

## Insurance Accounting Newsletter

### Refining divergent positions and a gleam of hope from IFRS 9 planned revisions



#### Introduction

Since our last newsletter, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) continue to remain divided on the fundamental issues of accounting for the uncertainty surrounding insurance risk and the associated emergence of profit from in-force business.

However, at its meeting on 15 November 2011 the IASB unanimously agreed to consider targeted improvements to the classification and measurement requirements of IFRS 9 “Financial Instruments” to address the issues emerging from the accounting mismatches within insurance businesses that the combined effect of IFRS 9 and the new IFRS on Insurance Contracts could cause.

The Boards’ recent action arose from four meetings held in September, October and November.

There was a meeting of the IASB Insurance Working Group held on 24 October 2011 during which the industry had the opportunity to formulate several proposals which culminated in general support for an option to use OCI for movement in certain assets and liabilities and, also, a proposal to amend IFRS 9 requirements.

Whilst the debates have been at times particularly intense, the activity itself has resulted in limited progress as unsettled debates resurface. This newsletter covers the joint meetings held on 19 September, 20 October and 16 November as well as FASB meetings on 7 September and 30 November. Nearly all the tentative decisions from these meetings resulted in further refinements of the divergent positions which helped constituents in their appreciation of the practical implications that each model will have on their businesses. The IASB held its own education session on residual margins on 15 November, whilst FASB held education sessions before each of the above meetings.

Following the July revisions of the IASB Technical Plan, on which we commented in our previous newsletter, both Boards have now released their final plans covering their activity until the end of 2012. The highlights of the two plans are as follows:

- the target publication date of the final accounting standard (both from an IFRS and a US GAAP standpoint) has now been pushed to beyond 2012; and
- the US GAAP exposure draft will be issued before the end of the first half of 2012.

The IASB Technical Plan which was issued on 30 September now specifies that its next process document will also be issued within the same timeframe as the US GAAP exposure draft offering the potential to align the final stages of the two standard-setting processes. The latest IASB plan retains the option to re-expose or to issue a "review draft".

We have based our analysis of the Boards' recent activity on three themes:

- Accounting for uncertainty and profit (FASB meeting on 7 September, IASB meeting on 19 September and its education session on 15 November).
- Asset-liability accounting mismatch (Insurance Working Group meeting on 24 October, IASB meeting on 15 November and FASB meeting on 30 November).
- Presentation and disclosures (joint meetings on 19 September, 20 October and 16 November).

For each theme we have added a reference to the relevant meetings on which we have already reported via our IASPlus news service (<http://www.iasplus.com/agenda/insure2.htm>) and Insurance Contracts Project Insight newsletters (<http://www.iasplus.com/insight/insurancecontracts.pdf>).

In addition, we have also added commentary that highlights relevant extracts from our comments included in the Deloitte Comment Letter on the 2010 Exposure Draft, Insurance Contracts ("ED") as a means to show some of the movement from the original ED compared to our suggestions.

## Accounting for uncertainty and profit

### FASB refines its single margin model developing two separate profit earning approaches

At its meeting on 7 September, FASB reached a first set of important decisions that have provided its constituents with a preliminary understanding of the alternative to the current proposed IFRS model that FASB wishes to adopt.

Among these was the development of what is arguably a two model approach for the recognition of profit from insurance portfolios. FASB achieved this by deliberating on how the single margin (composite margin in previous papers) would be taken to profit or loss. The criteria that insurers will apply to account for their insurance contracts in one of the two approaches are the eligibility criteria that the IASB and FASB failed to agree on at their joint meeting last July to identify short duration insurance contracts.

FASB Staff presented a comprehensive paper setting out its recommendation on the profit pattern that should be adopted for short duration insurance contracts. Three options were set out:

- Option 1: retention of existing US GAAP with unearned premium liability and undiscounted claims liabilities;
- Option 2: use of the unearned premium method during the coverage period with a two-building block liability for the discounted post-claim cash flows (i.e. no margin added to claims liabilities); or
- Option 3: use of the unearned premium method during the coverage period with a single margin added to the discounted claims liability based on the reduced variability principle decided on 17-18 May 2011.

FASB Staff recommended that Option 3 be adopted, and in doing so, it provided examples to illustrate the three options and the resulting profit pattern an insurer would report in its financial statements. The Staff noted that at the end of the coverage period there are smaller, compared to point of sale, but still significant variability of cash flows associated with the probability weighted discounted estimate of claims cash flows. Because of that characteristic, FASB Staff recommended that insurers should increase this liability by adding a single margin that captures the residual exposure to variability at the end of the coverage period. The Staff also explained that it did not favour the retention of current US GAAP because, when material, the discounting of claims liabilities would be relevant financial information.

FASB members discussed extensively the principle of earning the single margin over or beyond the coverage period. They rejected the Staff recommendation to earn the single margin beyond the coverage period.

