Coming to an end of joint decisions before re-exposure
IFRS 4 Phase II Update

IASB/FASB meetings – January 2013

Francesco Nagari
Deloitte Global IFRS Insurance Lead Partner

6 February 2013

Agenda

- Highlights of decisions from the January 2013 joint and IASB-only meetings
- Detailed analysis of the Staff recommendations and Board discussions
- Update on timetable and next steps

Highlights

IASB Education Session – 29 January

- Presentation to the Board of the Staff's Papers that would be discussed in the joint IASB-FASB session and IASB only session during the following days

Joint IASB/FASB decisions – 30 January

- Presentation of insurance contract revenue when there are changes in the pattern of expected claims
- Determination of the basis for the presentation of insurance contract revenue after transition for contracts in force at transition date

IASB only decisions – 31 January

- Sweep issues

IASB Education Session

Staff Presentation

- The Staff presented and explained its recommendations to the Board members as analysed in the following papers:

Paper 2A/96A – Change in Expected Pattern of Claims

Paper 2B/96B – Transition Proposals for presentation of revenue in subsequent periods

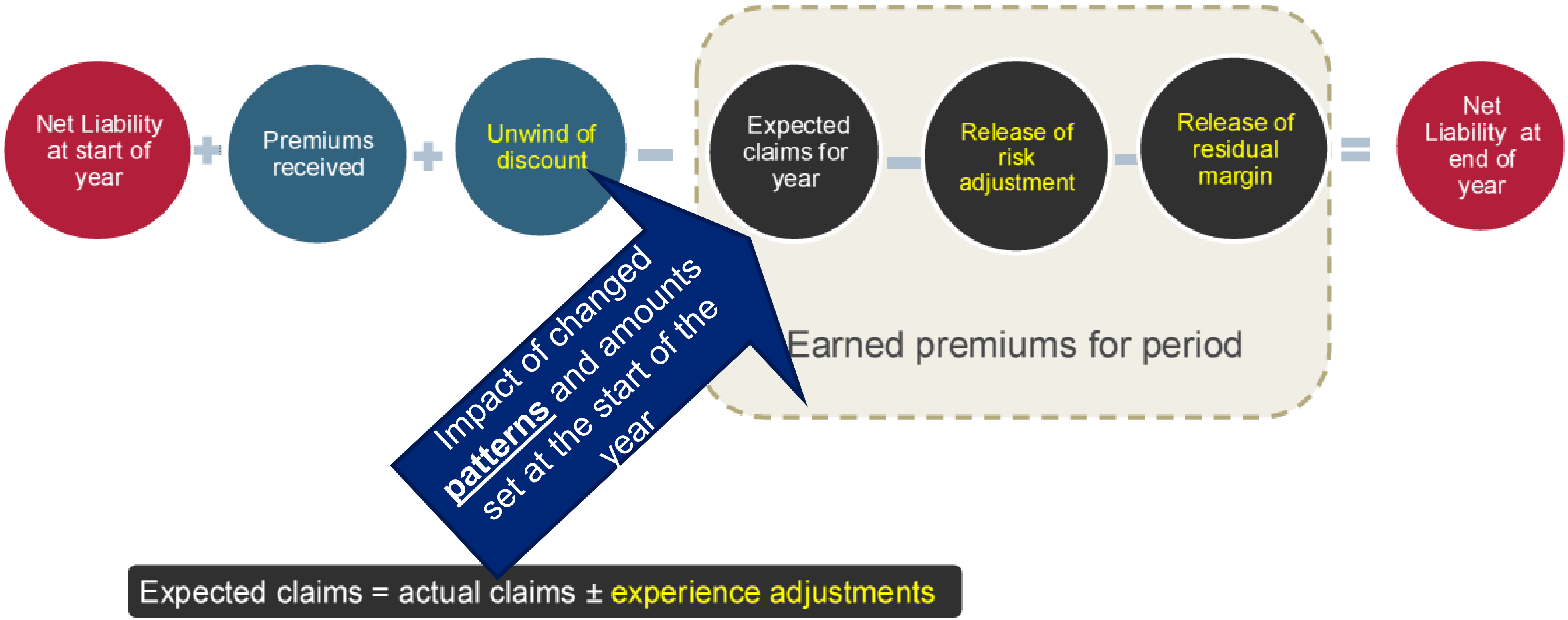
Paper 2C – Sweep Issues

Allocation of insurance contract revenue when there is a change in pattern of expected claims (Paper 2A/96A)

