performance of the same pool of contracts, assets or the profit or loss of the same company, fund or other entity”. The FASB Staff on the other hand, recommends that financial instruments with DPF should be outside the scope of the new insurance standard.

At the 28 February 2012 meeting the IASB, in a single board session, discussed whether financial instruments with DPF that do not meet the definition of insurance contracts should be included within the scope of the insurance contracts standard and how they should be defined. Staff noted that feedback from the exposure draft has identified that many insurers issue financial instruments with DPF that do not meet the additional criteria.

The Board came to the conclusion that it would support the Staff recommendation to include financial instruments with DPF within the scope of the revised IFRS 4. However, in voting the support for the Staff proposal the IASB majority increased from 7 to 12 when the Chair proposed that the Staff find a form of words that limits the application only to financial instruments issued by the insurance industry.

The Staff agreed to bring back a paper to a later meeting that improves the wording on the scope of the revised IFRS 4 to include both insurance contracts and financial instruments with DPF that do not meet the definition of an insurance contract but are issued only by entities that operate within the insurance industry. IASB members noted that the future paper will need to consider also financial conglomerate groups comprising both insurers and other entities that may issue financial instruments with DPF.

The FASB discussed the same issue on 7 March in a FASB-only meeting given that it believes the focus and issues are different in the US. With only a brief discussion the FASB members re-confirmed their original view, supporting the Staff recommendation to not exclude investment contracts with DPF from the scope of the insurance contracts standard and noting concern for instances where this decisions could have unintended consequences.

## Policy loans and riders

At their April joint meeting the Boards considered how general decisions on unbundling and disaggregation should apply to policy loans and contract modifications (riders). Policy loans are a feature of certain life insurance contracts (e.g. whole life, endowment) that nearly always have explicit or implicit account balance. The policyholder can borrow value for an unspecified period up to the minimum cash surrender of the policy. The loan amount with the accrued interest is either repaid or on termination of the contract (through lapse, settlement, death, surrender, etc.) it is offset against any cash payment due from the insurer. Often contracts state that at specified dates if the loan amount is greater than the minimum cash surrender value, then an insurer can demand either repayment to bring the loan below the cash surrender value or that the policy should lapse. The link between policy loans and insurance contracts is always maintained and outstanding loans reduce the benefit payable under an account balance. Because of this link, under IFRS 4 some insurers would currently account for these loans as part of insurance contracts whilst others would treat them as assets; creating diversity in practice. For all these reasons the Boards agreed with the Staff proposal to introduce an explicit requirement in the future accounting standard that mandates a net presentation of policy loans. They also decided (IASB 12 vs. 1, FASB unanimous) that in applying the unbundling and disaggregation decisions they would require insurers to treat policy loans as part of the investment components they relate to. The Staff were asked to consider whether separate disclosures would be necessary.

Riders are additional benefits and/or modifications to contractual terms, some are present at inception of the contract and some are added later. In considering the disaggregation and unbundling issue, the Boards had first looked at riders present at inception. Riders that are embedded derivatives, such as guaranteed minimum accumulation benefit, are already unbundled and accounted separately under IFRS and US GAAP financial instruments standards guidance. Others, if unbundled, would often be insurance contracts. Given that these options to modify the contract were awarded and known at the policy inception the Staff proposed to account for them as part of the insurance contract with all the applicable general guidance on disaggregation and unbundling being considered. The Boards agreed unanimously.

## Contract amendments, modifications and commutations

The ED/DP did not explicitly address accounting for contract modifications. However within the insurance industry there is a high volume of contract amendments and it is common for some contracts to be amended several times. The main accounting issues stem from the need to assess at what point an amendment is so significant that it requires recognition of a new contract and in that eventuality what are the implication for the resulting profit or loss, subsequent scope, choice of accounting model and treatment of margins.

The Staff, having considered existing derecognition guidance in IFRS 9, found it too burdensome when applied to insurance contracts and recommended a principles based threshold which would not require an explicit analysis of the present values of cash flows for the entire contract. A modification would be significant if an assessment of the amended contract would result in a different 1) scope; 2) accounting treatment (PAA or BBA); or 3) a transfer to a different portfolio (however it will be eventually defined for IFRS and US GAAP purposes). The Boards approved the first two criteria but not the third because transfers from one portfolio to another would apply too frequently (vote count was 12 vs. 1 for the IASB and 6 vs. 1 for the FASB). The Staff was asked to propose a new criterion instead.

On substantial modification a new contract is recognised. How this new contract amount is determined affects the gain or loss on derecognition of the original contract. The Staff considered three alternatives to measure the new contract based on 1) hypothetical entity specific price; 2) fair value; or 3) original contract amount adjusted for modifications. Alternative 2 was quickly rejected as fair value would only ever be a level 3 estimate and not consistent with the overall insurance model. Alternative 3 would not result in any gain or loss on derecognition and thus can inappropriately defer some economic gains on losses on settled obligations. The Boards eventually approved the Staff recommendation to use hypothetical entity specific price with a 12 vs. 1 vote for the IASB and a 6 vs. 1 vote for the FASB.

For non substantial modifications where there are still some elements of an insurance contract that have been settled as a result, the Boards confirmed the partial derecognition of such portions along with any related portion of residual/single margin should be followed as proposed in the ED.

For new added rights and obligations (i.e. post inception riders or endorsements) the Staff considered either to view them as adjustments to contract cash flows impacting on the margins or to view these additions as new contracts. The Boards unanimously approved the Staff recommendations to view additions as a new stand alone contract with its own margin and with no effect on the original contract.

Finally the Boards discussed reinsurance commutations where the reinsurer completely settles its obligation to the cedant through payment. Some currently present such payments gross adjusting premiums ceded for the cedant or reinsurance premiums earned for the re-insurer as well as claims and benefits. The net presentation shows the effects of commutations as a one line in claims and benefits. The Staff recommended net presentation as it more faithfully reflects the economic nature of liability settlement. The Boards approved the Staff recommendation (IASB 12:1, FASB unanimous).

## Next steps

Joint meetings were held during the week of 21–25 May. Deloitte’s observer reports on the outcome of these meetings are posted on [www.IASPlus.com](http://www.IASPlus.com). Issue 26 of the Insurance Accounting Newsletter will provide you with an in-depth analysis of the key decisions reached at these meetings. We will also closely follow the developments following the recent statements made by the FASB chairman and update you on any new outcome emerging from that.

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