Although a number of members had previously voted for the single margin to be earned on the basis that allocates it to the changes in the cash flow variability (see issue 21 of this newsletter), they explained at this meeting they had voted with a reservation that such decision would not apply to the short duration contracts. Furthermore, the debate on the short duration contracts eligibility last July and at the October meeting (see further details below) highlighted that for FASB, this group of contracts should be accounted for as what is arguably a separate model. The underlying principle of this earning approach is that the fulfilment of the stand ready obligation is complete when the coverage expires; any activity to settle the incurred claims does not qualify as a provision of service (some FASB members believe that this should align more with the Revenue Recognition project). Instead it is “an expense optimisation activity”, as described by one of the FASB members. FASB views the service of providing a “stand ready obligation” as complete once the insurer no longer has an obligation to take new claims under that policy even if it may take several years to receive the notification and complete the settlement of the incurred claim.

During the debate, FASB Staff noted that its soundings in the past few months suggested that users would not like additional complexities introduced for the short duration contracts accounting model which should remain as closely aligned as possible to US GAAP. FASB members noted that Option 2 appears to achieve this objective better than the other two options because it would simply require a more transparent and principle based claims liability measurement, i.e. the measure of claims liability using a discounted probability weighted cash flow estimate. As far as the cash flow variability is concerned, FASB members noted that users would have the information they needed by analysing the loss development tables provided in the financial statements.

This decision gives a clearer view of the separate model for short duration contracts FASB has been pursuing since May. It also increases the focus on developing a set of eligibility criteria that delivers a relevant and reliable basis for separating a sub-set of insurance contracts. As noted above, another unsuccessful attempt to achieve this took place at the October joint meeting (commented in more detail below).

The fundamental difference with the IASB approach to account for short duration contracts is that the claims liability for the IASB includes a remeasured risk adjustment liability that is released after the coverage period expires. Similarly to what was decided by FASB on the single margin approach, the IASB had decided that its approach would earn the residual margin over the coverage period.

## **Accounting for a single margin approach – FASB general principles for earning the margin under the building blocks approach**

FASB Staff presented a comprehensive paper setting out its recommendation on the subsequent accounting and earning of the single margin under the building blocks approach. The recommendation was based on the principle that the margin would be earned as the underlying uncertainty of the probability weighted cash flows decreases – this was defined as the “variability of the cash flows of a specified uncertain future event”:

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

The debate highlighted that these principles could apply to certain insurance contracts that are issued by non-life insurers only if they are not captured under the eligibility criteria for short duration contracts. FASB therefore determined that it would be appropriate to approve both categories irrespective of the number of application points that these categories will have in practice.

The FASB chair commented that eligibility criteria are still subject to debate and it is possible that some of the insurance contracts that are currently issued by the non-life insurance industry may not be captured by the eligibility criteria for short duration contracts once finalised. In this case, the earning of the single margin would follow the principle of the building block approach, with no separate measurement model between pre and post claim accounting.

FASB supported unanimously the Staff recommendation. The application guidance was also approved unanimously which included references to events that an insurer would need to consider for the implementation of the two principles. Another area of application guidance that the FASB approved unanimously was relating to the points in the life cycle that should be considered for examination in assessment of this decrease in the cash flow variability. The points should include among others:

- when an insurer incurs a claim that has not yet been reported;
- when a claim has been reported;
- when additional information becomes known;
- when the parties to the contract have agreed to settle the amount and;
- when the claim is paid.

These are the typical phases of a claim cycle.

#### Deloitte view on the accounting for the single margin

The FASB decision to abandon the basis for the accounting of the single margin published in the Discussion Paper in September 2010 introduces two features that move it towards the Deloitte recommendations set out in our comment letter: 1) the use of the cash flow variability to release the single margin rather than a benefit and claims payment approach is more reflective of the economics of assembling and managing insurance portfolios and it links the release to income to the prospective changes in the expected present value of future cash flows; and 2) the acceptance that variability of cash flows is common to the pre and post claim phases of an insurance portfolio and the consequential requirement that only an integrated approach to changes in the variability of cash flows across the whole life of an insurance portfolio could produce a relevant and reliable release of the single margin to income.

Our preference is for a risk adjustment and a residual margin model. However we commented that the accounting model for the residual margin and the single margin cannot be reliable if it does not recalibrate against the expected present value and if its release to income is based on incurred benefits and claims over time:

*"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."*

*"The systematic release of the residual margin is governed by paragraph 50 of the ED which requires that the residual margin be amortised based on the "passage of time" or the "expected timing of incurred claims and benefits" if it differs significantly from the passage of time. For many life insurance products, the pattern of claims and benefits will, in fact, be substantially different from the passage of time because the probability of having to pay benefits tends to increase in the later policy years. For example, whilst the death benefit under a whole life policy is often level throughout the life of the policy, the value of that benefit typically increases with duration as the probability of death increases with age. As another example, most of the benefits under a short-term endowment policy are paid at policy maturity. As compared to the "passage of time", an amortisation pattern based on the "expected timing of incurred claims and benefits" will result in a substantial back-loading of residual margin amortisation. For these reasons, we recommend that the Board modifies paragraph 50 to require that the systematic residual margin release be computed on the basis of passage of time, or another rational basis."*

*"In addition, we believe that the proposal in the ED to release the residual margin over the period of coverage under the insurance contract establishes an arbitrary bright line. Instead, we recommend that the period for the release of the residual margin be the combined coverage and claims handling period."*

The combined effect of the decisions for short duration contracts and for contracts accounted for under the building blocks approach produces two very different profit patterns for equivalent sets of cash flows with the former being front ended in recognising profit and the latter back ended.