Background

- This paper considers how insurers applying the building block approach should allocate insurance contract revenue, for mere presentation purposes, between periods if there is a change in the estimates of the **pattern** of expected claims (not the amount)
- This paper only relates to the presentation of the insurance contracts revenues that the Boards have decided to require based on the earned premium method.
- 2 possible approaches were explored by the Staff. These approaches considered whether insurance contract revenue should be:
  a) fixed at initial recognition, i.e. remaining revenue should be allocated on the basis of the initial estimates of the pattern of expected claims, or
  b) updated if and when estimates change, i.e. remaining revenue should be re-allocated prospectively to reflect the latest estimates of the pattern of expected claims
- The Staff favoured the latter as the most effective method for recognising revenue for types of contracts to which the BBA applies (typically life insurance type-contracts) and recommended it to the Boards.

Earned premiums – derived from measurement model



Expanding net profit and loss to show claims/benefits incurred

a) Expected amounts/pattern at inception; or
b) Updated estimates from last period

Change in risk adjustment
+ Release of residual margin
± Claims/benefits expected

= Earned premium
± Claims/benefits incurred

= Net profit or loss
(underwriting result)

Difference equals: ± Experience adjustments

Expand into:
+ Earned premium
- Claims/benefits incurred

Earned premium:
- Consistent with concept of revenue
- Consistent with measurement model for insurance contracts

Allocation of insurance contract revenue when there is a change in pattern of expected claims (Paper 2A/96A) (Cont.)

Staff recommendation

- Do you agree that, if there is a change in the expected *pattern* of future claims, the remaining insurance contract revenue should be re-allocated prospectively to reflect the latest estimates of that pattern?

Discussion

- Concerns were raised that this is open window to manipulate revenue by revising future estimates (expected pattern of future claims)
- Concerns around the consistency with the revenue recognition principles and suggested that if the Boards go ahead with supporting this method, then a sound justification of this method even from a theoretical basis would be required in the Exposure Draft's text.
- No other issues were raised

Allocation of insurance contract revenue when there is a change in pattern of expected claims (Paper 2A/96A) (Cont.)

Discussion

- The Boards generally agreed that
  1) the analogy of progress towards complete satisfaction of the contract obligations would be reasonable and consistent with revenue recognition principles
  2) the most recent estimates of the pattern of expected claims provide a more relevant measure of progress than the original estimates
  3) prospective (and current) re-allocation of remaining revenue is consistent with other aspects of the building block model.

Decision	IASB vote	FASB vote
Approve Staff recommendation	Majority (13 vs. 2)	Unanimous

Determining the residual/single margin at transition (Paper 2B/96B)

Background

- On transition, insurers should determine the part of the liability for remaining coverage that is used to determine the amount of the revenue to be recognised in the statement of comprehensive income after transition.
- However, because of the previous tentative decisions reached by the IASB and FASB, the staff reached different recommendations.

IASB Staff recommendation

a) In determining the residual margin through retrospective application of the new standard, an insurer shall assume the risk adjustment at inception equals the risk adjustment on transition; and consequently that

b) when retrospective application is impracticable, an insurer shall estimate the residual margin maximising the use of objective data (i.e. that an insurer should not calibrate the residual margin to the insurance liability measured using previous GAAP)

Determining the residual/single margin at transition (Cont.) (Paper 2B/96B)

Discussion

- One IASB member argued that the first part of Staff recommendation as described in paragraph (a) would overstate the residual margin on transition and proposed to search for other possible methods that would not lead to an overstatement to the residual margin at the transition date
- Board members acknowledged that in any approach or method explored, a degree of subjectivity would inevitably be introduced and thus agreed to accept the Staff recommendations.

Decision	IASB Vote
Approve Staff recommendation : paragraph (a)	Majority (1 against)
Approve Staff recommendation : paragraph (b)	Unanimous

Determining the residual/single margin at transition (Cont.) (Paper 2B/96B)

FASB Staff recommendation

- For the contracts in-force at transition, the amount of the revenue to be recognised after transition should be determined as follows:
  1. For restated contracts the insurance contract revenue remaining to be earned at the date of transition should be determined retrospectively utilising the assumptions applied in the retrospective determination of the single margin.

