

Accounting for non-life premium
remains undecided
IFRS 4 Phase II Update

IASB and FASB joint meetings – January 2012
Francesco Nagari
1 February 2012



Agenda

- Highlights of decisions from latest joint meetings
- Detailed analysis of Staff recommendations and FASB and IASB discussion for the educational session held on 18th and 25th January respectively
- Update on the timetable and next steps

Highlights – 18th and 25th January 2012

Trustee meeting on 12th January

- Hans Hoogervorst publicly acknowledged to the difficulties experienced in achieving convergence on the insurance project

No decisions reached on the criteria to account for non-life premium (the Premium Allocation Approach – PAA)

- The original plan to reach a joint decision this month was changed at the last minute
- Joint discussion was cancelled
- The Boards held separate education sessions on 18th and 25th January
- This delicate matter will be brought back to a joint meeting in February

Financial instruments – classification and measurement

- At their joint meeting on Friday 27th January the Boards decided to work together on a common solution to classification and measurement of financial instruments
- This solution will include a fair value through OCI category for debt securities that would take into account the interaction with IFRS 4 Phase II
- A joint press release was published to mark the importance of this decision

Details of IFRS Trustees meeting – 12th January

IASB Chairman Report

Selected quotes from the report:

“We have also had difficulties reaching converged solutions with the FASB on financial instruments and insurance.”

“Delays in completing these much needed improvements to financial reporting for those using IFRSs and US GAAP are unfortunate, but they should not be seen as a failure. They reflect the IASB being cautious, responsive and responsible.”

The Chairman also made additional observations:

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

Details of FASB and IASB meeting – 18th and 25th January

Paper 2A (IASB) / 78A (FASB) – PAA eligibility

- The Staff presented a progress report on the whole project and two papers on the very sensitive topic of the premium allocation approach (PAA).
- After the release of the papers the sessions were demoted to educational sessions.
 1. Agenda paper 2/78: Progress report;
 2. Agenda paper 2A/78B: Eligibility criteria for the PAA; and
 3. Agenda paper 2B/78B: Mechanics of the PAA
- This was the fourth time that premium allocation has been discussed
- Additionally, the papers did not cover the following issues relating to the PAA which will be the subject of future papers:
 1. Whether insurers should be permitted, rather than required, to apply the PAA to contracts that meet the eligibility criteria.
 2. Whether a practical expedient should be introduced to permit (or require) the use of the PAA for contracts with a coverage period of one year or less.

Details of FASB and IASB meeting – 18th and 25th January

Paper 2A (IASB) / 78A (FASB) – PAA eligibility

Eligibility criteria for the premium allocation approach

- The eligibility criteria were last discussed at the October 2011 joint meeting. Taking on feedback from this meeting, the staff proposed two principles based eligibility criteria.
- Additionally, the staff acknowledged that application guidance will need to be developed.

Staff recommendations

If either of the following two criteria apply, insurers should use the Building Block Approach (BBA) rather than the PAA:

- a. Expected cash flows criterion – It is likely that, during the period before a claim, there will be significant changes in expected net cash flows that would not be captured by the onerous contract test.
- b. Allocation of premium criterion – Significant judgement is required to determine the amount of premium to be recognised in each reporting period, for example where there is significant uncertainty about the length of the coverage period.

Details of FASB and IASB meeting – 18th and 25th January

Paper 2A (IASB) / 78A (FASB) – PAA eligibility

FASB discussion

- Members were not convinced the Staff decision to include the onerous contract test in the first criterion is useful
- The Staff explained that the test is to capture situations where the expected cash outflows could significantly decline after initial recognition. This is a positive outcome that the onerous contract test would not capture for measurement
- The Staff explanation that the first criterion would depend on the unit of account was also criticised because the distinction between cash flow estimates at individual contract or portfolio level is not seen as producing different results
- The staff also explained that the second criterion is in relation to the allocation of premium in the reporting period
- Some FASB members noted that this would make the second criterion a less effective selection device given that nearly all contracts would pass that test for short reporting periods (e.g. a quarter or six months)
- The discussion highlighted some FASB members' continue to have a strong preference for the two-model approach