In addition the earnings volatility for claims liabilities from short duration contracts could be substantial under the FASB proposals given the requirement to use a statistical mean for the estimate of the expected present value of cash flows with no margin carried forward from the pre-claim phase of the life of the portfolio.

#### The IASB refines its requirements for risk adjustment liabilities

Without FASB participation, the IASB at its meeting on 19 September refined the measurement model for the risk adjustment by reaching three important decisions, one of which was against the Staff recommendation.

The first recommendation was to define the objective of the risk adjustment as the "compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract". The Staff also asked the IASB to ratify two previous decisions, the first of which was to include in the final IFRS guidance on this objective using the following example:

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

The second decision the Staff asked the IASB to ratify was that an insurer should perform the risk adjustment calculation considering both favourable and unfavourable outcomes within the probability distribution of the expected cash flow estimates. The IASB approved these recommendations unanimously.

#### Deloitte view on the objective of the risk adjustment

With these decisions the IASB has adopted the recommendations from our comment letter and it has introduced language to confirm the neutrality in the assessment of the additional liability that captures the statistical uncertainty that surrounds the mean used to calculate the probability weighted net present value of future cash flows and to reinforce the entity specific nature of the assessment which should link the process to the particular risk appetite of the reporting insurer.

The IASB has also agreed with the Deloitte recommendation to include an illustrative example to clarify circumstances under which the risk adjustment would be zero.

The second recommendation from the Staff was to remove the requirement from the ED to disclose the equivalent confidence interval percentage that would be derived from re-computing, using the confidence interval technique, all risk adjustment liabilities calculated with a different technique. This was a disclosure requirement that many commentators, including Deloitte, recommended to be removed. However, the IASB was uncomfortable with the Staff's proposal and rejected it because its retention would offer a disclosure reference that could assist investors in comparing different insurers. Only 4 Board members out of 15 were in favour of the Staff's recommendation.

#### **Deloitte position on the compulsory disclosure of confidence intervals**

The statement from our comment letter continues to fully capture the essence of this issue in our view:

*"We believe clarification of paragraph 90 (b) of the ED is critical because there are two incompatible interpretations of this disclosure requirement: (1) when the Cost of Capital (CoC) or Conditional Tail Expectation (CTE) methods are used to measure the risk adjustment, an insurer must solve for what the confidence interval (CI) would be to arrive at the same result; or (2) if the CoC or CTE methods are used, an insurer must disclose the confidence level used in those techniques. We believe that the basis for conclusion BC117 (c) confirms that interpretation (1) is what the IASB intended. On that basis, we do not agree with that disclosure requirement.*

*"The disclosure of how an insurer measures the risk adjustment should be sufficient to provide users with useful and transparent information. We do not agree that the disclosure proposed in paragraph 90 (b) of the ED would enhance comparability because, as the Board acknowledges, there are instances where the CL methodology is not appropriate, and thus if the CoC or CTE were chosen as the most appropriate technique to measure a particular risk, it would be meaningless to then try to reproduce the same amount under a less appropriate technique.*

*"Furthermore, there is currently limited experience in converting CTE and/or CoC results into CL amounts and the resulting disclosures would likely be prepared inconsistently for a number of periods. For example, paragraph B82 of the ED refers to a risk such as an earthquake exposure – in that case the CoC and CL methods would take into account the possibility of low-frequency high-severity losses in all but the extreme tail of the probability distribution curve and it is likely that insurers would not deem them appropriate. It would be meaningless to compare the resulting risk adjustment calculated using CTE (or another more relevant technique) to an "equivalent" risk adjustment using the CL technique."*

The third recommendation was to remove the requirement from the ED that the risk adjustment technique has to be chosen from the three techniques of confidence interval, cost of capital and conditional tail expectation. The Staff recommended that these techniques and the associated application guidance are retained as examples only. The majority of the IASB was supportive of the Staff's recommendation although a few Board members voiced the concern that this would make the IFRS liabilities less comparable (12 in favour, 3 against).

#### **Deloitte view on the objective of the risk adjustment**

The IASB decision to remove the narrow choice on risk adjustment techniques adopts the Deloitte's recommendation.

However retaining the three original techniques (confidence interval, conditional tail expectations or CTE and cost of capital) as examples of techniques should be coupled with an expanded application guidance to include the characteristics that would indicate a high versus a low percentile for the Confidence Level and CTE techniques; and the characteristics that an insurer would need to consider to determine a higher or lower amount of capital and cost of capital rate for the Costs of Capital technique.