Determining the residual/single margin at transition (Cont.) (Paper 2B/96B)

FASB Staff recommendation

2. For contracts for which retrospective application is impracticable:

   a) The liability for remaining coverage for these contracts at the date of transition shall be <u>presumed not to consist of any losses on initial recognition or changes in estimate of future cash flows recognised in profit or loss after the inception of the contracts</u>.

   b) The remaining insurance contract revenue to be earned shall be <u>limited to the total expected cumulative consideration</u> for in-force policies in the portfolio (plus interest accretion and less investment component receipts) ➡ **future premiums cap**

   c) The remaining insurance contract revenue shall be allocated to periods subsequent to the date of transition in proportion to the value of coverage (and any other services) that the insurer has provided for the period (i.e. <u>applying the pattern of expected claims and expenses and release of margin</u>).

Determining the residual/single margin at transition (Cont.) (Paper 2B/96B)

Discussion

- There was relatively little debate and vote was taken.

Decision	FASB Vote
Approve Staff recommendation	Unanimous

Paper 2C – Sweep Issues (IASB)

Background

- In this Paper IASB Staff considered sweep issues that were raised by respondents to the ED or are unintended consequences identified as a result of the IASB’s tentative decisions.
- The staff proposed to discuss 16 sweep issues with the IASB on an exceptions basis only
- The table in the slides that follow lists all of the sweep issues approved by the IASB

Discussion

- The IASB was satisfied to agree most of the sweep issues as recommended by the staff.
- Sweep issues 13-15 relating to the restatement of past business combinations at transition date attracted a significant amount of debate

Paper 2C – Sweep Issues (IASB) (Cont.)

Restatement of business combination prior to transition date

- Alternative 1 would require accounting for those contracts applying the business combination guidance in the revised IFRS 4 at the date of the business combinations To apply this alternative the insurer would need to:
    a) Determine the fair value of the insurance contracts at the business combination date and book the difference between the fair value and fulfillment cash flows at that as the residual margin or goodwill, and
    b) Establish a locked in discount rate at that date.

- Alternative 2 (recommended by Staff) the insurer shall account for all in-force contracts in the same way, irrespective of the form of the origination of the contract based on the general transition requirements and ignoring business combination dates:
    a) Establish the margin through modified retrospective application as for other contracts, and
    b) Establish the locked in discount rate at inception of the contracts

Paper 2C – Sweep Issues (IASB) (Cont.)

Discussion

- A lively debate ensued in which the majority of the IASB members were not convinced with the Staff recommendation
- A number of issues emerged around the consistency of the Staff recommendation with business combination accounting and the new accounting standard on insurance contracts.
- No vote was taken on these matters and these issues will be brought back in a future session.

Paper 2C Sweep issues (Cont.)

Topic Area	Staff Recommendation	Paper 2C paragraph
1. Policyholder accounting	Do not address policyholder accounting (except for cedants) in this project.	3-5
2. Grandfathering of the definition of an insurance contract	Do not create explicit guidance.	6-11
3. Takaful	Do not create explicit guidance.	12-22
4. Recognition point for deferred annuity contracts	Revise the recognition point to clarify that the recognition point for deferred annuities is the earlier of the start of the coverage period or the date on which the first premium becomes due. In the absence of a contractual due date, the premium is deemed to be due when received.	23-34
5. Income taxes included in fulfilment cash flows	Clarify that cash flows relating to tax payments should be evaluated and treated like any other cash flows.	35-42

Paper 2C-Sweep Issues (Cont.)