Details of FASB and IASB meeting – 18th and 25th January

Paper 2A (IASB) / 78A (FASB) – PAA eligibility

IASB discussion

- As in previous meetings, there was some discussion around whether the PAA should be considered as a proxy for the BBA or a distinct model.
- Board members appeared to agree that the PAA should be a proxy. However, some had concerns that the proposed criteria might lead to a two model approach.
- There was also general agreement that PAA is likely to apply primarily to contracts with a coverage period up to 12 months and that it would be useful to include reference to 12 months in the criteria
- A suggestion was made that the staff recommendations be updated to state that PAA can be used as proxy to the BBA.
- The criteria proposed could then be included as application guidance, and should also be updated to include explicit reference to contracts with a duration of less than 12 months.

Details of FASB and IASB meeting – 18th and 25th January

Paper 2B (IASB) / 78B (FASB) – PAA mechanics

Mechanics of the premium allocation approach

Staff proposals – discounting and accretion

The staff proposed two alternatives relating to discounting and interest accretion to be discussed:

- A. The liability for remaining coverage should not be discounted and interest should not be accreted on the liability.
- B. Discounting and interest accretion should be required for contracts that have a significant financing component and as a practical expedient, insurers need not apply it if the coverage period of the contracts is less than one year.

Discussion

- The IASB generally appeared to favour the second option. This option is intended to be in line with revenue recognition which appears to be favoured.
- The outcome of the FASB education session resulted in split views as to which option to select for the final accounting standard

Details of FASB and IASB meeting – 18th and 25th January

Paper 2B (IASB) / 78B (FASB) – PAA mechanics

Mechanics of the premium allocation approach

Staff proposals – acquisition costs

The staff raised two issues relating to acquisition costs:

1. Should the measurement of acquisition costs be in line with BBA (a) or in line with revenue recognition (b)?
 - a) Acquisition costs include directly attributable costs (FASB success based) and insurers permitted to expense directly attributable costs that are not incremental.
 - b) Acquisition costs include only incremental costs and insurers permitted to expense all acquisition costs if the coverage period is one year or less.
2. In line with the revenue recognition project, acquisition costs should be recognised as an asset (with the liability being gross of acquisition costs) and should be amortised in line with the reduction of the liability for remaining coverage.

Details of FASB and IASB meeting – 18th and 25th January

Paper 2B (IASB) / 78B (FASB) – PAA mechanics

FASB discussion – acquisition costs

- Some FASB members would favour consistency with BBA and the revenue standard which would suggest addressing the three situations together
- Others noted that if the PAA is a separate model then it could be aligned to the revenue approach without amending the BBA treatment
- Some noted that the permission to expense some acquisition costs and to capitalise others would produce inconsistent results and it should not be included in the final accounting standard

IASB discussion – acquisition costs

- The IASB generally appears to favour consistency with the BBA treatment
- There was some discussion around whether “incremental” would be at a portfolio or contract level.
- Several IASB members felt that DAC should not be an asset, as it has nothing to do with cash flows, but it was suggested that it could be considered instead as a component of the contract

Next steps and timetable

- Next joint meeting on insurance expected on 27-29 February
- Subject to further amendments, “short duration contracts – eligibility criteria and mechanics” will return to the table in February
- Topics that remain to be deliberated:
 - Investment contracts with participating features
 - Unbundling/disaggregation of deposit components
 - Unlocking of residual margin / subsequent measurement of single margin
 - Use of OCI / financial instruments accounting
 - Presentation of premiums in the income statement
- Commitment to issue by June 2012 the next due process document for both IASB and FASB
- Final accounting standard in 2013
- Next IWG meeting – Likely date late March 2012

Contact details

Francesco Nagari

Deloitte Global IFRS Insurance Leader

+44 20 7303 8375

fnagari@deloitte.co.uk

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<http://www.iasplus.com/agenda/insure2.htm>

Insurance Centre of Excellence:

insurancecentreofexc@deloitte.co.uk





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