It appears that many of the IASB members believe that the previous decision on a disclosure that would require a company to disclose an equivalent confidence interval in instances where it has chosen to use another measure for the risk adjustment would alleviate their concerns on comparability. However, it would appear that there is insufficient appreciation amongst some members of the IASB as to the difficulty, and potentially lack of usefulness, in developing and showing equivalents.

#### **IASB prepares for further refinements of its model to unlock the residual margin liabilities**

The IASB met on the 15 November for an educational session on residual margin. During the meeting, the IASB Staff presented the papers and asked the Board its views on certain questions without formally asking for decisions to be taken. Although FASB Staff joined by teleconference, it did not participate in the discussions as FASB prefers the route of a single margin.

The IASB discussed only two of the four papers tabled focussing on the paper that presented the reassessment of the June tentative decision to unlock against the Exposure Draft's position not to unlock and the paper that attempted to answer the question "Which changes in estimate adjust the residual margin?". The outcome of this important test on the tentative decision to unlock reached last June could be summarised as follows:

- a narrow IASB majority continues to support the concept of unlocking the residual margin for assumptions that depend on non-financial variables. The balance of IASB members remain unconvinced that this decision would deliver benefits in excess of the costs that the complexity of unlocking would create;
- there was an acknowledgement that both non-financial and financial variables affect certain assumptions (e.g. lapse rate assumptions) and more work would be required to establish whether the proposed split could be used to develop a reliable unlocking model; and
- the final decision on allowing financial variables within the unlocking model or not will be taken in parallel with the targeted improvements on IFRS 9 that the IASB decided to consider at the same meeting.



#### Deloitte view on the unlocking of the residual margin

The statement from our comment letter captures our position on this issue:

*"We therefore recommend that if an insurer measures the related financial assets at amortised cost, it should recalibrate the residual margin at each reporting date and use the prospective changes in the building blocks to determine the subsequent measurement of the residual margin component of the insurance liability, after deducting the systematic release."*

*"The final IFRS should also require that when a portfolio becomes onerous, the insurer must release to profit or loss any remaining aggregate residual margin in full or in part (to the extent needed)."*

*"We also recommend that if an insurer measures the related financial assets at fair value through profit or loss, it should remove from the recalibration of the residual margin financial variables like interest rate risk, thus allowing the change in discount rates caused by movements in market interest rates to flow directly to profit or loss."*

## Asset-liability accounting mismatch

### Industry proposes its "OCI solutions" to the asset-liability accounting mismatch

The discussion around an "OCI solution" dominated the Insurance Working Group meeting on 24 October when two industry groups presented their views on how to use the OCI section of the Statement of Comprehensive Income to deal with the accounting volatility that the combined effect of the new IFRS for insurance contracts and the requirements for financial assets under IFRS 9 would produce.

OCI is the section of the Statement of Comprehensive Income that follows the net results after tax and it is used under IFRS to recognise all gains and losses that an IFRS requires to be recognised outside the profit or loss of a reporting period.

The Hub Global Insurance Group and the European Insurance CFO Forum in conjunction with the Comité Européen des Assurances (CEA) presented their respective proposals. These have several common statements. Both argued that the insurance business model is one that unfolds over a longer period of time and that the short term fluctuations of financial variables that the current IFRS proposal require to be recognised in the profit or loss of an insurer do not affect the actual cash flows from the assets that insurers need to settle their liabilities. Including these gains and losses in the profit or loss of the period obfuscates the underlying financial performance in that period. Separating from the profit or loss those gains and losses that are caused by such fluctuations would produce more relevant performance information and leave the balance sheet unchanged from the current proposals given that assets and liabilities would still be adjusted by those gains and losses albeit recognised via the OCI.

The Hub Global Insurance Group's proposal articulated the necessary amendments to IFRS as follows:

1. Introduce a category of "assets backing insurance liabilities" that operates across all types of financial instruments (i.e. both derivative and non-derivatives) and includes also real estate investments (i.e. investment properties). A second best option would be to reintroduce the "available for sale" category for non-derivative financial instruments;
2. Introduce the accounting option that would allow an insurer to designate these assets to be accounted for at fair value through OCI or at fair value through profit or loss;
3. Apply to the relevant financial instruments at fair value through OCI the impairment principles currently developed for financial assets at amortised cost. Develop impairment principles for equity instruments when measured at fair value through OCI;
4. Require the "recycling" through profit or loss of gains and losses initially recognised in OCI on the grounds of realisation and impairment decisions;
5. Reflect through OCI all subsequent changes to the insurance liabilities that are caused by the alignment of the initial discount rate to the level of current market interest rates. The interest expense from insurance liabilities would be based on the discount rate selected at the initial recognition of the liability; and
6. Require the "recycling" through profit or loss of gains and losses initially recognised in OCI when insurance liabilities are derecognised and when options and guarantees embedded in the insurance liabilities are "in the money" (i.e. current market interest rates have fallen below a minimum guaranteed rate feature embedded in an insurance liability).