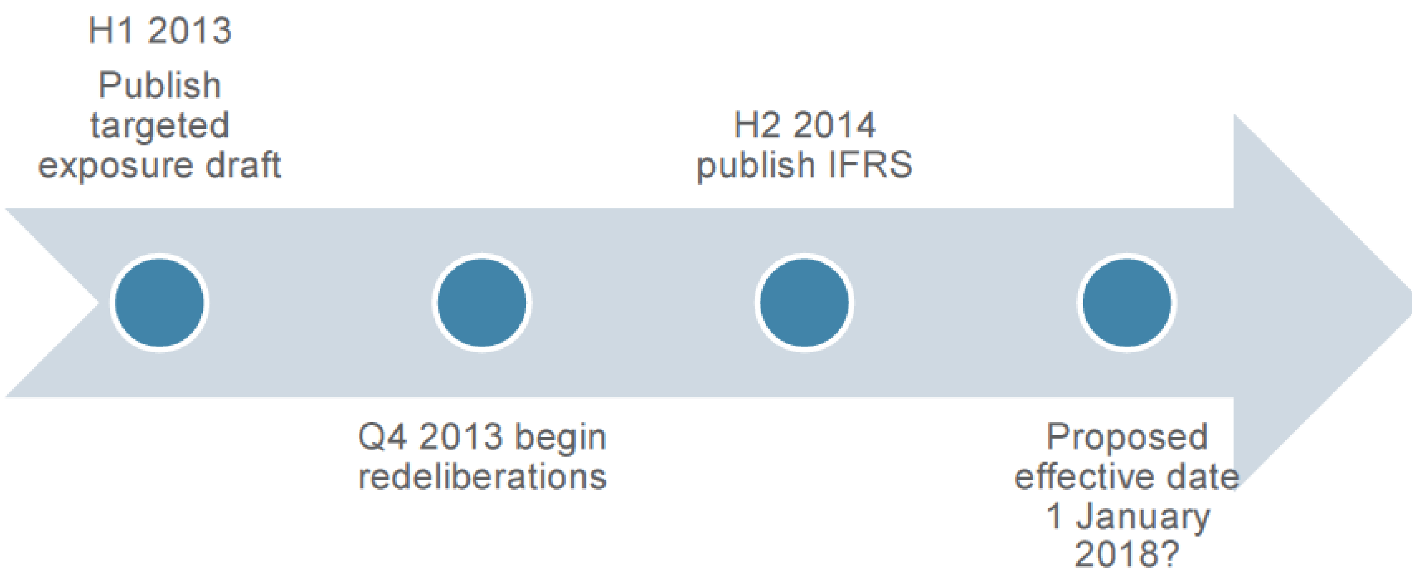
Topic Area	Staff Recommendation	Paper 2C paragraph
6. Discounting of deferred taxes	Do not address discounting of deferred taxes in this project.	43-45
7. Tacit renewals	Do not create explicit guidance.	46-47
8. Cash bonus	Do not create explicit guidance.	48-52
9. Reinsurance contracts held by cedant— unfavourable changes that adjust the positive residual margin	Do not impose a limit on unfavourable adjustments against the positive residual margin.	53-59
10. Treatment of ceding commission in cedant's financial statement	Confirm the ED proposal that an insurer should treat ceding commissions as a reduction of premiums ceded to reinsurer.	60-64

Paper 2C-Sweep Issues (Cont.)

Topic Area	Staff Recommendation	Paper 2C paragraph
11. Alignment of the allocation pattern for the premium in the premium allocation approach with the residual margin in the building block approach	Align the requirements to reduce the liability for remaining coverage to the requirements for releasing the residual margin in the building block approach.	65-70
12. Disclosure of maturity analysis for contracts accounted for using the premium allocation approach	The insurer shall be relieved from providing disclosure about maturity analysis of cash flows for the liability for remaining coverage for contracts accounted for using the premium allocation approach.	71-73
16. Implementation guidance in IFRS 4	Do not carry forward the implementation guidance that currently accompanies IFRS 4 to the new standard.	90-92

Next steps and timetable

- Next IASB meeting expected to be held in the week commencing 18 February
- Outstanding sweep issues not voted upon will be addressed
- IASB will continue its field testing preparation during this month
- The Staff progress report published in late December on the status of the project presents the following timetable:



Contact details

Francesco Nagari

Deloitte Global IFRS Insurance Lead Partner

+44 20 7303 8375

fnagari@deloitte.co.uk

LinkedIn

@Nagarif

Deloitte Insights into IFRS Insurance (i2ii)

www.deloitte.com/i2ii

Insurance Centre of Excellence:
insurancecentreofexc@deloitte.co.uk