The European CFO Forum proposals were supportive of a principle that allows the designation of assets to be accounted for at fair value through OCI but were not as detailed as those summarised above. Instead they were limited only to the discussion of how the amendments to IFRS would apply to different types of policyholder's participation features.

The European CFO Forum noted that there are broadly two forms of policyholder's participation commonly found in the insurance market and that these would require different types of "OCI solutions".

One form of participation would use the principle of realised gains and losses to distribute surplus between the insurer and its policyholders (defined as "continental style" participation). In this case the Hub Global Insurance Group's proposal would operate effectively.

Another form of participation uses the principle of expected long term asset return to determine the amount that is credited to policyholders and, at the same time, the amount distributed to shareholders in a given period (defined as "UK-style" participation). This participation mechanism would not operate effectively with the Hub Global Insurance Group's proposal.

The European CFO Forum key recommendation was for the IASB to reflect this fact in the consideration of its adoption of an "OCI solution".

#### **IASB unanimously decides to reopen IFRS 9 to accommodate insurers' asset-liability mismatch**

Some may remember the opening remarks of the then chairman of the IASB, at one of the 2010 Insurance Working Group meetings when he stated that the IASB was not planning to reopen IFRS 9 to address the financial reporting issues of insurers.

At its meeting on 15 November the IASB, under the chair of Hans Hoogervorst, unanimously decided to consider targeted improvements to IFRS 9 which would, among other things, address the issues from asset-liability mismatches that would affect insurers.

Although the IASB was briefed by its Staff that, based on feedback received to date, the IFRS 9 was fundamentally sound and operational, there are issues that support a limited reconsideration of IFRS 9. The Staff noted that the primary reason for the reconsideration of IFRS 9 as presented by the Staff was the interaction with the insurance contracts project and classification and measurement of financial assets under IFRS 9. Specifically, the decisions to date in the insurance project would recognise the re-measurement of insurance liabilities with components through profit or loss and other components through other comprehensive income. Meanwhile the financial assets backing those insurance liabilities would either be recognised at either amortised cost or fair value through profit or loss resulting in an accounting mismatch with the associated liabilities.

Additional reasons to reopen IFRS 9 are some early adoption issues encountered and the establishment of the proper standard setting environment for the IASB to consider FASB re-deliberations on financial instrument classification and measurement which are due to be released in the near future.

However, the Staff acknowledged that any reconsideration of IFRS 9 should be as targeted as possible such that they could be developed with due respect for those entities which have already early adopted IFRS 9 as well as those other entities have already dedicated significant time and resources to the implementation of IFRS 9.

All of the IASB members generally agreed that a "targeted" reconsideration of IFRS 9 was appropriate. However the reasons the Board members gave for its support and the level of its support varied. Most of the members acknowledged the issue arising from the interaction with the insurance contracts project and the need to reconsider how best to facilitate that interaction.

The opportunity for further convergence with FASB was seen by some IASB members as an important benefit of a reconsideration of IFRS 9 while other members were more sceptical of reopening IFRS 9 for the sake of convergence citing past difficulties in the joint financial instrument projects and expressing concern over the FASB's decision to release a very different exposure draft in 2010 after IFRS 9 had already been issued.

#### **FASB decides to converge with the IASB's decision on the measurement of participating liabilities in a way that mitigates accounting mismatches**

At its meeting on 30 November FASB deliberated on the measurement of participating insurance liabilities. This decision was focussed on a particular situation that IASB had already considered last May and it is notable because it represents the first instance where FASB has subsequently converged with a prior IASB decision since the publication of the exposure draft in 2010.

The scope of the decision impacts insurance liabilities where some or all of the cash flows arise from "non discretionary performance-linked participating features that both contractually depend wholly or partly on the performance of other assets or liabilities recognised on the insurer's statement of financial position, or the performance of the insurer itself, and are a component of an insurance contract's obligations".

The IASB decision was to require the insurer to measure these cash flows by reference to the carrying amounts of the related assets. In addition, the insurer would present through profit or loss the changes in that component of the insurance liability only if the changes in the associated assets are also presented through profit or loss. In the event that the assets' changes were presented through OCI then the changes in the insurance liability would also follow the same presentation.

FASB discussed the merit of this approach and decided that it was a practical solution to address a clear case of accounting mismatch. This decision would only apply to those cash flows that present these characteristics and no further measurement would be required for them. With a unanimous vote FASB approved a set of decisions that aligns its position to that of the IASB.

## Presentation and disclosure requirements

### Converged balance sheet presentation requirements

At the joint meeting on 20 October, the Staff presented six recommendations on the Statement of Financial Position (SoFP) presentation requirements in the exposure draft.

The first recommendation was to disaggregate the expected future cash flows, risk adjustment (only IASB), residual margin (only IASB), the single margin (only FASB) and the effect of discounting ('the building block components') either in the SoFP or in the notes to facilitate reconciliation to the SoFP. Both Boards approved this recommendation, with 9 out of 15 from the IASB in favour and 6 out of 7 from FASB in favour.

The second recommendation was to present separately the liability for unexpired coverage from the liability for incurred claims for those contracts measured under the premium allocation approach in the SoFP, instead of in the notes. The Staff believes that separate presentation would increase the transparency of an entity's financial statements, since separation of the performance obligation and the obligation to pay an amount in the SoFP would enhance a user's ability to assess the amount, timing, and uncertainty of the entity's future cash flows. Similar treatment for the liability is consistent with separate presentation of the components in the Statement of Comprehensive Income (SoCI). Both Boards unanimously approved this recommendation.

The combined third and fourth recommendations were:

- a) to present in the SoFP the unconditional right to receive a premium as a receivable separately from the insurance asset or liability; and
- b) the conditional right to receive a premium under the premium allocation approach should be deducted from the liability for unexpired coverage presented in the SoFP.

The Boards unanimously agreed with both proposals for the building block approach but unanimously rejected the treatment of conditional premium under the premium allocation approach, preferring that under the premium allocation approach, all premium should be treated as an asset separate from the insurance contract's carrying amount. The Boards overruled the Staff on the grounds that this would be a departure from the existing practice to account for the unearned premium liability as if all premiums have been received at the inception of the policy irrespective of whether payment has been collected or a premium receivable is recognised instead. This practice appears to have support from many users and the Boards decided that the benefit of retaining a practice that has users' support is preferable to approving the Staff common principle across the premium allocation and the building blocks approaches.

It was noted that where there are significant conditional premium payments (e.g. for a short duration contract where premiums are paid by instalments and the policyholder has a right to cancel the policy and stop any future payments), both the asset and the unearned premium liability would be lower than they would be for the same policy with a premium paid in full upfront. The reduction of the asset and liability carrying amount reflects the potential cancellation of the policy.

The fifth recommendation was to present separately the liability (or asset) for insurance contracts measured using the building block approach from those measured using the premium allocation approach. The Staff recommendation was initially rejected by the IASB as it was perceived as being a vote favouring the two approaches being distinct accounting models, which the IASB had rejected at a previous meeting. After further discussion which clarified that there was no attempt to introduce a two or single accounting model principle with this decision it was approved by the IASB with a majority of 12 in favour and 2 against, while FASB unanimously approved it.

The sixth recommendation was not to allow aggregation of portfolios in an asset position with those in a liability position in the SoFP. This recommendation applies to both the premium allocation and the building block approach. However it is highly unlikely that it will apply to short duration contracts given the decision to present separately the rights to receive premiums for these contracts that the Boards reached earlier.

The proposal on the presentation of asset-portfolios was approved on the grounds that there will be a future debate on the presentation of acquisition costs given the interest expressed by a few IASB and FASB members to consider presentations of these costs alternative to the current decision to treat them as if they were part of the contract's cash flows and thus deducted from net present value of cash flows. These Boards' members noted that in certain cases a portfolio becomes an asset mainly because of the deduction of upfront acquisition costs from a small net present value of future cash flows. Indeed this is typical for regular premium contracts where most of the future inflows are part of the net present value. FASB unanimously approved this decision and 13 out of 15 IASB members reached the same conclusion.

### No progress on the income statement presentation requirements

At the same October meeting discussed above the Boards also attempted to reach converged decisions on the income statement presentation. The objective was to resolve the conundrum of keeping a margin based presentation that is also capable to produce volume information on the insurer's activity during the period. The attempts to evolve the past tentative decisions in a more complete set of requirements were not productive and the subject will be tabled again at a future meeting.



It is important to note that Stephen Cooper, a member of the IASB, put forward at this meeting a new proposal on this subject that in his view would produce a shorter income statement compared to that last approved (see issue 22 of this newsletter) and could facilitate the comparison of insurers' performance with that of reporting entities from other sectors.

The Boards were interested in exploring in detail this new proposal and this fact contributed to their decision to defer any conclusion on this important subject to a future meeting.

#### **Disclosure requirements**

At the joint meeting on 19 September, the Staff presented five recommendations on the disclosure principles proposed in the exposure draft.

The first recommendation was to delete the requirement that an insurer should not aggregate information if this is arising from different operating segments. The Staff explained that the general principle of aggregation and disaggregation to ensure that *"information that is useful is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics"* is sufficient to obtain the relevant disclosures. The overlap of the requirement to avoid aggregation of data reported in different operating segments could create an unnecessary conflict and the response letters had pointed out these internal conflicts. The Staff confirmed that this was the case and therefore proposed the removal. Both Boards approved unanimously the amendment to the exposure draft.

The combined second and third recommendations were to retain the requirement that an insurer should disclose changes to inputs used for the measurement of the insurance contract and, in addition to that, introduce a requirement to disclose the changes in methods used to calculate the insurance contracts amounts. In addition the insurer would need to disclose the full yield curve used to discount cash flows of non-participating contracts.

The addition of the requirement to disclose changes in methods recognises the need to inform investors on the qualitative characteristics of the models used. The addition of the yield curve disclosure for the discount rate ratified a decision already taken last March on the discount rate deliberations for non-participating contracts. All of these disclosures will be developed within the overriding materiality principle informing IFRS and US GAAP, and all of the recommendations received unanimous support from FASB, and 14 out of 15 in favour from the IASB.

The fourth recommendation was to delete the requirement that an insurer should disclose an analysis that measures the underlying uncertainty and to replace it with a cross-reference to the requirements set in IFRS 13 *Fair Value Measurement*. This is an area where the Boards decided to disagree and ended up in different positions. The IASB approved the proposal (14 in favour, 1 against) from the Staff. FASB instead rejected it, with 2 in favour (5 against) and decided not to adopt the same approach for US GAAP.

The requirements are very similar in both bodies of literature. What is in IFRS 13 is also found in ASC 275-10-50-6, which is the equivalent standard on fair value measurement under US GAAP. The types of disclosures that may be found in IFRS 13, which focus particularly on the "level 3" fair values, include quantitative disclosure on the nature and changes in the unobservable inputs and sensitivity of the "level 3" values to changes in the unobservable inputs that reflect reasonably possible alternative assumptions.

FASB was uncomfortable relying on the US GAAP equivalent of IFRS 13 and rejected the proposal on the grounds that the accounting standard on insurance should contain all the relevant requirements for the disclosure of the uncertainty surrounding a measurement basis that is clearly not on a fair value basis.

The fifth and final recommendation was to remove the optional disclosure on expected maturities leaving only a requirement to disclose a table based on expected maturities with a mandatory minimum five year prospective analysis. The requirement of a five years minimum table aligns this requirement to the leases disclosures current draft in an effort to improve consistency of disclosure across the different standards. The Staff also proposed removing the disclosure of the amount payable on demand for outstanding insurance liabilities which was part of the exposure draft.

FASB did not agree with this recommendation and expressed its preference for a recent decision it took on the same topic which defined financial institutions as a group of entities including insurers that would be required to disclose the liquidity table inclusive of asset information and with narrative commentary on the fungibility of liquidity across the group entities. Having reached that decision on 7 September, FASB was unanimous in rejecting the Staff's recommendation. The IASB was supportive with a majority of 14 in favour and 1 against.

### Disaggregation of explicit account balances

At their meeting on the 16 November, the IASB and FASB discussed the disaggregation of explicit account balances. This topic had previously been referred to as the unbundling of non-insurance components. The Staff highlighted its recommendation that an account balance was explicit if it was an accumulation of the monetary amount, credited with an explicit return. They also clarified that they would distinguish between unbundling and disaggregating non-insurance components. The disaggregation of an explicit account balance would be for presentation purposes only and the insurer would measure the cash flows of the explicit account balance together with all the other cash flows from the insurance contract under the building blocks approach. Subsequently to the completion of the measurement it would present any explicit account balance separately. The Staff asked five questions to the Boards on this subject:

1. Do the Boards agree that all explicit account balances should be presented separately from the insurance contract liability?
2. Do the Boards agree with the following criteria for identifying explicit account balances? A contract has an explicit account balance if both of the following conditions are present:
  - a) The balance is an accumulation of the monetary amount of transactions between the policyholder and the insurer.
  - b) The balance is credited with an explicit return.  
A return is explicit if it is determined by applying either of the following to the balance: (1) a contractual formula in which the insurer may have the ability to reset the return rate during the life of the contract or (2) an allocation determined directly by the performance of specified assets.
3. Do the Boards agree that all explicit account balances and the related assets should be recognised in an insurer's financial statements and that they should not be offset against each other?
4. Do the Boards agree that an insurer shall measure explicit account balances and services associated with the explicit account balances, if any, together with the other components of insurance contracts?
5. Do the Boards agree that explicit account balances should be presented separately from the insurance contracts liability on the face of the Statement of Financial Position (rather than the notes) to an amount equal to the sum of:
  - i. the explicit account balance; and
  - ii. an accrual for all fees and returns though the reporting date.

The FASB chair asked for a vote on the first question noting that they would need to assume that the Staff proposal would be a de minimis in terms of disaggregation of account balances and conceding that members may wish to expand it. Both Boards agreed, some said that other items would need to be considered and explored further. The Boards decided to avoid the second question because of the underlying issues around what should be included and how it should be measured and preferred to consider the other questions. The Staff reiterated that explicit account balances would not be unbundled with a separate measurement from the insurance component of the contract. Instead they would be measured together with the other components of an insurance contract's cash flows. However their disaggregation from the insurance contract carrying amount would result in a separate presentation from it on the face of the statement of financial position. Such an approach would not require the explicit account balances to be discounted. Following inconclusive discussions among Board members, the IASB Staff attempted to survey the Boards with some different questions. When asked if the Board members believe the whole contract should be measured using the building blocks (excluding embedded derivatives, etc. and other items already unbundled) 9 IASB members said they did with 6 members preferring unbundling to disaggregation. However the IASB members were unanimous that at least disaggregation would be needed in the final IFRS. Finally the same majority of 9 indicated that they would be comfortable to restrict the disaggregation requirements to explicit account balances only as defined in the Staff paper. The other members were prepared to go further in disaggregating deposit components. When asked similar questions, only two FASB members believed that the whole contract should be measured using the building blocks.

The IASB chairman declared that no tentative decisions could be recorded at the end of the session and asked the Staff to explore other approaches.

## Other decisions – Fixed fee service contracts scope exclusion

At their joint meeting held in March 2011, the Boards tentatively decided to exclude certain types of fixed fee contracts from the definition of an insurance contract (see issue 19 of this newsletter).

At the meeting held on 20 October, the Staff recommended that fixed-fee contracts that provide a service as their primary purpose should be excluded if they exhibit all of the following characteristics:

- the contracts are not priced on the basis of an assessment of the risk associated with an individual customer;
- the contracts compensate customers by providing a service, rather than cash payment; and
- the type of risk transferred by the contracts are primarily related to the use (or frequency) of service relative to the overall risk transferred.

The Staff assessed various contracts that provide a service for a fixed fee, and identified the features of those contracts that distinguished them from traditional insurance contracts. The focus for the analysis was on the rationale for the exclusion, on the difference in applying revenue recognition rather than the insurance premium allocation approach and on any implementation concerns.

The Staff's analysis confirmed that the results for fixed-fee contracts under both proposals are comparable and costs associated with applying the insurance guidance to these contracts impose an additional burden on preparers relative to the application of revenue recognition.

The Staff's recommendation was unanimously approved by both Boards, subject to redrafting certain language and inclusion of application guidance or examples.

### Deloitte view

In our comment letter we did not agree with the proposed amendment to the scope exclusions leaving out fixed fee service contracts. This scope exclusion is not well defined and it could result in less relevant information than if these contracts were in the scope of the final IFRS.

The Boards' decision appears to have addressed this issue.

## Timetable and next steps

As noted earlier, the target publication date of the final accounting standard for both Boards is now no longer expected to be before the 2012 calendar year-end.

It is our expectation that a re-exposure of the draft IFRS will take place together with the publication of the US GAAP exposure draft aligning the two timetables.

With publication of the final IFRS and US GAAP at some point in 2013, the pressure to move the effective date beyond 1 January 2015 will be significant. The same fate has been suffered by the financial instruments project with both impairment and macro-hedging target publication dates beyond 2012. The EU accounting body EFRAG has proposed in its draft response letter to change the effective date of IFRS 9 from 1 January 2015 to "a three year period from the later of the publication dates of IFRS 4 Phase II and IFRS 9".

The decision to carry out targeted improvements of IFRS 9 with the potential introduction of an "OCI solution" could defuse certain industry stances but it would absorb time at the Boards to have this unplanned activity completed in parallel with the deliberations on the few matters that have not been discussed as yet. Furthermore, the IASB announced via its webpage on the 8 December that it is seeking feedback on four specific areas (cash flows, discount rate, risk adjustment, disclosure) using working drafts of implementing decisions taken to date.

During the joint meeting planned for 15-16 December the Boards will have a fairly extensive session on insurance that will cover two of the remaining major issues except for the transitional provisions:

- definition of a portfolio; and
- unit of account for risk adjustment and residual margin and for the single margin.

Deloitte will report on the outcome of this joint meeting shortly after its completion via our IASPlus news service (<http://www.iasplus.com/agenda/insure2.htm>) followed by our post meeting Insurance Contracts Project Insight newsletter (<http://www.iasplus.com/insight/insurancecontracts.pdf>). Finally, James L. Kroeker, the US Securities and Exchange Commission (SEC) chief accountant, announced in a speech he gave at a AICPA National Conference on 5 December that the SEC Staff final report on the incorporation of IFRS for US issuers will be delayed by a "few additional months". This document was expected to clarify the direction and pace of IFRS adoption within the US with an obvious influence on the tone of the convergence activities that the Boards have undertaken for the last couple of years and that is being extensively reopened and re-exposed.

We will observe the developments that this SEC delay may have on the specific insurance contracts deliberations. A number of commentators speculated that the slow pace of the joint deliberation activity in the second half of the year was also influenced by the need to wait for a clarification from the US Government as to whether and how it would deliver on its commitments to the G20 group to support Global GAAP.

The influence on the insurance joint work would depend in particular on whether this commitment would be fulfilled by a US acceptance of a form of IFRS adoption within the US or by demanding the achievement of convergence between IFRS and US GAAP prior to endorsement of IFRS in the US capital market regulations.

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